Advanced Financial Accounting (Fin611)

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LESSON # 1

ACCOUNTING FOR INCOMPLETE RECORDS

1. Introduction

This topic is also known as *Single Entry System of Accounting*. In this chapter we will learn how an accountant prepares financial statements of those organizations which are not keeping up proper double entry book keeping system of accounting.

From accounting system stand point, business organizations can be classified into three broad categories:

1.1 Small scale business entities

These consist of very small sized business entities like; barber shop, mutton shop, washer man, general store, electrician etc. etc.

1.2 Medium scale business entities

These consist of medium sized business entities like; drycleaner, motor car dealers, house building contractors, schools etc. etc.

1.3 Large scale business entities

These consist of large sized business entities like; importers/exporters, motor car manufactures, transporters etc. etc.

Here it must be made clear that large scale business entities have these much resources with them that these can easily afford a systematic accounts department where they will be following the double entry book keeping system. Moreover, most of these concerns are incorporated bodies and these have to maintain systematic accounting records in order to fulfill requirements of the Companies Ordinance 1984 and International Financial Reporting Standards (IFRS).

2. Accounting for Small scale business entities

Small scale business entities are often single owner organizations (Sole proprietorship). These are very small in size and cannot afford an accounts department in their organizations. They have a very little setup in which a sole trader is acting so many rolls; he/she is the sales manager, and also the purchase manager, also responsible for marketing and accounts matters as well.

A sole proprietor is also concerned about financial performance (profitability) and financial position of the organization, which can make him/her able to take certain future decisions. Certain government agencies, like taxation department, also required to know about the require knowing profits of the organization.

But as the sizes of the organizations are very small and these can hardly afford an accountant therefore a very simple accounting system is proposed for such organizations.

2.1 Accounting Records

These organizations do not have to keep any complex accounting records, these are directed by their accounts consultants (Qualified Accountants) to keep certain information relating to cash receipts (introduction of fresh capital) and payments (drawings) and also relating to the period end balances of assets and liabilities. As size of the transactions are very small therefore one can remember very easily what are the year end balances of loan taken or was there any addition or disposal of assets during the year. Finally the consultants prepare a statement of profit or loss for the period and also a balance sheet as on the closing date of such period.

2.2 *Statement of Profit or Loss*

As you have studied in your earlier courses that profit is an out come of the "Income Statement" that is prepared in a systematic way with the help of a trial balance extracted from the ledger. But over here in the absence of a trial balance, we are not able to prepare an Income Statement. Here we will see that where that profit goes within the financial statements, we finally find that the profit is added up in the Owner's Equity, which appears like this:

	Rs.
Owner's Equity (opening balance)	***
Add:	
Fresh capital (introduced during the year)	***
Net profit (for the year)	***
Less:	
Drawings (during the year)	(**)
Owner's Equity (closing balance)	***

For small scale business entities, which are not preparing proper books of accounts and cannot extract a trial balance, the technique to calculate Net Profit will be to come other way round.

To calculate Net Profit figure from the above equation one must know all other information that has to be put into it. Now the above equation will be reversed and Net Profit figure will be its out come and this equation is then named as the "Statement of Profit or Loss".

Name of the Organization
Statement of Profit or Loss
For the year ended December 31, 20x7

	Rs.
Owner's Equity (closing balance)	***
Add	
Drawings (during the year)	***
Less	
Owner's Equity (opening balance)	(**)
Fresh Capital (introduced during the year)	(**)
Net profit (for the year) [balancing figure]	***

2.3 *Statement of Affairs*

From examination stand point, Drawings and Fresh capital will be given in the questions but often the students will be required to calculate the opening and closing balances of Owner's Equity as these will not be given in the question as a single amount.

If you have not yet forgotten the basic accounting equation then Statement of Affairs is very simple to understand. What you learned in the basic accounting equation was that:

ASSETS = OWNER'S EQUITY + LIABILITIES

So to calculate the balance of owner's equity the equation will be reversed like:

OWNER'S EQUITY = ASSETS + LIABILITIES

Name of the Organization
Statement of Affairs
As on Opening and Closing Date

	Opening Rs.	**Closing Rs.**
ASSETS		
Furniture and fixture (net of depreciations)	***	***
Stocks	***	***
Debtors (net of provisions)	***	***
Prepaid expenses	***	***
Bank	***	***
Cash	***	***
LIABILITIES		
Loan	(**)	(**)
Creditors	(**)	(**)
Accrued expenses	(**)	(**)
OWNER'S EQUITY (Net Assets)	***	***

The balance of Owner's Equity can also be termed as Net Assets as it is the balance of assets after subtracting all liabilities.

2.4 *Difference between Balance Sheet and Statement of Affairs*

The only difference is that in Balance Sheet we put *RESOURCES* (Assets) against the *SOURCES* (Owner's equity and Liabilities). By doing this we come to know the financial position of the organization, whereas in Statement of Affairs we simply calculate the balance of owner's equity at opening/closing dates of the accounting period by subtracting liabilities for the asset. Balance sheet equation provides help in calculating the balance of owner's equity and that's all.

Solved Questions

1 From the following information prepare statement of profit or loss for the year.

	Rs.(000)
Opening balance of capital	100
Closing balance of capital	150
Drawings	40
Fresh capital introduced during the year	25

Solution:

Statement of profit & loss:

	(Rs.)
Closing capital	150
+ Drawings	40
- Fresh Capital	(25)
- Opening Capital	(100)
Net profit	=65/-

Solved Questions

2 Bilal Anwar started in business on 1 January 2005 with Rs. 10,000 in a bank account. Unfortunately he did not keep proper books of account. He is forced to submit a calculation of profit for the year ended 31 December 2005 he had stock valued at cost Rs. 3,950, a van which had cost Rs. 2,800 during the year and which had depreciated by Rs. 550, debtors of Rs. 4,970, expenses prepaid of Rs. 170, bank balance Rs. 2,564, cash balance Rs. 55, trade creditors Rs. 1,030, and expenses owing Rs. 470. His drawings were: cash Rs. 100 per week for 50 weeks, Cheque payments Rs. 673. Draw up statements to show the profit or loss for the year.

Solution:

Bilal Anwar
Statement of affairs
As on December 31, 2005

Assets		**Amount Rs.**	**Liabilities**	**Amount Rs.**
Stock		3,950	Trade Creditor	1030
Van	2,800		Expense Owing	470
	- 550	2,250		
Debtors		4,970	Closing Capital (Balancing Figure)	12,459
Prepaid expense		170		
Bank		2,564		
Cash		55		
Total		13,959	Total	13,959

Bilal Anwar
Statement of profit & loss:
For the year ended on 31st December, 2005

	(Rs.)
Closing capital	12,459
+ Drawing (100*50+673)	5,673
- Opening Stock	10,000
Net profit	8,132/-

Solved Questions

3 Jehan Zeb is a dealer who has not kept proper books of account. At 31 August 2006 his state of affairs was as follows:

Particulars	Rs.
Cash	115
Bank Balance	2,209
Fixtures	4,000
Stock	16,740
Debtors	11,890
Creditors	9,052
Van (at valuation)	3,000

During the year to 31 August 2007 his drawings amounted to Rs. 7,560. Winnings from a football pool Rs. 2,800 were put into the business. Extra fixtures were bought for Rs. 2,000. At 31 July 2007 his assets and liabilities were: Cash Rs. 84; Bank overdraft Rs. 165; stock Rs. 21,491; Creditors for goods Rs. 6,002; Creditors for expenses Rs. 236; Fixtures to be depreciated Rs. 600; Van to valued at Rs. 2,500; Debtors Rs. 15,821; prepaid expenses Rs. 72 Draw up a statement showing the profit and loss made by Jehan Zeb for the year ended 31 August 2007.

Solution:

Jehan Zeb
Statement of affairs
As on August 31, 2006

Assets	Amount Rs.	Liabilities	Amount Rs.
Bank Balance	2,209	Creditors	9,052
Fixture	4,000		
Stock	16,740	Closing Capital	28,902
Debtors	11,890		
Van (at valuation)	3,000		
Total	37,954	Total	37,954

Jehan Zeb
Statement of affairs
As on August 31, 2007

Assets	**Amount Rs.**	**Liabilities**	**Amount Rs.**
Cash	84	Creditors for goods	6,002
Bank overdraft	(165)	Creditors for expenses	236
Stock	21,491		
Fixtures (4,000+2,000-600)	5,400	Closing capital	38,965
Van	2,500		
Debtors	15,821		
Prepaid Expense	72		
Total	45,203	Total	45,203

Jehan Zeb
Statement of profit & loss:
For the year ended on 31st August, 2007

	(Rs.)
Closing Capital	38,965
+ Drawing	7,560
- Fresh capital	2,800
- Opening capital	28,902
Net profit	=14,823/-

LESSON # 2

PRACTICING ACCOUNTING FOR INCOMPLETE RECORDS

Following question illustrates how adjustments are incorporated in the closing statement of affairs and what is the difference in a Balance Sheet and a Statement of Affairs.

By solving this question students will learn that the Statement of Profit or loss consists of four items i.e., opening balance of owners' equity, closing balance of owners' equity, fresh capital and drawings. The result after adjusting these items accordingly will be Net profit for the year. Remember one thing the adjustments like depreciations, provision for doubtful debts, accruals etc are not accounted for in the statement of profit or loss.

Solved Questions

Ali and Bilal are partners in a firm sharing profits and losses in the proportion of 3:2. They keep their books on the single entry system. On 31 December, 2006, the following Statement of Affairs was extracted from their books:

Liabilities	Rs.	Assets	Rs.
Capital Accounts		Plant & Machinery	30,000
Ali	25,000	Stock	20,000
Bilal	20,000	Sundry Debtors	35,000
Loan- Bilal	25,000	Cash at Bank	15,000
Sundry Creditors	30,000		
	1,00,000		1,00,000

On 31st December, 2007, their assets and liabilities were: Sundry Debtors Rs 40,000; Sundry Creditors Rs 25,000 Plant & Machinery Rs 50,000; Stock Rs 30,000; Bills Receivable Rs 5,000; Cash at Bank Rs 25,000; Loan- Bilal Rs 25,000.

You are required to prepare a Profit and Loss Statement for the year ended 31st December, 2007 and a Statement of Affairs as at that date after taking into consideration the following:

a) Plant and machinery is to be depreciated by 10% p.a.
b) Stock is to be reduced to Rs 25,000.
c) A provision for bad debts to be raised at 5% on Sundry Debtors
d) Interest on loan is to be allowed at 6% p.a.
e) During the period Ali and Bilal draw Rs 5,000 and Rs 3,000 respectively.

Solution

Statement of Affairs
Ascertainment of Combined Closing Capital as on December 31, 2007

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
Loan- Bilal	25,000		Plant & Machinery	50,000	
Add: Outstanding Interest	1,500	26,500	Less: Depreciation	5,000	45,000
			Stock		25,000
			Sundry Debtors	40,000	
Creditors		25,000	Less: Provision for	2,000	
			Doubtful debts		38,000
			Bills Receivable		5,000
Combined Capital		86,500	Cash at bank		25,000
(balancing figure)					
		1,38,000			**1,38,000**

Ali & Bilal
Statement of Profit and Loss for the year ended 31.12.2007

	Rs.	Rs.
Combined closing Capital (as above)		86,500
Add: Combined Drawings during the year (Rs 5,000+Rs 3,000)		8,000
		94,500
Less: Combined Opening Capital (Rs 25,000 + Rs 20,000)		45,000
Profit before adjustments		
		49,500
Divisible profit:		
Ali-3/5th of Rs. 49,500	29,700	
Bilal 2/5th of Rs. 49,500	19,800	**49,500**

Ali & Bilal
Balance Sheet as at 31.12.2007

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
Capital–Ali			Plant & Machinery	50,000	
Opening balance	25,000		Less: Depreciation	5,000	45,000
Add: Profit	29,700		**Stock**		25,000
	54,700		Sundry Debtors	40,000	
Less: Drawings	5,000	49,700	Less: Provision for	2,000	
Capital- Bilal			Doubtful debts		38,000
Opening Balance	20,000		Bills Receivable		5,000
Add: Profit	19,800		Cash at bank		25,000
	39,800				
Less: Drawing	3,000	36,800			

Loan- Bilal Outstanding Interest Sundry Creditors		25,000 1,500 25,000			
		1,38,000			**1,38,000**

Following question illustrates how changes in the balances of assets and liabilities affect the in crease or decrease in the balances of owner's equity.
Important tips:

- Increase in the balance of asset will cause an increase in the owner's equity
- Increase in the balance of liabilities will cause a decrease in the owner's equity
- Decrease in the balance of asset will cause a decrease in the owner's equity
- Decrease in the balance of liabilities will cause an increase in the owner's equity
- Increase in balance means that closing balance is greater than the opening balance and vice versa.

Solved Questions

Calculate net profit for the year ending on December 31, 2007 from the information regarding changes occurred at the end of the year in following balances:

	Rupees
Increase in Machinery	14,000
Increase in Stocks	6,000
Decrease in Debtors	2,000
Decrease in Cash	1,000
Increase in Creditors	1,500
Decrease in Accrued expenses	300
Drawings during the year 2007	10,000
Fresh capital introduced during the year 2007	4,000

Solution

Working:	Rupees
Increase/decrease in owner's equity (net assets)	
Increase in Machinery	14,000
Increase in Stocks	6,000
Decrease in Debtors	(2,000)
Decrease in Cash	(1,000)
Increase in Creditors	(1,500)
Decrease in Accrued expenses	300
	15,800

Statement of Profit or Loss
For the year ended December 31, 2007

	Rupees
Increase in owner's equity	15,800
Add Drawings	10,000
Less Fresh Capital	(4,000)
Net Profit	**21,800**

Solved Questions

A and B are carrying on business in partnership sharing profits and losses equally. They were unable to maintain full and complete records. From the following available information, compute the profits of the firm and prepare a Balance Sheet:

PARTICULARS	1.1.2007 (Rs)	31.12.2007 (Rs)
Land and Building (Cost)	50,000	50,000
Machinery (Cost)	60,000	75,000
Furniture (Cost)	20,000	25,000
Stock	12,000	30,000
Debtors	17,000	22,000
Bank	4,900	5,000
Cash	1,100	5,000
Prepaid Insurance Premium	5,000	-
Bills Receivable	-	8,000
Creditors	60,000	50,000
Bills Payable	10,000	-

At the beginning of the year, the capitals of the partners were equal. During the year, A brought in Rs. 15,000 and B has withdrawn Rs. 5,000. An insurance policy matured during the year for Rs. 10,000. A sum of Rs. 4,000 has become bad out of debtors. Provision has to be made for depreciation @ 10% on Land and Building, Machinery and Furniture.

Solution:

A & B Business
Statement of profit & loss
For the year ended on 31st Dec, 2007

Assets	Amount Rs.	Liabilities	Amount Rs.
Land & Building	50,000	Creditors	60,000
Machinery	60,000	Bills payables	10,000
Furniture	20,000		
Stock	12,000		
Debtors	17,000	Closing capital	100,000
Prepaid Insurance	5,000		
Bank	4,900		

Cash	1,100		
Total	170,000	Total	170,000

A & B Business
Balance Sheet
As on 31st Dec, 2007

Assets	Amount Rs.	Liabilities	Amount Rs.
Land & Building (50,000-5,000) Machinery (75,000-7,500) Furniture (25,000-2,500) Stock Debtors (22,000-4,000) Bills Receivable Bank Cash	45,000 67,500 22,500 30,000 18,000 8,000 5,000 5,000	Creditors Closing capital	50,000 151,000
Total	201,000	Total	201,000

A & B Business
Statement of profit & loss:
For the year ended on 31st Dec, 2007

	(Rs.)
Closing stock	151,000
+ Drawing	5,000
- Further capital	15,000
- Opening capital	100,000
Net profit	41,000/-

Solved Questions

From the following information calculate net profit for the year ending on December 31, 2007 by preparing statement of profit or loss:

	Rupees
Increase in Furniture	78,000
Decrease in Stocks	25,000
Decrease in Debtors	11,000
Increase in prepaid rent	2,000
Increase in Bank	7,000
Increase in Creditors	10,000
Decrease in Accrued expenses	3,000
Drawings during the year 2007	35,000
Fresh capital introduced during the year 2007	50,000

Solution:

Increase/decrease in owner's equity (net assets)

	(Rs.)
Increase in furniture	78,000
- Decrease in stocks	25,000
- Decrease in Debtors	11,000
+ Increase in prepaid rent	2,000
+ Increase in bank	7,000
- Increase in creditors	10,000
+ Decrease in accrued expenses	3,000
Change in capital	=44,000/-

Statement of profit & loss:
For the year ended on 31st Dec, 2007

	(Rs.)
Change in capital	44,000
+ Drawing	35,000
- Fresh Capital	50,000
Net profit	=29,000/-

CONVERSION OF SINGLE ENTRY IN DOUBLE ENTRY ACCOUNTING SYSTEM

Necessary documents required in conversion method:

a) Cash Book
b) Debtors (Accounts Receivables) Ledger
c) Creditors (Accounts Payables) Ledger
d) Statement of Affairs (Opening)
e) Year-end adjustments

LESSON # 3

CONVERSION OF SINGLE ENTRY IN DOUBLE ENTRY ACCOUNTING SYSTEM

1.1 Accounting Records

Accountants of these entities are directed to maintain following set of information, which although does not constitute a complete accounting system but can work:

a) Cash Book
   i. Cash Account
   ii. Bank Account
b) Debtors (Accounts Receivables) Ledger
c) Creditors (Accounts Payables) Ledger
d) Statement of Affairs (Opening)
e) Year-end adjustments
   i. Closing stock
   ii. Depreciation of fixed assets
   iii. Provision for doubtful debts
   iv. Accruals and prepayments
   v. Disposal of Assets

1.2 Preparation of Financial Statements

Now let's see how Income Statement and Balance Sheet can be prepared with the help of a set of incomplete records. For this, we will analyze the contents of Income Statement and Balance Sheet item by item in the following pages.

Name of the Organization
Income Statement
For the year ended December 31 20x7

	Source of Information	**Rs.**
Sales		
Cash Sales	Cash Book receipts side	
Credit Sales	Debtors account Dr side	
Cost of Goods Sold		
Opening Stock	Statement of Affairs	
Purchases		
Cash Purchases	Cash Book payment side	
Credit Purchases	Creditors account Cr side	
Closing Stock	Year-end Adjustments	
Gross Profit		
Operating Expenses		
Cash based expenses	Cash Book payment side	
Adjusted with:		
Accrued Expenses	S O A-opening/Year-end Adjustments	
Prepaid Expenses	S O A-opening/Year-end Adjustments	
Expenses against receivables		

Bad Debts/Discounts	Debtors account Cr side
Provision for doubtful debts	S O A-opening/Year-end Adjustments
Expenses against fixed assets	
Depreciation	Year-end Adjustments
Loss on disposal	S O A-opening/Cash Book receipts
Profit from operations	
Other Income	
Cash based income	Cash Book receipts side
Adjusted with:	
Accrued incomes	S O A-opening/Year-end Adjustments
Unearned incomes	S O A-opening/Year-end Adjustments
Incomes against payables	
Discounts	Creditors accounts Dr side
Incomes against fixed assets	
Gain on disposal	S O A-opening/Cash Book receipts
Net profit	**Result**

Name of the Organization
Balance Sheet
As on December 31 20x7

	Source of Information	**Rs.**
Assets		
Fixed Assets	S O A-opening	
Addition	Cash Book payment side	
Disposal	Year-end Adjustments	
Depreciation	Year-end Adjustments	
Investments	S O A-opening	
Addition	Cash Book payment side	
Disposal	Year-end Adjustments	
Current Assets		
Stocks	Year-end Adjustments	
Debtors	Debtors Account	
Prepaid expenses	Year-end Adjustments	
Accrue incomes	Year-end Adjustments	
Bank	Cash Book (Bank Account)	
Cash	Cash Book (Cash Account)	
Total		Result
Owner's Equity		
Opening balance	S O A-opening	
Fresh capital	Cash Book receipts side	
Net profit	Income Statement	
Drawings	Cash Book payment side	

Liabilities

Loans

Further loan taken	Cash Book receipts side
Repayment of loan	Cash Book payment side

Current liabilities

Creditors	Creditors Account
Accrued expenses	Year-end Adjustments
Unearned incomes	Year-end Adjustments
Bank overdraft	Cash Book

Total Result

Cash Book

Receipts	**Amount Rs.**	**Payment**	**Amount Rs.**
Opening balance	xxx	All payments either relating to capital or revenue payments	xxx
All receipts either relating to capital or revenue receipts	xxx	Closing balance	xxx
	xxx		xxx

Debtors Account

Increase in Debtors	**Amount Rs.**	**Decrease in Debtors**	**Amount Rs.**
Opening balance	xxx	Cash received from debtors	Xxx
		Discount allowed	xxx
Credit sales	xxx	Bad debts	xxx
		Sales return	xxx
		Closing balance	xxx
	xxx		xxx

Creditors Account

Decrease in Creditors	**Amount Rs.**	**Increase in Creditors**	**Amount Rs.**
Cash paid to creditors	xxx	Opening balance	xxx
Discount received	xxx	Credit purchase	xxx
Purchase return	xxx		
Closing balance	xxx		
	xxx		xxx

Statement of Affairs as on opening date

Opening Assets	xxx
Opening Liabilities	(xxx)
Owner's Equity	**xxx**

Debit (Dr.) and Credit (Cr.) Rules:

Debit (Dr.) group

Assets →	→	Increase Dr.
Expenses →	→	Decrease Cr.

Credit (Cr.) group

Owner's equity →	→	Increase Cr.
Liability →		
Income →	→	Decrease Dr.

Company Name
Income Statement
For the year ended -------

Sales		xxx
Less: Cost of goods sold		
Opening Stock	**xxx**	
Add Purchases	**xxx**	
Less Closing Stock	**xxx**	
CGS		xxx
Gross profit		xxx
Less Operating expenses		xxx
Less Other expenses		xxx
Add Other Income		xxx
Net Profit		xxx

Operating Expenses:

1. Cash based expenses
2. Expenses relating to receivables
3. Expenses relating to fixed assets
   a). Depreciation
   b). Loss on disposal of an assets

Cash Based Expenses:

Expenses paid in cash during the year	xxx
Less Opening balance of Accrued expenses	xxx
Add Closing balance of Accrued expenses	xxx
Add Opening balance of prepaid expenses	xxx
Less Closing balance of prepaid expenses	xxx
	xxx

Provision for Doubtful Debts

1. When there is an increase in Provision it will be charged as an expense.
2. When there is a decrease in Provision it will be credited to the expense.

Incomes Based on Cash

Cash received during the year	xxx
Less Opening balance of Accrued income	xxx
Add Closing balance of Accrued income	xxx
Add Opening balance of advance income	xxx
Less Closing balance of advance income	xxx
	xxx

Solved Questions

From the following given information you are required to prepare Income Statement and Balance Sheet for the year 2007.

Cash Book

Receipts	Amount Rs.	Payment	Amount Rs.
Opening balance b/f	1,500	Salaries and wages	2,000
Cash sales	12,000	Rent and rates	800
Received from Debtors	25,000	Electricity bill	500
Loan from brother	10,000	Drawings	15,000
		Paid to creditors	24,000
		Closing balance c/f	6,200
	48,500		48,500

Debtors Account

Particulars	Amount Rs.	Particulars	Amount Rs.
Opening balance b/f	8,000	Cash received from debtors	25,000
		Discount allowed	200
Credit sales	22,000	Bad debts	300
		Closing balance c/f	4,500
	30,000		30,000

Creditors Account

Particulars	Amount Rs.	Particulars	Amount Rs.
Cash paid to creditors	24,000	Opening balance	5,500
Discount received	400	Credit purchase	25,000
Closing balance c/f	6,100		
	30,500		30,500

Statement of Affairs as on opening date

	Rupees	Rupees
Opening Assets		
Furniture	20,000	
Stocks	6,000	
Debtors	8,000	
Cash	1,500	35,500
Opening Liabilities		
Creditors		5,500
Owner's Equity		**30,000**

Year end adjustments

Closing stock Rs. 3,200; rent prepaid Rs. 200; salaries owing Rs. 500; and furniture is to be depreciated @ 10%.

Solution:

Income Statement
For the year ended on year 2007

		(Rs.)
Sales (Cash 12,000 + Credit Sale 22,000)		34,000
Less		
Cost of goods sold		
Opening stock	6,000	
+ Credit purchase	25,000	
- Closing stock	3,200	27,800
		6,200

Less Expense:		
Salaries & Wages (2,000+500)	2,500	
Rent & Rates (800-200)	600	
Electricity bills	500	
Depreciation (20,000*10%)	2,000	
Discount allowed	200	
Bad Debts	300	(6,100)
+ Discount Received		400
		=500/-

Balance Sheet

Assets	Amount Rs.	Liabilities		Amount Rs.
Furniture	18,000	Current Asset		
Stock	3,200	Creditors		6,100
Debtors	4,500	Salaries owing		500
Rent Prepaid	200	Loan taken from brother		10,000
Cash	6,200			
		Owner`s Equity		
		Owner Equity	30,000	
		+Net profit	500	
		-Drawing	15,000	15,500
Total	32,100	Total		32,100

LESSON # 4

SINGLE ENTRY
CALCULATION OF MISSING INFORMATION

As we have already learned that a medium sized entity will not be preparing its books of accounts based on double entry book keeping system rather it will be maintaining following set of records in order to prepare its financial statements:

a) Cash Book
   i. Cash Account
   ii. Bank Account
b) Debtors (Accounts Receivables) Ledger
c) Creditors (Accounts Payables) Ledger
d) Statement of Affairs (Opening)
e) Year-end adjustments
   i. Closing stock
   ii. Depreciation of fixed assets
   iii. Provision for doubtful debts
   iv. Accruals and prepayments
   v. Disposal of Assets

Above information provides sufficient data which is required to prepare Income Statement and Balance Sheet of the entity.

For students the question becomes more complex when the above set of records is not completely prepared and some information is missing from these records. In this case the students have to put expertise in searching out the missing information firstly and then to prepare financial statements.

Possible missing information and the procedure to ascertain that information is being discussed hereunder:

Sales

Sales may be of two types (i) Credit Sales, and (ii) Cash Sales. Credit Sales will be ascertained by preparing Debtors Account while Cash Sales will be found out from the Cash Book.

Solved Questions

From the following information, find out the credit sales:

	Rupees
Opening balance of Debtors	12,000
Returns Inward	5,000
Cash received from debtors	45,000
Discount allowed	3,000
Bad Debts	1,500
Closing balance of Debtors	10,000

Solution

Calculation of Credit sale:

Cash received from debtors	45,000
Add: Discount allowed	3,000
Add: Bad Debts	1,500

Add: Return Inward	5,000
Add: Closing balance of debtors	10,000
Less: Opening balance of debtors	(12,000)
	52,500

Solved Questions

From the following cash transactions ascertain the amount of cash sales:

	Rupees
Opening Cash balance	5,000
Opening Bank balance	10,000
Cash collected from Debtors	20,000
Commission received	5,000
Payment to Creditors	10,000
Cash purchases	20,000
Closing Cash balance	10,000
Closing Bank balance	15,000

Solution

Cash Sale

Receipt	**Amount Rs.**	**Payments**	**Amount Rs.**
Opening cash	5,000	Payment to creditors	10,000
Opening Bank	10,000	Cash purchase	20,000
Cash collected from debtors	20,000	Closing cash balance	10,000
Commission received	5,000	Closing bank balance	15,000
Cash Sale	**15,000**		
	55,000		55,000

Purchases

The purchases may also be of two types (i) Credit Purchases and (ii) Cash Purchases. Credit Purchases will be ascertained by preparing Creditors Account while Cash Purchases will be appearing in the Cash Book.

Solved Questions

From the following information, find out the Credit purchases:

	Rupees
Opening Creditors	7,600
Cash paid to Creditors	20,000
Discount received	500
Returns outward	2,400
Closing Creditors	9,500

Solution

Cash paid to creditors	7,600
Add: Discount Received	500
Add: Return outward	2,400
Add: Closing creditors	9,500
Less: Opening Creditors	(7,600)
	24,800

Stocks/Inventory

Opening stock appears in the Statement of Affairs and Closing stock is an item given in the year end adjustments. Sometimes these information are hidden. In this case the stock balances will be ascertained through the equation of cost of goods sold i.e.

Opening Stock + Purchases – Closing Stock = Cost of Goods Sold

Solved Questions

From the following information, calculate opening stock:

	Rupees
Purchases	20,000
Sales	30,000
Closing Stocks	10,000
Gross profit	20% of Sales

Solution

If gross profit is 20% of sales then Cost of goods sold is 80%. So Cost of goods is:

Sales – Cost of goods sold = Gross profit
30,000 – CGS = 6,000 (30,000*0.2)
So after rearranging
CGS = 30,000 – 6000 = 24,000

Opening stock can be found out as:

Opening Stock + Purchase – Closing stock = Cost of goods sold
Opening stock + 20,000 – 10,000 = 24000
Opening stock = 24,000 + 10,000 – 20,000 = **14,000**

Drawings

Some times cash drawings are missing, this information appears in payments side of the cash book. Cash book is prepared to ascertain drawings as a balancing figure in the credit side.

Information in Cash Book

Receipts	Rupees	Payments	Rupees
Opening Balance b/f	*****	Cash purchases	*****
Cash Sales	*****	Paid to creditors	*****
Received from debtors	*****	Operating expenses	*****
Other incomes	*****	Purchase of assets	*****

Fresh capital	*****	Repayment of loan	*****
Loan taken	*****	Drawings	*****
Sales proceeds of assets	*****	Investments	*****
		Fixed deposits	*****
		Closing balance c/f	*****

Information in Debtors Account

Debit	Rupees	Credit	Rupees
Opening Balance b/f	*****	Cash received from debtors	*****
Credit Sales	*****	Cheques received form debtors	*****
		Discount Allowed	*****
		Bad Debts	*****
		Sales returns	*****
		Closing Balance c/f	*****

Information in Creditors Account

Debit	Rupees	Credit	Rupees
Cash paid to creditors	*****	Opening Balance b/f	*****
Cheques paid to creditors	*****	Credit Purchases	*****
Discount Received	*****		
Purchase returns	*****		
Closing Balance c/f	*****		

Information in Statement of Affairs (Opening)

	Rs.	Rs.
All Assets		
Fixed Assets	***	
Investments	***	
Current Assets	***	***
<u>Less</u>		
All Liabilities		
Loans	***	
Current Liabilities	***	***
Owner's Equity.		***

LESSON # 5

SINGLE ENTRY
CALCULATION OF MARKUP AND MARGIN

Cost Structure

Cost structure stands for the percentage structure of Sales Revenue, Cost of Goods Sold and Gross profit. Through cost structure percentage of gross profit is determined over the cost of goods sold and over the sales revenue. It can be expressed in equation like this:

	Sales Revenue		Sales
Less	Cost of Goods Sold	**or**	COGS
	Gross profit		**G P**

Markup rate

Markup rate is the rate of gross profit over the cost of goods sold, it is expressed in %age and it is formulated like this:

$$\frac{GP}{COGS} \times 100 = \%$$

In calculating markup rate, the cost of goods sold is kept equal to 100%. Suppose the markup rate is 25% then the cost structure in markup will be like this:

Sales	125%
COGS	100%
G P	25%

Margin rate

Margin rate is the rate of gross profit over the sales revenue, it is expressed in %age and it is formulated like this:

$$\frac{GP}{Sales} \times 100 = \%$$

In calculating margin rate, the sales revenue is kept equal to 100%. Suppose the margin rate is 25% then the cost structure in markup will be like this:

Sales	100%
COGS	75%
G P	25%

These markup/margin rates are used in calculating gross profit or cost of goods sold or even sales, it will all depend upon the scenario. For example:

Scenario I

Sales Rs. 80,000
Purchases (to be found)
Opening Stock Rs. 6,000
Closing Stock Rs. 2,000
Whereas goods are sold at a markup of 25%

Solution Scenario I

The cost structure is like this:

Sales	125%
COGS	100%
G P	25%

Gross Profit $= 80{,}000 \times \frac{25}{125} = 16{,}000$

Cost of goods sold = Sales – Gross profit
= 80,000 – 16,000
= 64,000

Direct calculation of Cost of goods sold

$= 80{,}000 \times \frac{100}{125} = 64{,}000$

		Rs.
Opening Stock (given)	=	6,000
Purchases (balancing figure)	=	60,000
Cost available for sale	=	66,000
Closing Stock (given)	=	2,000
Cost of goods sold (calculated)	=	64,000

Scenario II

Sales (to be found)
Purchases Rs. 155,000
Opening Stock Rs. 10,000
Closing Stock Rs. 15,000
Whereas goods are sold at a margin of 25%

Solution Scenario II

The cost structure is like this:

Sales	100%
COGS	75%
G P	25%

Cost of goods sold	=	Opening stock	10,000
		Purchases	155,000
		Closing stock	15,000
			150,000

Gross Profit $= 150{,}000 \times \frac{25}{75} = 50{,}000$

Sales = Cost of goods sold + Gross profit
= 150,000 + 50,000
= 200,000

Direct calculation of Sales

$$=150,000 \times \frac{100}{75} = 200,000$$

ACCOUNTING FOR NON-PROFIT ORGANIZATIONS

Introduction

Accounting is a language to communicate and understand financial information. Every organization, whether involve in business or non business activities, needs accounting to get financial reports.

Non profit organizations are not involved in complex transactions like trading of goods or services and manufacturing activities therefore a very simple accounting system can work.

Mainly these organizations are engaged in welfare activities or the activities that will entertain its members specifically and others in general. A very commonly understood example of such organizations is mosque or church. Almost all of us use to visit our worship place frequently and can understand very easily that it is an organization where we can have examples of assets, liabilities, incomes and expenses as well.

But remember, non profit organizations do not have owner's equity because these are not owned by any one rather a managing committee looks after all affairs of the organization. Therefore there is no question of owner's equity in the financial information of non profit organizations.

Accounting Records

Cash book is prepared in a chronological sequence; it is the only book of original entry that is maintained by the accountant of a non profit organization. At the end of the accounting year a summary of total cash receipts and total cash payments is made under different heads, such summary is known as Receipt and Payment Account.

Cash book will contain subscription received on different dates during the year where as the Receipt and Payment Account will contain a single amount of total subscription received during the year. Similarly cash book contains payment of salaries made on different dates of the year, whereas, the Receipt and Payment Account will show the total salaries paid during the year as a single information.

Memorandum Records

A non profit organization that has a large number of members will also maintain a memorandum record of members, and if that organization is running activities like providing medicines or providing library facilities or running a sports club then it will also be maintaining memorandum record for the inventory items.

Financial Statements

Non profit organizations prepare ***Income and Expenditure Account*** that replaces Income Statement of a business concerns to obtain surplus (excess of incomes over the expenses) or deficit (excess of expenses over the incomes).

Incomes of a non profit organization

Incomes of a non profit organization mainly include the following:

- Subscription
- Donation
- Entrance fee
- Lockers rent
- Membership fee etc. etc.

All these incomes are measured according to the accrual concept. Actual receipts of these incomes are recorded in the Cash Book and ultimately become part of the Receipt and Payment account. Such receipts are then adjusted with the opening and closing owing/advance income to get the balance of income that belongs to the current accounting period.

For example:

Rs. 55,000 subscription received during the year ending on December 31 20x7 of which Rs 5,000 relate to the subscription due in the year 20x6 and Rs. 2,000 was received in advance that was relating to the year 20x8. Rs. 3,000 subscription of few members was received in advance during the year 20x6 and Rs. 4,000 subscription relating to the year 20x7 is still due to be received.

	Rupees
Cash received during the year 20x7	55,000
Less Cash received not related to year 20x7 (5,000 + 2,000)	7,000
Add Income relating to the year 20x7 (3,000 + 7,000)	10,000
Subscription income for the year 20x7	**58,000**

Subscription (Income) Account

Debit	Rupees	Credit	Rupees
Opening Due	5,000	Opening Advance	3,000
Closing Advance	2,000	Cash Received	55,000
Income (balancing figure)	58,000	Closing Due	7,000

Expenses of a non profit organization

Expenses are also measured according to the accrual concept. All revenue expenditures appearing in the payment side of the Cash Book (Receipt and Payment Account) are adjusted with the opening and closing balances of outstanding and prepaid expenses. This process of adjustment converts the revenue payments in expenses. Such expenses are ultimately matched with the Incomes to calculate surplus/deficit.

Balance Sheet is prepared to know the financial position in the same way as we already have studied for business entities. The only difference in the balance sheet of a non profit organization comparing with the balance sheet of a business entity is that there will be no owner's equity instead there will be a balance of accumulated fund also known as capital fund in the balance sheet of a non profit organization as a main source of finance.

Accumulated Fund

Like owner's equity, accumulated fund is also a difference of Assets and Liabilities.

Accumulated Fund = Assets – Liabilities

Accumulated fund represents the funds that are the source of the Assets obtained or constructed for the organization. These funds consist of grants, donations, legacies, entry fees, life membership fees etc.

Often in the examination questions Statement of Affairs is prepared to find the opening balance of accumulated fund.

Division of Non-profit organizations

Small scale organizations → Receipt & Payment A/c

Medium scale organizations → Cash book
Statement of affairs
Year-end adjustments

LESSON # 6

ACCOUNTING SYSTEM IN NON-PROFIT ORGANIZATIONS

Non-profit organizations like business entities are also large, medium and small in size. A large organization will be having a complete accounting system along with a full fledge accounts department where the double entry accounting will be followed. Whereas, medium or small sized non profit organization will be maintaining few books of accounts and will not be having proper accounting system.

Small size non-profit organization

We can observe so many examples of a small size non-profit organizations around us, the very commonly understood example will be of a street library where cash book would have been maintained as the only book of account and finally a summary of that cash book is prepared at the end of the year just to have an overview of the total receipts and payment made during the year.
Because of the very simple and few transactions, its members do not need to know its financial position at the end of each accounting period therefore Income & Expenditure Account and Balance Sheet is not prepared.

Large size non-profit organization

On the contrary, member of the large size organization will be interested in all financial results of the entity and a proper book-keeping system is developed over there. The outcome of which is production of a Trial Balance which is used to prepare Income & Expenditure Account and Balance Sheet.

Medium size non-profit organization

Medium size non-profit organizations although do not prepare proper books of accounts but need to know the financial status in terms of surplus income and financial position of the organization. For this purpose; rules of conversion of single entry into the double entry are followed and finally Income & Expenditure Account and Balance Sheet is prepared.

How can we prepare "Receipt & Payment Account"? Have a look at the following table, which guides about preparing "Receipt & Payment Account":

Receipt and payment Account
For the year ended 31st Dec, 2008

Receipt	Cash	Bank	Payment	Cash	Bank
Opening balance	****	****	Telephone bill	****	****
Subscription received	****	****	Rent	-----	****
Membership fee	****	****	Salaries	****	****
Donations	-----	****	Entertainment exp.	****	****
Loan received	****	****	Any other expenses	****	-----
Any other income	****	****	Closing balance	****	****
	****	****		****	****

Income Statement can be prepared using either:

1. Function of expenses method, or
2. Nature of expenses method

Income statement under
Function of expense method

Sales		xxx
Less Cost of goods sold		xxx
Gross profit		xxx
Less Operating expenses		
Administrative	xxx	
Selling and marketing	xxx	
		xxx
Profit from operations		xxx
Add other income		xxx
Profit before tax		xxx
Less Income Tax		xxx
Profit after tax		$\boxed{xxx}$

Function of expenses:

1. Cost of goods sold
2. Administrative expenses
3. Selling and Distribution expenses
4. Financial expenses
5. Income tax expenses

Income and Expenditure Account
Nature of expenses method

Income		
Subscription income	xxx	
Membership fee	xxx	
Entrance fee	xxx	
Total income		xxx
Expenses		
Salaries	xxx	
Entrance fee	xxx	
Electricity bill	xxx	
Building rent	xxx	
Total expenses		xxx
Excess of Income over Expenditure/surplus		xxx

(This is not difficult at your level to understand what appears in debit and credit sides of a trial balance and which information is put in the income & expenditure and with information relates to the balance sheet. For practicing purposes a solved problem is shown hereunder)

<u>Solved Questions</u>

From the following Trial Balance of a club prepare an Income & Expenditure Account for the year ended on 31st March 2008 and Balance Sheet as on that date:

Particulars	Dr. Rupees	Cr. Rupees
General fund		30,000
Cash in hand	2,000	
Cash at bank	3,000	
Sundry debtors	2,400	
Sundry creditors		1,500
Loan @ 15% (1-07-2007)		20,000
Furniture & Fixture	10,000	
Building	40,000	
Stock of cold drink	500	
Rent	6,000	
Rate, Taxes & Insurance	600	
Secretary Honorarium	1,200	
Entrance fee	1,000	
Subscription received in advance		1,500
Salaries & Wages	5,800	
Extension of building	10,000	
Printing & Stationary	1,000	
Legal charges	500	
Annual subscription		30,000
Card & Billiard room receipts		4,000
Sundry expenses	1,600	
Cold drink sales		5,000
Repair of building and furniture	400	
Utility expenses	1,000	
Purchase of clod drink	4,000	
Interest on Loan	1,000	
Total	**92,000**	**92,000**

Additional Information

1. Subscription for the year end outstanding Rs. 2,000
2. Write off depreciation @10% per annum on furniture and 2% on building including the extension.
3. Stock of cold drinks Rs. 1,000

Solution

------ Club
Income and Expenditure Account
For the year ended 31.03.2008

Expenditure	Rs.	Income	Rs.
To Consumption of cold drink	3,500	By Subscriptions 30,000 Add: Outstanding 2,000	32,000
To Rent	6,000		
To Rates, taxes & insurance	600	By Card & Billiard Room Receipts	4,000
To Secretary's honorarium	1,200		
To Entrance fees	1,000	By Cold Drinks	5,000
To Salaries & wages	1000		
To Printing and Stationary	5800		
To Legal charges	500		
To Sundry expenses	1,600		
To Repairs to building and furniture	400		
To Utility Bills	1,000		
To interest on loan 1,000 Add: Outstanding 1,250	2,250		
To Depreciation	2,000		
To Excess of income over Expenditure – Surplus	14,150		
	41,000		41,000

----- Club
Balance Sheet
As at 31.03.2008

Liabilities		Rs.	Assets		Rs.
Capital Fund	30,000		Club House	40,000	
Add: Surplus	14,150	44,150	Add: Extension	10,000	
Sundry Creditors		1,500		50,000	
15% Loan		20,000	Less: Depreciation	1,000	49,000
Interest on Loan (Outstanding)		1,250			
Subscriptions received in advance		1,500	Furniture & Fixture	10,000	
			Less : Depreciation	1,000	9,000
			Stock in hand:		
			Cold Drink	1,000	1,000
			Sundry Debtors		2,400
			Subscription due		2,000
			Cash at Bank		3,000
			Cash in hand		2,000
		68,400			68,400

LESSON # 7

ACCOUNTING SYSTEM IN NON-PROFIT ORGANIZATIONS (Cont.)

Preparing financial statements with incomplete records

Most of the non-profit organizations operate in medium scale and do not prepare proper books of accounts. The only accounting record that is maintained in such sized organizations is cash book along with year end adjustments. The management also keeps Statement of Affairs as on opening date to maintain during the year movements in the balance sheet items.

- Cash Book (Receipt and Payment Account)
- Statement of Affairs (as on opening date)
- Year end Adjustments
    - Accrued incomes and expenses
    - Advance receipts and payments
    - Depreciation rate

Like business entities, these few accounting records are used to convert the information into double entry system and to produce Income & Expenditure Account and Balance Sheet.

The technique of preparing financial statements of a non-profit organization is similar to that used for preparing financial statements of a business entity.

While preparing *Income & Expenditure Account,* following shall be assumed to calculate expenses and incomes

Calculation of incomes

For non-profit organizations the incomes are picked up from the cash books and amended with the year end adjustment:

Cash based incomes

Cash based incomes are the revenue receipts that are picked up from its original cash book and are processed into the filter of accruals, like this:

	Rs.
Cash received during the year	***
Less Opening balance of accrued income	***
Add Closing balance of accrued income	***
Add Opening balance of advance receipts	***
Less Closing balance of advance receipts	***
	***

Fixed Assets based incomes

Profit/gain on disposal of Assets are calculated with the help of sales proceeds appearing in receipts side of Cash Book and some relevant information appearing in the year-end adjustments like cost and accumulated depreciation of the asset disposed off.

Calculation of expenses

For non-profit organizations the expenses are picked up from the cash books and amended with the year end adjustment:

Cash based expenses

Cash based expenses are the revenue payments that are picked up from its origin cash book and are processed into the filter of accruals, like this:

	Rs.
Expenses paid in cash during the year	***
Less Opening balance of accrued expenses	***
Add Closing balance of accrued expenses	***
Add Opening balance of prepaid expenses	***
Less Closing balance of prepaid expenses	***
Expense for the year to be shown in the Income Statement	***

Fixed Assets based expenses

1. Depreciation is calculated based on the depreciation rate mentioned in the Year-end Adjustments
2. Loss on disposal of an asset are calculated with the help of sales proceeds appearing in receipts side of Cash Book and some relevant information appearing in the year-end adjustments like cost and accumulated depreciation of the asset disposed off.

Balance Sheet of a non-profit organization is prepared in the usual way and contains particulars of all assets and liabilities of the organization on the date on which it is prepared. Net assets of non-profit organization are represented by Capital Fund in the balance sheet. This Capital Fund replaces the owner's equity.

The opening balance of Capital Fund is calculated through the Statement of Affairs as on the opening date. Such opening Capital Fund is then adjusted with the surplus or deficit in the Balance Sheet.

Capital receipt like; specific donations, funds, grants etc. for purchase/acquisition or construction of assets are also included in the Capital Fund of the organization.

Calculating Subscription Income

Although calculating subscription income is not a separate issue apart from the calculation of incomes for the year originating from the cash book, but even then its calculations are being shown over here just to give confidence through practice.

Subscription is cash based income and like other revenue receipts it appears in receipts side of the cash book summary. It is picked up from there and then amended with the opening and closing balances of subscriptions accrued and received in advance.

Solved Questions

	Rupees
Subscription received during the year 2007	7,000
Subscription outstanding at the beginning of 2007	1,400
Subscription outstanding at the closing of 2007	1,600

Calculate the amount of subscription income for the year 2007.

Working:	(Rs.)
Subscription received during the year	7,000
Less Opening due	1,400
Add Closing due	1,600
Income for the year	7,200

Subscription Income Account

Date	Particulars	Amount Rs.	Date	Particulars	Amount Rs.
1/1/07	Subscription opening due	1,400	DTY	Cash	7,000
31/12/07	Subscription income	7,200	31/12/07	Subscription closing due	1,600
		8,800			**8,800**

Solved Questions

	Rupees
Subscription received during the year 2007	12,000
Subscription received in advance for 2008	1,400
Subscription outstanding at the beginning of 2007	1,600
Subscription outstanding at the closing 2007	700

Calculate the amount of subscription at the closing of 2007.

Working:	(Rs.)
Subscription Received during the year 2007	12,000
Less Opening due	2,000
Less Closing advance	1,600
Add Closing due	700
Income for the year	9,100

Subscription Income Account

Date	Particulars	Amount Rs.	Date	Particulars	Amount Rs.
1/1/07	Opening due	2,000	DTY	Subscription received	12,000
31/12/07	Closing advance	1,600	31/12/07	Subscription closing due	700
31/12/07	Income for the year	9,100			
		12,700			**12,700**

Solved Questions

Receipts and Payment Account
For the year ended December 31, 2008

Receipts	Rs.	Payments	Rs.
Subscription 2007 Rs. 2,000 2008 6,000 2009 2,000	10,000		

Additional information:

1. Subscription due on 31-12-2007 Rs. 2,000
2. Subscription due on 31-12-2008 Rs. 4,000
3. Subscription received in advance as on 31-12-2007 Rs. 3,000
4. Subscription received in advance as on 31-12-2008 Rs. 2,000

Working:	*Rupees*
Cash received during the year	10,000
Less Opening balance of accrued income	2,000
Add Closing balance of accrued income	4,000
Add Opening balance of advance receipts	3,000
Less Closing balance of advance receipts	2,000
Income for the year	**13,000**

Income and Expenditure Account
For the year ended December 31, 2008
(Extract)

	Rupees
Incomes	
Subscription income	13,000

Balance Sheet
As at December 31, 2008
(Extract)

	Rupees
Assets	
Subscription receivable	4,000
Liabilities	
Subscription received in advance	2,000

Solved Questions

Receipts	Rs.	Payments	Rs.
Subscription 2007 Rs. 1,800 2008 10,000 2009 4,000	15,800		

Additional information:

1. Subscription due on 31-12-2007 Rs. 2,000
2. Subscription due on 31-12-2008 Rs. 3,000
3. Subscription received in advance as on 31-12-2007 Rs. 2,000
4. Subscription received in advance as on 31-12-2008 Rs. 4,000

Working:	*Rupees*
Cash received during the year	15,800
Less Opening balance of accrued income	2,000
Add Closing balance of accrued income	3,000
Add Opening balance of advance receipts	2,000
Less Closing balance of advance receipts	4,000
Income for the year	**14,800**

Income and Expenditure Account
For the year ended December 31, 2008
(Extract)

	Rupees
Incomes	
Subscription income	14,800

Balance Sheet
As at December 31, 2008
(Extract)

	Rupees
Assets	
Subscription receivable	3,000
Liabilities	
Subscription received in advance	4,000

Solved Questions

Following is the data relating to membership fee of HF Club for the accounting year April 2007 to March 2008.

1. Cash/Cheque received during the year totaled Rs. 100,000.
2. As on April 1, 2007 Rs. 2,000 was in arrears for March 31, 2007 and Rs. 800 was received in the previous year as advance membership fee.
3. Received Rs. 1,500 towards the next year's membership fee, but could not yet recovered Rs. 1,700 from current year members.

Calculate "Membership Fee" for the year 2007-08

Working:

Membership fee received during the year	Rs. 100,000
Opening advance	Rs. 800
Closing advance	Rs. 1,500
Opening due	Rs. 2,000
Closing due	Rs. 1,700

Membership fee Account

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
1/4/07	Opening due	2,000	1/4/07	Opening advance	800
31/3/07	Closing advance	1,500	DTY	Cash	100,000
31/12/07	Income for the year	9,100	31/3/08	Closing due	700
		12,700			**12,700**

LESSON # 8

PREPARATION OF FINANCIAL STATEMENTS OF NON-PROFIT ORGANIZATIONS FROM INCOMPLETE RECORDS

Questions often require candidates to prepare an Income & Expenditure Account and Balance Sheet from incomplete records. Generally, a summary of bank and cash transactions is provided along with information relating to opening and closing assets and liabilities.

To solve these types of problems, the following steps are followed:

1. Prepare a receipt and payment account (if not given in the question).
2. Prepare statement of affairs as on opening date.
3. Post the balances of assets and liabilities from the statement of affairs into the relevant ledger a/c as opening balance b/f or put these in the working for further calculation of closing balance.
4. Pick up the revenue receipts and payment and pass these from the filter of accruals to calculate incomes and expenses for the year.
5. Prepare such ledger accounts as are deemed necessary (like subscription a/c).
6. Work out depreciation charge for the fixed assets and treat them accordingly.
7. Prepare trading account for supporting trading activities undertaken by the non-trading organization.
8. Draft the income and expenditure account and balance sheet.

Solved Questions

Karachi Golf Club prepared the following Receipts and Payments Account for the year ended December 31, 2007

Receipts	Amount Rs.	Payments	Amount Rs.
Opening balance b/f	3,800	Sports Equipments	
Subscription		(purchased on 1.9.2007)	10,000
2006	2,000	Tournament expenses	4,000
2007	18,500	Electricity	500
2008	900	Printing	300
Entrance fees		Salaries and wages	3,400
(capital receipts)	800	Expenses for exhibition	2,100
Interest on Investment	1500	Closing Balance c/f	7,200
	27,500		**27,500**

Additional information:

1. Non-current assets of the club on January 1, 2007 include the following:

	Rupees
Club Ground	50,000
Sports Equipment	15,500
Furniture	2,000
Investment	12,000

2. Subscription for 2007 collected in 2006 Rs. 500
3. Unpaid subscriptions for 2007 Rs. 300
4. Depreciation to be provided @ 5% p.a. on furniture and @ 20% p.a. on sports equipment.

Required: prepare Income statement and balance sheet for the year 2007.

Statement of Affairs
As on January 1, 2007

Assets	**Rs.**
Club ground	50,000
Sports equipment	15,500
Furniture	2,000
Investments	12,000
Subscription due	2,000
Cash balance	3,800
	85,300
Less Liabilities	
Subscription received in advance	500
Capital fund	84,800

Sports Equipment Account

Date	Particulars	Amount Rupees	Date	Particulars	Amount Rupees
1 Jan 2007	Opening balance	15,500	31 Dec 2007	Depreciation	3,767
1 Sep 2007	Addition During the year	10,000	31 Dec 2007	Balance	21,733
Total		25,500	Total		25,500

Sports Equipment			***Rupees***
Opening balance			15,500
Add Addition 1.9.2007			10,000
			25,500
Less Depreciation	15,500 x 20%	3,100	
	10,000 x 20% x 4/12	667	3,767
Net book value			**21,733**

Furniture		
Opening balance		2,000
Add Addition	1.9.2007	0
		2,000
Less Depreciation	2,000 x 5%	100
Net book value		**1,900**

Subscription Income

Subscriptions received during the year	21,400
Less Opening due	2,000
Add Closing due	300
Add Opening advance	500
Less Closing advance	900
	19,300

Income & Expenditure Account
For the year ended December 31, 2007

Incomes	**Rupees**	**Rupees**
Subscription	19,300	
Interest on Investment	1,500	20,800
Expenses		
Tournament expenses	4,000	
Electricity	500	
Printing	300	
Salaries and wages	3,400	
Exhibition expenses	2,100	
Depreciation		
furniture	100	
Sports equipment	3,767	14,167
		6,633

Owner's Equity

Opening capital	xxx
Add Net profit	xxx
Add Fresh capital	xxx
Less Drawings	xxx
Closing capital	xxx

Capital Fund

Opening capital fund	xxx
Add Surplus	xxx
Add Capital receipts during the year	xxx
Closing capital fund	xxx

Capital fund as on December 31, 2007	*Rupees*
Opening capital	84,800
Add Surplus	6,633
Add Capital receipts	800
Closing capital fund	92,233

Balance Sheet
As on December 31, 2007

Assets	Amount Rupees	Capital fund & Liabilities	Amount Rupees
Club building	50,000	Capital fund	92,233
Sports equipment	21,733	Subscription received in	
Furniture	1,900	advance	900
Investments	12,000		
Subscription due	300		
Cash	7,200		
Total	**93,133**	Total	**93,133**

Some of the non-profit organizations believe on self sufficiency. These types of organizations run a trading activity within the organization. These may include a canteen, a juice shop, a book shop, a tuck shop etc. Following is a solved problem that covers working for such trading activity.

Solved Questions

The following summary of the Cash Book has been prepared by the Treasure of a club.

Receipts	Amount Rupees	Payment	Amount Rupees
Cash in hand & at bank		Wages-Outdoor staff	13,380
on April 1, 2007	4,740	Restaurant purchases	50,400
Member's subscription	29,720	Rent-18 months June 30,	7,500
Entrance fee	3,200	2008	
Restaurant fee	56,800	Rates	2,200
Games competition receipts	13,640	Secretary salary	3,120
Dues to secretary		Lighting, Cleaning &	7,700
for petty expenses	80	Sanitary service	
		Competition prizes	4,000
		Printing, postage &	6,000
		Sundries	
		Fixed deposit in bank	8,000
		Balance	5,880
	108,180		**108,180**

On April 1, 2007, the club assets were: Furniture and Equipment Rs. 48,000; Restaurant stocks Rs. 2,600; Stock of prizes Rs. 800, and Rs 5,200 owed for supplies to the restaurant.

On March 31, 2008 the restaurant Stocks were Rs. 3,000 and prizes on hand were Rs. 500 while the club owed Rs. 5,600 for restaurant supplies.
It was also found that member's subscription unpaid on March 31, 2008, amounted to Rs. 1,000 and that the amount of Rs. 29,720 shown in cash book included Rs. 700 in respect of previous year and Rs. 400 paid in advance for the following year.
Prepare the Income & Expenditure Account and Balance Sheet for Club.

Working for trading activity	**Rupees**
Supplies	
Cash paid	50,400
Less Opening due	5,200
Add Closing due	5,600
Supplies purchase expenses	50,800
Cost of goods sold	
Purchases of supplies	50,800
Add opening stock	2,600
Less closing stock	3,000
Cost of goods sold	50,400
Trading Account	
Sales	56,800
Less Cost of Goods Sold	50,400
	6,400

CLUB
Income and Expenditure Account
For the year ended 31.03.2008

Expenditure	Rs.	Income	Rs.
To Wages – Outdoor staff	13,380	By Members' subscriptions	29,620
To Rent	5,000	By Games competition receipts	13,640
To Rates	2,200	By Restaurant profit	***6,400***
To Secretary's Salary	3,120		
To Lighting, cleaning and sanitary services	7,700		
To Competition prizes	4,300		
To Printing, postage and sundries	6,000		
To depreciation on Furniture & Equipment – 10%	4,800		
To Excess of Income over Expenditure	3,160		
	49,660		49,660

CLUB
Balance Sheet
As at 31.03.2008

Liabilities		Rs.	Assets		Rs.
Capital Fund:			Furniture & Equipment	48,000	
Opening Balance	50,390		Less: 10% Depreciation	4,800	43,200
Add: Entrance Fees	3,200		Restaurant Stock		3,000
Add: Excess of Income			Prizes in hand		500
over Expenditure	3,160	56,750	Fixed deposit with bank		8,000
Subscriptions received in advance		400	Cash in hand at bank		5,880
Creditor for restaurant supply		5,600	Prepaid Rent (April to June 2008)		1,250
Due to secretary		80	Subscriptions outstanding		1,000
		62,830			62,830

LESSON # 9

DEPARTMENTAL ACCOUNTS

A business entity where diversified natures of economic activities are undertaken is split into number of departments for accounting purposes. Generally, it is management who will decide the number of departments in which the whole business is to be divided, but the criteria for identifying the departments in an examination question is always the separate sales/work-done revenue.

Each department is considered as a profit centre, though none of the departments is separated geographically from the rest of the departments. This type of organizational subdivision creates a need for internal information about the operating results (profitability) of each department. Based upon the departmental knowledge of profitability and growth rate, the management takes certain decisions e.g. pricing, costing, sales promotion, closure etc.

Allocation of Incomes and Expenses

Until unless the size of the business entity is very large, the entire book keeping system for the entity is kept by a central accounts department along with some departmental specific records e.g. sales, purchases, stocks and staff salaries etc. Rest of the operating expenses and other incomes need to be allocated among the departments based on their nature, utility, economic benefits and belongingness.

For allocation and division purposes the expenses/incomes can be categorized as:

1. Separately identified
2. Obvious just ratio
3. Specific ratio/sales ratio
4. Un-allocable

Separately identified

It depends upon the size of the entity that it can separately identify its expenses with each of the department. A large entity will be incurring most of the operating expenses that are department specific e.g. carriage inward, receiving and handling, wages and salaries, electricity, telephone, repair and maintenance, entertainment, advertisement, sales promotion, selling commissions, research and development cost etc.

Obvious just ratio

Most of the expenses are allocated on the most logical basis that is obvious and also just. Nature of the expenses and nature of the business will determine the basis for division. Some important basis and expenses are given below:

S#	Basis	Expenses
1	Sales/Work-done Revenue	Selling and distribution expenses After sales service Discount allowed Carriage/freight outward Bad debts Selling commissions Advertisement
2	Number of Employees	Salaries and wages

		Staff welfare Canteen/cafeteria facility Group insurance
3	Area Occupied	Building rent Building depreciation Building insurance Building repair and maintenance Air conditioning and heating Property tax Inter-com
4	Purchases of goods/raw material	Carriage/freight inward Import duties Custom tax Receiving and handling cost Discount received (income)

Specific ratio or sales ratio

Still there are some expenses which provide economic benefits to more than one department and should be allocated but the ratio is not obvious, for such expenses a specific ratio will be determined or otherwise these will be divided in the ratio of their respective departmental sales revenue. These may include:

Insurance on stock/inventory
Insurance on plant and machinery
Power and fuel
Depreciation/Amortization

Un-allocable

These are the expenses which provide economic benefits to the business entity on the whole; these cannot be identified with a specific department. Such expenses are often incurred against financial facilities. Examples include; loss on disposal of investments, damages paid for infringement of law, interest on loan and bank overdrafts etc.

There are certain financial incomes as well that cannot be identified or allocated among the department e.g. interest on investment, profit on disposal on investments, profit on fixed deposits etc.

All these types of expenses and incomes are shown in a general profit and loss account where profits or losses of each department are clubbed to ascertain the operating results of the business on the whole.

Allocation of income tax expense

Unlike other operating expenses income tax expense is divided on the basis of departmental operating profits. Some students having knowledge of income tax law may possibly get confused that nevertheless there are certain expenses or losses admissible from the tax stand point that are shown in the general profit and loss account have not yet been deducted from the departmental operating results then why this income tax expense is being charged before subtracting certain expenses.

Remember this is just an allocation of income tax expense (that has already been calculated) among the different departments. It has nothing to do with the calculation of taxable profit or income tax charge for the year.

Format of departmental profit and loss account
Income statement
For the year ended December 31, 2008

Particulars	A	B	Total
Sales	***	***	***
Less Cost of goods sold	***	***	***
Gross profit	***	***	***
Less Operating expenses			
Salaries & Wages	***	***	***
Rent, rates & taxes	***	***	***
Repair & renewal	***	***	***
Lighting & heating	***	***	***
Profit from operations	***	***	***
Add Other incomes	***	***	***
Profit before tax	***	***	***
Less Income tax	***	***	***
Net profit/Profit after tax	***	***	***
Less General expenses	-	-	***
Net profit of the business			***

Solved Questions

From the following information of Trendy Store prepare departmental Income Statement and also compute net profit of the entity on the whole for the year ending on 31.12 2008

Particulars	Jewellery Rs.	Hairdressing Rs.	Clothing Rs.
Opening stock (1/1/2008)	2,000	1,500	3,000
Purchases	11,000	3,000	15,000
Closing stock (31/12/2008)	3,000	2,500	4,000
Sales and work done	18,000	9,000	27,000
Staff salaries	2,800	5,000	6,000

Following expenses cannot be traced to any particular department:

	Rupees
Rent	3,500
Repair expenses	4,800
Air conditioning & lighting	2,000
General expenses	1,200

Basis of allocation
Rent & Air-conditioning expense **(Floor space occupied)**
Repairs & General expense **(Sales and work done)**

Floor space occupied ratio:

Jewellery	Hairdressing	Clothing
1/5	1/2	3/10

Rent		
Jewellery	3,500 x 1/5 =	700
Hairdressing	3,500 x 1/2 =	1,750
Clothing	3,500 x 3/10 =	1,050
Air conditioning & lighting		
Jewellery	2,000 x 1/5 =	400
Hairdressing	2,000 x 1/2 =	1,000
Clothing	2,000 x 3/10 =	600
Repair expenses		
Jewellery	4,800 x 18/54 =	1,600
Hairdressing	4,800 x 18/54 =	800
Clothing	4,800 x 18/54 =	2,400

Trendy Store
Departmental Trading and profit and Loss Accounts
For the year ended 31 December 2008

Particulars	Jewellery Rs.		Hairdressing Rs.		Clothing Rs.	
Sales and work done		18,000		9,000		27,000
Cost of goods or materials:						
Stock 01.01.2008	2,000		1,500		3,000	
Add Purchases	11,000		3,000		15,000	
Less Stock 31.12.2008	(3,000)	(10,000)	(2,500)	(2,000)	(4,000)	(14,000)
Gross Profit		8,000		7,000		13,000
Less Expenses						
Wages	2,800		5,000		6,000	
Rent	700		1,750		1,050	
Administration Expenses	1,600		800		2,400	
Air conditioning & lighting	400		1,000		600	
General expenses	400	(5,900)	200	(8,750)	600	(10,650)
Net Profit / (Loss)		**2,100**		**(1,750)**		**2,350**

LESSON # 10

DEPARTMENTAL ACCOUNTS (Cont.)

Sometimes departments prefer to buy goods from their internal departments. For this purpose, prices are charged equal to the normal selling prices or a department may transfer at its original cost price. Since each department is considered as a separate profit centre, it is necessary to have separate records for inter-departmental transfer of goods or even services.

The department which transfers the goods considers its transfers as equal to sales and the department which receives the goods considers it as equal to its purchases and put it in the cost of goods sold. Generally a periodical analysis sheet is prepared to record these departmental transfers:

	Transferring Departments			*Receiving Departments*		
Date	**X (Rs)**	**Y (Rs)**	**Z (Rs)**	**X (Rs)**	**Y (Rs)**	**Z (Rs)**
April 3 (from X to Y)	400	----	----	----	400	----
April 10 (from Y to X)	----	500	----	500	----	----
April 20 (from Z to Y)	----	----	300	----	300	----
April 30 (from X to Z)	200	----	----	----	----	200
Total	**600**	**500**	**300**	**500**	**700**	**200**

At the end of the period the inter-departmental transfers are recorded by recording the following accounting entry:

Receiving Department	Dr. (at transfer price)
X	500
Y	700
Z	200
Transferring Department	Cr. (at transfer price)
X	600
Y	500
Z	300

Solved Questions

A firm has two departments X and Y. Department Y (manufacturing department) receives goods from department X as its raw material. Department X supplies the goods to Y at cost price. From the following information prepare a Departmental Income Statement for the year ended on 31 December 2007:

Particulars	X Rupees	Y Rupees
Opening Stock (1-1-2007)	250,000	75,000
Purchases (Outside supplier)	1,000,000	20,000
Sales (Outside customer)	1,200,000	300,000
Closing stock (31-12-07)	150,000	50,000

Other Information:

1. Depreciation is charged on building @ 20% p.a. Cost of building is Rs. 105,000 and occupancy ratio is 2/3 and 1/3 for X and Y respectively.
2. X department transferred goods Rs. 250,000 to department Y.
3. Manufacturing expenses Rs. 10,000.
4. Selling expenses Rs. 15,000.
5. General expenses Rs. 58,000.

Solution:

Income Statement for the year ended December 31, 2007

Particulars	X (Rs).	Y (Rs).	Total (Rs).
Sales	1,200,000	300,000	1,500,000
Transfer to Y	250,000	----	250,000
Total Revenue	**1,450,000**	**300,000**	**1,750,000**
Less Cost of goods sold			
Opening stock	250,000	75,000	325,000
Add Purchases	1,000,000	20,000	1,020,000
Less closing stock	150,000	50,000	200,000
Transfer from X	----	250,000	250,000
Manufacturing expenses	----	10,000	10,000
Total cost	**1,100,000**	**305,000**	**1,405,000**
Gross profit	350,000	(5,000)	345,000
Less Selling expenses	12,000	3,000	15,000
Deprecation	14,000	7,000	21,000
Net profit	**324,000**	**(15,000)**	**309,000**
Less General expenses			58,000
Net profit of business			**251,000**

Working:

Selling expense Rs. 15,000

Particulars	X (Rs)	Y (Rs)
Sales	1,200,000	300,000
Sales ratio	12	3

X =15,000 X 12/15 = 12,000
Y =15,000 X 3/15 = 3,000

Depreciation expense

Building 105,000 X 20/100 = Rs. 21,000

Particulars	X (Rs)	Y (Rs)
Deprecation	2/3	1/3

X =21,000 X 2/3 = 14,000
Y =21,000 X 1/3 = 7,000

BRANCH ACCOUNTING

Introduction

Large business entities open up branches in diversified geographic segments such as towns and cities and even in different countries. Segmenting their business geographically facilitate the business to market its products/services over a large territory and thus increase its profits. Here we must make this distinction that departments are business segments whereas, branches are geographic segments.

A branch may be defined as a segment of an enterprise that is geographically separated from the rest of the entity, controlled by a head office, and generally carrying on the same or substantially same activities as of the entity.

For example in our daily life we observe branches of banks, bakeries, shoes stores, schools, hotels and restaurants etc.

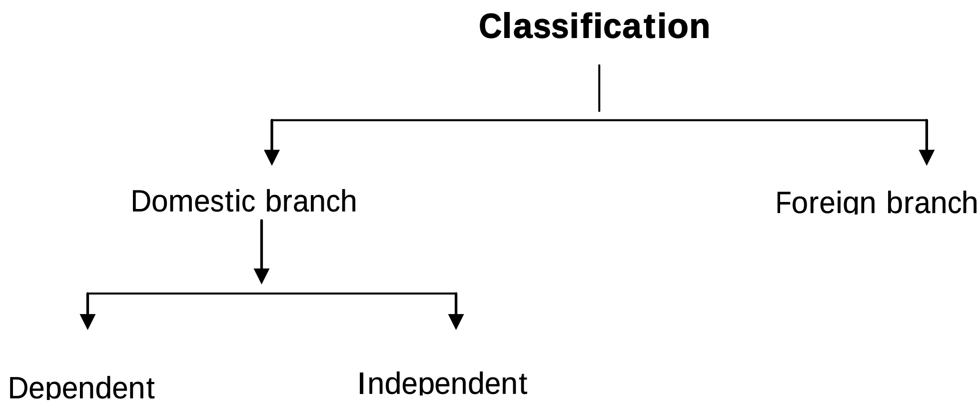
It is worth mentioning here that a branch is not a separate legal entity, it is simply a segment of an entity. From accounting perspective, a branch is identified as a profit centre and if it is an independent branch then it becomes an investment centre.

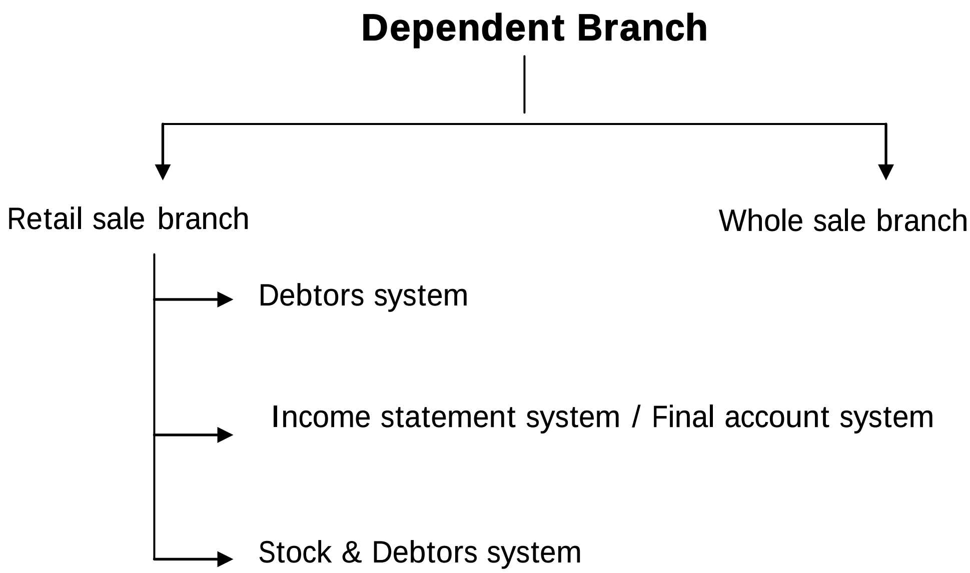
To have clear picture of the performance, profits of each branches are calculated separately and then are consolidated in the accounts of the head office. Depending upon the size of the branch, the decision is taken regarding the accounting system to be implemented there. If the branch size is small, there would have been single entry system. Where the branch size is considerable large and it can afford a complete accounts department there we will follow the double entry accounting system, such are often independent branches.

Classification of Branches

For accounting purposes branches are classified as under:

1. Foreign Branch *(not part of our syllabus)*
2. Domestic Branch
    a. Independent branch *(investment centre)*
    b. Dependent branch *(profit centre)*
        i. Whole-sale branch
        ii. Retail branch





Independent Branch
This is the type of branch which maintains its own set of books. The method of accounting is the double entry book keeping.
Branch manager of such a branch is given certain powers for decision making regarding procurement, selling, advertising, staffing, pricing, and even for purchasing of fixed assets. These branches are taken as an investment centre.

Dependent Branch
This is the type of branch which does not maintain its own set of books. All records are maintained by the head office, which is concerned with the branch profits only.
Branch manager of such a branch is not given decision making powers, the manager acts according to the instruction and policies directed by the head office.

LESSON # 11

BRANCH ACCOUNTING SYSTEM

Accounting system for Retail Dependent Branch

There are three methods to calculate profits of a retail dependent branch. Any of these can be used to calculate branch profits; nevertheless, selection of method will depend upon the nature of operations, size and level of complexity of the transaction.

- Debtor system
- Income statement system
- Stock and debtor system

Debtor System

This system of accounting is suitable for the small sized branches. In this system a Branch a/c is opened for each of the branches in the main ledger of head office. Each and every transaction that is made in between the head office and its branches is entered into the specific branch account. For example there are two branches of a business one in Gujranwala and the second in Karachi. The head office will open two ledger accounts in its main ledger one named and titled as Gujranwala Branch a/c and the other as Karachi Branch a/c. The branch accounts are maintained in such a way that these will give the amount of profits or losses of the respective branches.

Lets have a glance, how does a Branch a/c look like?

Books of the Head Office
Branch Account

Particulars		Rs.	Particulars		Rs.
Op. Stock		***	Op. Creditors	Opening Liability	***
Op. Debtors	Opening Assets	***	Op. Outstanding Expenses		***
Op. Petty Cash		***	Cash received from branch		
Op. Furniture		***	Cash Sales		***
Op. Prepaid Expenses		***	Collection from Debtors	Drawin	***
Goods sent to Branch		***	Goods Returned by Branch		***
Cash sent to branch	Fresh Capital		Cl. Stock		***
for branch expenses		***	Cl. Debtors	Closing Assets	***
for any other purpose		***	Cl. Petty Cash		***
Cl. Creditors	Closing Liability	***	Cl. Furniture		***
Cl. Outstanding Expenses		***	Cl. Prepaid Expenses		***
Profit & Loss A/c (Profit)		***	**Profit and Loss A/c (Loss)**		***
		***			***

In the above Branch a/c we can very well observe few facts which are as under:

1. At the beginning of the year the Branch a/c is debited with the opening balances of assets lying with the branch and credited with the opening balances of the branch liabilities. Doing this debit and credit as a result we have opening capital balance at debit side of the Branch a/c
2. At the ending of the year the Branch a/c is credit with the closing balances of assets lying with the branch and debited with the closing balances of the branch liabilities. Doing this debit and credit as a result we have closing capital balance at credit side of the Branch a/c

3. During the year the head office has sent to branch goods for selling and cash for whatever purposes. These both are debited to the Branch a/c. This can be considered as fresh capital (resources) introduced by head office into its branch.
4. During the year the head office has received goods (as returned goods) and cash (resources) from its branch, the source might be any one e.g. cash sales or credit customer or even by selling branch assets. This receipts of cash and return of goods is credited to the Branch a/c. This can be considered as drawings made by the head office out of the branch.

Now applying the rules studied in the single entry accounting system we can get the amount of net profit/loss of the branch.

Accounting Entries in the Books of Head Office

1. For opening balances of assets at the branch
   Branch a/c
   Branch assets a/c (individual accounts)

2. For opening balances of liabilities at the branch
   Branch liabilities a/c (individual accounts)
   Branch a/c

3. For goods sent to the branch
   Branch a/c
   Goods sent to branch a/c

4. For return of goods by the branch
   Goods sent to branch a/c
   Branch a/c

5. For remittance of cash or cheque to the branch
   Branch a/c
   Cash/Bank a/c

6. For cash or cheque received from the branch
   Cash/Bank a/c
   Branch a/c

7. For closing balances of assets at the branch
   Branch asset a/c (individual accounts)
   Branch a/c

8. For closing balances of liabilities at the branch
   Branch a/c
   Branch liabilities a/c (individual accounts)

9. For closing goods sent to branch account.
   Goods sent to branch a/c
   Purchases a/c

10. For closing branch account into the profit and loss account

Incase of profit

Branch a/c

Profit & loss a/c

Incase of loss

Profit & loss a/c

Branch a/

Solved Questions

From the following information relating to the **Sialkot Branch** for the year ending 31st March, 2007, prepare the Branch Account in the books of head office.

	Rs.		Rs.
Opening Stock at Branch	37,500	Cheque sent to Branch	
Opening Debtors in Branch	75,000	Salaries	22,500
Opening Petty Cash at Branch	750	Rent & Taxes	3,750
Goods Sent to Branch	630,000	Petty Cash	2,750
Cash Sales	150,000	Closing Stock at Branch	62,500
Cash Received from Debtors	525,000	Closing Debtors at Branch	120,000
Goods Returned by Branch	5,000	Closing Petty Cash at Branch	500
Credit Sales	570,000		

Solution:

Books of Head Office- Sialkot Branch Account

Particulars	Rs.	Particulars	Rs.
Opening Stock	37,500	Cash Received from Branch	675,000
Opening Debtors	75,000	Goods returned from Branch	5,000
Opening Petty Cash	750	Closing Stock	62,500
Cash sent to Branch	29,000	Closing Debtors	120,000
Goods sent to Branch A/c	630,000	Closing Petty Cash	500
General Profit & Loss A/c (Profit)	90,750		
	863,000		863,000

Solved Questions

Excellent Garments of Multan has a branch at Lahore. Goods are supplied to the branch at cost. The expenses of the branch are paid from Multan and the branch keeps a sales journal and the debtors' ledger only. From the following information supplied by the branch, prepare a Branch Account in the books of the head office. (All figures in rupees)

Opening Stock	24,000	Closing Debtors	9,150
Closing Stock	18,000	Opening Debtors	?
Goods received from HO	33,600	Bad Debt	140
Credit Sales	41,000	Exp. paid by Head office	10,400
Cash Sales	17,500	Cash received from Debtors	37,900
Pilferage of goods by the employees (Normal Loss)			2,000

Solution:

In the books of Head Office (Multan)
Lahore Branch Account

Particulars	Rs.	Particulars	Rs.
Opening Stock	24,000	Cash Received from Branch	17,500
Opening Debtors	6,200	Cash Received from Debtors	37,900
Cash sent to Branch	10,400	Closing Stock	18,000
Goods sent to Branch a/c	33,600	Closing Debtors	9,160
General Profit & Loss a/c (Profit)	8,360		
	82,560		82,560

Working:

Debtors Account

Particulars	Rs.	Particulars	Rs.
Op. Debtors (Balancing fig)	6,200	Cash Received from Debtors	37,900
		Bad Debts	140
Sales (credit)	41,000	Cl. Debtors c/f	9,160
	47,200		47,200

<u>Solved Questions</u>

From the following particulars of a dependent branch. Prepare Branch a/c showing the profit or loss of the branch for the year ended 31-12-2007: (all figures are in Rs.)

Opening stock	30,000	Goods sent to branch	90,000
Cash sent by head office		Cash sales	120,000
for salaries	10,000		
for other expenses	4,000		

Closing stock could not be ascertained but it is know that the branch usually sells at cost plus 20% of the cost.

Solution:

Branch Account

	Rupees		*Rupees*
Opening stock	30,000	Cash received from branch	120,000
Goods sent to branch	90,000	closing stock	20,000
Cash sent to branch	14,000		
Profit & loss a/c	**6,000**		
	140,000		**140,000**

Working:

Calculation for Closing Stock

Sales at	120%	120,000
Cost of sales at	100%	120,000 x100/120 = 100,000

Opening stock + Goods sent – Closing stock = Cost of sales
30,000 + 90,000 – X = 100,000
X (closing stock) = 120,000 – 100,000
X (closing stock) = 20,000

LESSON # 12

BRANCH ACCOUNTING SYSTEM (Cont.)

Income Statement System

The head office may also prepare an Income Statement to find out the profits of branch. Such Income Statement is merely a memorandum; the only reason for preparing the statement is to have full information of all transactions which are ignored in Debtor System (already discussed in the previous section). While preparing the Income Statement of the branch we shall be using all those skills which we have learned in the single entry system of accounting during conversion of single entry into double entry.

We know very well that in "Income Statement" incomes and expenses are measured on the basis of accrual concept and the profits are measured according to the matching concept. So the cost of goods sold will be determined keeping in view that the goods sent to branch are equivalent to purchases of the branch and should be included at cost. Obviously the opening and closing stocks can not be measured at a value that is above its cost.

Above problem can be solved through Income Statement System as well. Following is the solution.

Accounting Entries in the Books of Head Office

1. *For opening balances of assets at the branch*
   Branch a/c
   Branch assets a/c (individual accounts)

2. *For opening balances of liabilities at the branch*
   Branch liabilities a/c (individual accounts)
   Branch a/c

3. *For goods sent to the branch*
   Branch a/c
   Goods sent to branch a/c

4. *For return of goods by the branch*
   Goods sent to branch a/c
   Branch a/c

5. *For reversal of loading on (net) goods set to branch*
   Goods sent to branch a/c
   Branch a/c

6. *For remittance of cash or cheque to the branch for expense*
   Branch a/c
   Cash/Bank a/c

7. *For cash or cheque received from the branch*
   Cash/Bank a/c
   Branch a/c

8. *For closing balances of assets at the branch*
   Branch asset a/c (individual accounts)
   Branch a/c

9. *For closing balances of liabilities at the branch*
   Branch a/c
   Branch liabilities a/c (individual accounts)

10. *For closing goods sent to branch account.*
    Goods sent to branch a/c
    Purchases a/c

11. *For closing branch account into the profit and loss account*

<u>*Incase of profit*</u>
Branch a/c
Profit & loss a/c

<u>*Incase of loss*</u>
Profit & loss a/c
Branch a/c

12. *For abnormal loss (should always be accounted for at cost)*
    Abnormal loss a/c (at cost)
    Branch a/c

    Insurance claim a/c (claim admitted)
    Profit & loss a/c (balance if not admitted by the insurance company)
    Abnormal loss a/c (cost of the abnormal loss)

Note: No accounting entry is required for normal losses.

<u>Solved Questions</u>

Excellent Garments of Multan has a branch at Lahore. Goods are supplied to the branch at cost. The expenses of the branch are paid from Multan and the branch keeps a sales journal and the debtors' ledger only. From the following information supplied by the branch, prepare profit and loss account using income statement system in the books of the head office. (All figures in rupees)

Opening Stock	24,000	Closing Debtors	9,150
Closing Stock	18,000	Opening Debtors	?
Goods received from HO	33,600	Bad Debt	140

Credit Sales	41,000	Exp. paid by Head office	10,400
Cash Sales	17,500	Cash received from Debtors	37,900
Pilferage of goods by the employees (Normal Loss)			2,000

Solution:

Income statement
In the books of Head Office (Multan)

	(Rs.)	(Rs.)
Sales		
Cash sales	41,000	
Credit sales	17,500	**58,500**
Less: Cost of Goods Sold:		
Opening Stock	24,000	
Add: Received From H.O	33,600	
Less: Closing Stock	18,000	**39,600**
Gross Profit		18,900
Less: Expenses		
Expenses	10,400	
Bad debts	140	**10,540**
Net profit		**8,360**

Note: pilferage of Rs. 2,000 is treated as normal loss

Pro-forma Invoice Price

Head office may send goods to branch either at "cost" or at "pro-forma invoice price". In previous section of this chapter we have discussed accounting treatment for a dependent branch to which the goods are sent to branch at cost price. In the forthcoming section we will discuss the accounting treatment for the dependent branch to which goods are sent at pro-forma invoice price. The treatment is slightly different but before discussing the accounting treatment we must know what pro-forma invoice price is and why head office prefers to send goods at pro-forma invoice price.

Pro-forma invoice price is higher than the cost price. Adding a reasonable profit in the cost makes the price equal to the pro-forma invoice price. Here we must know what is selling price? Selling price is the price at which goods are sold to the customers. So the selling price will be higher than the pro-forma invoice price in normal circumstances. Difference between cost and pro-forma invoice price is known as loading and the difference between cost and the selling price is the profit in real terms.

Head office usually sends goods to its branches at the pro-forma invoice price to keep its profit margin secret from the branch managers. Had the cost been known to the branch manager he would have been in a position to determine the exact profits enjoyed by the head office, which may induce the branch manager to confront the business as a competitor. Moreover by sending goods to the branches at pro-forma invoice price, the head office can dictate pricing policy to its branches, as well as save work at the branch because prices have already been decided. Sending goods at pro-

forma invoice price is generally done where goods are of standard type, pre-packed and unlikely to fluctuate in price.
Here it is worth mentioning that "pro-forma invoice" is name of the document which is sent to branches along with the goods sent; in this document description and quantity of the goods sent is written along with the price. Therefore the price appearing on the pro-forma invoice is named as pro-forma invoice price.
The document which is sent to the customers to evident the sales of goods to them is known as "invoice"; this document discloses the quantity, description and selling price of the goods sold, along with the settlement terms. Technically speaking "selling price" may also be termed as "invoice price", but "invoice price" and "pro-forma invoice price" are different. It is a common error that often people do not care while using the terminology and confuse "invoice price" with the "pro-forma invoice price".
The method of preparing Branch a/c while goods are sent at pro-forma invoice price is the same with the exception that the accounting entries relating to the goods sent to and goods returned from the branch are recorded at pro-forma invoice price and a reverse adjustment is required with the amount of loading (difference between cost and pro-forma invoice price).
Remember; the accounting entries for opening and closing stocks are recorded at cost price. Do not record stocks at pro-forma invoice price.
Rationale; an accountant is supposed to record accounting entries evidenced by a source document. Goods sent to branch are evidenced through "pro-forma invoice" therefore price mentioned on the document cannot be ignored while recording this transaction. Whereas, valuation of opening and closing stocks is not reported through pro-forma invoice therefore to make it simple, stocks are accounted for at cost.

Accounting Entries in the Books of Head Office

1. *For opening balances of assets at the branch*
   Branch a/c
   Branch assets a/c (individual accounts)

2. *For opening balances of liabilities at the branch*
   Branch liabilities a/c (individual accounts)
   Branch a/c

3. *For goods sent to the branch (at pro-forma invoice price)*
   Branch a/c
   Goods sent to branch a/c

4. *For return of goods by the branch (at pro-forma invoice price)*
   Goods sent to branch a/c
   Branch a/c

5. *For reversal of loading on (net) goods set to branch (with the amount of loading)*
   Goods sent to branch a/c
   Branch a/c

6. *For remittance of cash or cheque to the branch*
   Branch a/c
   Cash/Bank a/c

7. *For cash or cheque received from the branch*
   Cash/Bank a/c
   Branch a/c

8. *For closing balances of assets at the branch*
   Branch asset a/c (individual accounts)
   Branch a/c
9. *For closing balances of liabilities at the branch*
   Branch a/c
   Branch liabilities a/c (individual accounts)

10. *For closing goods sent to branch account.*
    Goods sent to branch a/c
    Purchases a/c

11. *For closing branch account into the profit and loss account*

Incase of profit
Branch a/c
Profit & loss a/c

Incase of loss
Profit & loss a/c
Branch a/c

12. *For abnormal loss (should always be accounted for at cost)*
    Abnormal loss a/c (at cost)
    Branch a/c

    Insurance claim a/c (claim admitted)
    Profit & loss a/c (balance if not admitted by the insurance company)
    Abnormal loss a/c (cost of the abnormal loss)

Note: No accounting entry is required for normal losses.

Solved Questions

Excellent Garments of Multan has a branch at Lahore. Goods are supplied to the branch at cost. The expenses of the branch are paid from Multan and the branch keeps a sales journal and the debtors' ledger only. From the following information supplied by the branch, prepare a Branch Account in the books of the head office. Goods are sent to branch at pro-forma invoice price which is cost plus 20%. (All figures in rupees)

Opening Stock (at Pro-forma invoice)	28,800	Closing Debtors	9,150
Closing Stock (at Pro-forma invoice)	21,600	Opening Debtors	?
Goods received from HO (at Pro-forma invoice)			40,320
Bad Debt	140		
Credit Sales	41,000		
Expenses paid by Head office	10,400		
Cash Sales	17,500		
Cash received from Debtors	37,900		
Pilferage of goods by the employees (Normal Loss)	2,000		

Solution:
(Debtors System)
In the books of Head Office (Multan)
Lahore Branch Account

Particulars	Rs.	Particulars	Rs.
Opening Stock	24,000	Cash Received from Branch	17,500
Opening Debtors	6,200	Cash Received from Debtors	37,900
Cash sent to Branch	10,400	Goods sent to Branch	
Goods sent to Branch a/c	40,320	(loading)	6,720
General Profit & Loss a/c	**8,360**	Closing Stock	18,000
(Profit)		Closing Debtors	9,160
	89,280		89,280

Working:
Debtors Account

Particulars	Rs.	Particulars	Rs.
Op. Debtors (Balancing fig)	6,200	Cash Received from Debtors	37,900
		Bad Debts	140
Sales (credit)	41,000	Cl. Debtors c/f	9,160
	47,200		47,200

Opening stock at cost
28,800 x 100/120 = **24,000** (pro-forma invoice **x** % of cost ***by*** % of pro-forma invoice)

Closing stock at cost
21,600 x 100/120 = **18,000** (pro-forma invoice **x** % of cost ***by*** % of pro-forma invoice)

Loading on goods sent to branch (net)	*Rupees*
Goods sent to branch (at pro-forma invoice)	40,320
Less Goods returned by branch (at pro-forma invoice)	0
Net goods sent (at pro-forma invoice)	40,320

40,320 x 20/120 = **6,720** (pro-forma invoice **x** % of loading **by** % of pro-forma invoice)

LESSON # 13

BRANCH ACCOUNTING SYSTEM (Cont.)

Solved Questions

Opening stock at invoice price (1 Jan, 2008)	Rs. 3,000
Goods sent to branch at invoice price	Rs. 24,000
Remittance from branch	Rs. 25,000
Cash paid by the head office for sundry expenses	Rs. 4,500
Return from the branch invoice price	Rs. 150
Closing stock at invoice price	Rs. 8,000

Solution:-
Cost of opening stock = 3,000 / 125 x 100 = 2,400
Cost of closing stock = 8,000 / 125 x 100 = 6,400
Goods sent to branch = 24,000
Goods return from HO = 150
$\boxed{23,850}$
Invoice price of the goods sent to branch netted off by good return from HO = 23,850
Loading = 23,850 / 125 x 25 = 4,770

Branch
In the books of Head Office

Particulars	Rs.	Particulars	Rs.
Opening stock	2,400	Cash received from HO	25,000
Goods sent to branch	24,000	Goods return to HO	150
Cash send to branch for expenses	4,500	Goods sent to branch (Reverse of loading)	4,770
Profit/Loss	5,420	Closing stock	6,400
Total	36,320	Total	36,320

Accounting Entries (For abnormal loss):

At the time of loss
Abnormal loss A/c 4,000
Branch A/c 4,000
Insurance claim
Insurance claim A/c 3,500
Abnormal loss A/c 3,500
Profit & loss
Profit & loss A/c 500
Abnormal loss A/c 500

BRANCH ACCOUNTING - STOCK AND DEBTOR SYSTEM

Stock and Debtors system is generally used when the goods are sent to the branch at pro-forma invoice price and the size of the branch is large. Under this system, the branch maintains a few central accounts to exercise greater control over the branch stock and other related expenses. These accounts usually are:

1. Branch Stock Account
2. Branch Debtors Account
3. Branch Expenses Account
4. Branch Adjustment Account
5. Goods Sent to Branch Account
6. Branch Stock Reserve Account

Branch Stock Account

This account is on the pattern of a stock account. The account helps the Head Office in maintaining an effective control over the Branch Stock and tells about shortage and surplus in the branch stock because of the difference between the pro-forma invoice price and the selling price.

Unlike traditional accounting practice, branch stock a/c is always maintained on the selling price or pro-forma invoice price. Selling price is used to record the goods sold by the branch to its customer and goods returned by the branch customers. Rest of the information (even opening and closing balances) in branch stock a/c is recorded at pro-forma invoice price.

Branch Debtors Account

Branch debtors' a/c is maintained in the traditional manner to record transactions in between branch and its credit customers.

Branch Expense Account

The purpose of maintaining this account is nothing but to compile all branch expenses at one place. This will include all types of expenses i.e. cash based expenses and receivables based expenses.

Branch Adjustment Account

Branch adjustment a/c replaces the branch income statement (profit & loss a/c). This is the account in which all expenses and losses are closed along with the margin that is a difference between cost and the selling price. This difference is split into two; one is termed as "surplus" that comes from the branch stock a/c representing the difference between selling price and pro-forma invoice price, the second is termed as "loading" that represents the difference between pro-forma invoice price and cost. This loading is calculated on opening and closing stock balances and also on the net of the goods sent branch.

Goods Sent to Branch Account

This is a supporting account, which is maintained to show second effects of the goods sent to branch and the goods returned from branch at pro-forma invoice price. Although the goods sent to and returned form the branch should be adjusted in the purchases a/c of the head office, but as we know that the branch stock a/c is not maintained at cost price, therefore, second effect of goods sent to and returned from branch is not recorded directly into the purchases a/c instead this second effect is recorded into the goods sent to branch a/c which after adjustment of the loading is finally closed into the purchases a/c.

Branch Stock Reserve Account

This is contra to branch stock account. In this account opening and closing balance of loading on branch stock is maintained.

ACCOUNTING ENTRIES IN THE BOOKS OF HEAD OFFICE

Sr no.	JOURNAL ENTRIES	Debit	Credit
(1)	**For Goods Sent to Branch (at Invoice)** Branch Stock Account (Dr) Goods Sent To Branch Account (Cr)	xxx	xxx
(2)	**For Goods Sold At Branch On Credit** Branch Debtors Account (Dr) **(At Selling Price)** Branch Stock Account (Cr)	xxx	xxx
(3)	**For Goods Sold At Branch For Cash** Branch Cash Account (Dr) **(At Selling Price)** Branch Stock Account (Cr)	xxx	xxx
(4)	**For Cash Received From Branch Debtors** Branch Cash Account (Dr) Branch Debtors Account (Cr)	xxx	xxx
(5)	**For Goods Returned by debtors** Branch Stock Account (Dr) Branch Debtors Account (Cr)	xxx	xxx
(6)	**For Goods Returned by Branch To Head Office** Goods Sent To Branch Account (Dr) **(At Invoice)** Branch Stock Account (Cr)	xxx	xxx
(7)	**For Cash Sent By Head Office to Branch For Expenses** Branch Expenses Account (Dr) Cash Account (Cr)	xxx	xxx
(8)	**For Bad Debts/ discount Allowed To Branch Debtors** Branch expense Account (Dr) Branch Debtors Account (Cr)	xxx	xxx
(9)	**For Shortage/ Shrinkage in Branch Stock** Branch Adjustment Account (Dr)	xxx	

	Branch Stock Account (Cr)		xxx
(10)	**For Surplus In Branch Stock** Branch Stock Account (Dr) Branch Adjustment Account (Cr)	xxx	xxx
(11)	**For Closing Branch Expenses Account Into Branch Adjustment Account** Branch Adjustment Account (Dr) Branch Expenses Account (Cr)	xxx	xxx
(12)	**For Transfer of Opening Stock Reserve (Loading) Into The Branch Adjustment Account** Branch Stock Reserve Account (Dr) **(with loading of opening** Branch Adjustment Account (Cr)	xxx	xxx
(13)	**For Creating Stock Reserve on Closing Balance of Stock (Loading on Closing Stock)** Branch Adjustment Account (Dr) Branch Stock Reserve (Cr)	xxx	xxx
(14)	**For Loading on Net Amount of Goods Sent to Branch** Goods Sent to Branch Account (Dr) Branch Adjustment Account (Cr)	xxx	xxx
(15)	**For Closing Goods Sent To Branch Account Into Purchase Account** Goods Sent To Branch Account (Dr) Purchases Account (Cr)	xxx	xxx
(16)	**For Closing the Branch Adjustment Account Into Profit & Loss Account** Branch Adjustment Account (Dr) **(with the amount of profit on branch)** Profit & Loss Account (Cr)	xxx	xxx

LEDGER ACCOUNTS
IN THE MAIN LEDGER OF HEAD OFFICE

BRANCH STOCK ACCOUNT			
Particulars	**Debit**	**Particulars**	**Credit**
Balance Brought Forward (At Invoice)	******	Branch Debtors (Credit Sales) (Selling Price)	Jef (2)
Goods Sent to Branch (At Invoice)	Jef (1)	Branch Cash (Cash Sales)(Selling Price)	Jef(3)
Branch Debtors (Sales Return)	Jef (5)	Goods Sent to Branch (Return)	Jef(6)
Branch Adjustment (Surplus)	Jef (10)	Branch Adjustment (Shortage)	Jef(9)
		Balance Carried Forward (At Invoice)	******

GOODS SENT TO BRANCH ACCOUNT			
Particulars	**Debit**	**Particulars**	**Credit**

Branch Stock (Credit Sales)	Jef(6)	Branch Stock (Goods Sent) (At Invoice)	Jef(1)
Branch Adjustment (Loading)	Jef(14)		
Purchases (Balancing Figure)	Jef(15)		

BRANCH EXPENESE ACCOUNT			
Particulars	**Debit**	**Particulars**	**Credit**
Cash (Expense)	Jef(7)	Branch Adjust (Closing)	Jef(11)
Branch Debtors (Discount Allowed + Bad Debts)	Jef(8)		

BRANCH DEBTORS ACCOUNT			
Particulars	**Debit**	**Particulars**	**Credit**
Opening Balance Brought Forward	******	Cash Received	Jef(4)
Branch Stock (Credit Sales)	Jef(2)	Branch Stock (Sales Return)	Jef(5)
		Branch Expense (Bad Debts + Discount Allowed)	Jef(8)
		Balance Brought Forward	******

STOCK RESERVE ACCOUNT			
Particulars	**Debit**	**Particulars**	**Credit**
Branch Adjustment (Transfer of Opening Balance)	Jef(12)	Opening Stock Reserve Brought Forward	******
Closing Stock Reserve Balance c/f	******	Branch Adjustment (Closing Loading)	Jef(13)

BRANCH ADJUSTMENT ACCOUNT			
Particulars	**Debit**	**Particulars**	**Credit**
Branch Stock (Shortage)	Jef (9)	Branch Stock (Surplus)	Jef(10)
Branch Expense (Closed)	Jef (11)	Branch Stock Reserve (Opening Balance)	Jef(12)
Branch Stock Reserve (Closing)	Jef (13)	Goods Sent to Branch (Loading)	Jef(14)
Profit & Loss Account (Balancing Figure)	Jef (16)		

Note: (Jef = Journal Entry Reference)

LESSON # 14

BRANCH ACCOUNTING - STOCK AND DEBTOR SYSTEM (Cont.)

Solved Questions

On 1st January, 2008 goods costing Rs. 132,000 were invoiced by Multan head office to its new branch at Lahore and charged at selling price to produce a gross profit of 25% on the selling price. At the end of the year, the return from Lahore Branch showed that the credit sales were Rs. 150,000. Goods invoiced at Rs. 2,000 to Lahore branch have been returned to Multan head office. The closing stock at Lahore branch was Rs. 24,000 at selling price. Record the above transactions in the books of
(i) Lahore Branch Stock Account; (ii) Goods Sent to Lahore Branch Account; (iii) Lahore Branch Adjustment Account; and (iv) Lahore Branch Debtors Account in the head office book and close the said accounts on 31st December 2008.

Solution

In the Books of the Head Office, Multan

Lahore Branch Stock Account

Date	Particulars	Rs.	Date	Particulars	Rs.
2008 Dec.1	To Goods Sent to LHR Br. A/c	176,000	2008 Dec.31	By Goods Sent to LHR Br. A/c (Returns)	2,000
					150,000
				By Branch Debtor A/c (Credit Sales)	24,000
		176,000		By Balance c/d	176,000

Goods Sent to Lahore Branch Account

Date	Particulars	Rs.	Date	Particulars	Rs.
2008 Dec.31	To Lahore Branch Stock A/c (Returns)	2,000	2008 Dec.31	By Lahore Branch Stock A/c	176,000
	To Lahore Branch Adjustment A/c	43,500			
	To Purchases A/c (Transferred)	130,500			
		176,000			176,000

Lahore Branch Debtors Account

Date	Particulars	Rs.	Date	Particulars	Rs.
2008 Dec.31	To Lahore Brach Stock A/c	150,000	2008 Dec.31	By Balance c/d	150,000
		150,000			150,000

Lahore Branch Adjustment Account

Date	Particulars	Rs.	Date	Particulars	Rs.
2008 Dec.31	To Stock Reserve A/c	6,000	2008 Dec.31	By Goods Sent to Delhi Branch A/c	43,500
	To General Profit & Loss A/c	37,500			
		43,500			43,500

Solved Questions

X Ltd. of Karachi has a branch at Lahore. Goods are invoiced to the branches at cost plus $33^1/_3$%. The branch remits all cash received to the head office and all expenses are paid by the head office. From the following particulars, prepare Branch Stock Account, Branch Adjustment Account, Branch Debtors Account and Branch Profit & Loss Account in the books of the head office. (All figures in Rs.)

Branch Debtors on 1.1.2008	6,000
Branch Stock on 1.1.2008 (invoice price)	2,400
Sales Cash Credit	3,000 60,000
Goods from head office (invoice price)	72,000
Cash received from Debtors	57,600
Discount allowed to Debtors	1,400
Bad debts	300
Branch expenses paid by Head Office	5,000
Branch stock on 31.12.2008 (invoice price)	12,000

Solution

In the Books of the Head Office, Karachi

Branch Stock Account

Date	Particulars	Rs.	Date	Particulars	Rs.
2008 Jan.1 Dec.31	To Balance b/d To Goods Sent to Branch A/c Branch Adjustment (Surplus)	2,400 72,000 600	2008 Dec.31	By Bank A/c (Cash sales) By Branch Debtors A/c By Balance c/d	3,000 60,000 12,000
		75,000			75,000

Branch Adjustment Account

Date	Particulars	Rs.	Date	Particulars	Rs.
2008 Dec.31	**Branch Expense:** Discount allowed Bad debts Cash expenses Closing stock	 1,400 300 15,000 3,000	2008 Dec.31	By Stock Reserve A/c (2,400 x 33.33/133.33) By Goods sent to Branch A/c Branch Stock (Surplus) Loss (Bal Fig.)	600 18,000 600 500
		19,700			19,700

Branch Debtors Account

Date	Particulars	Rs.	Date	Particulars	Rs.
Jan.1 2008	To Balance b/d	6,000	2008	By Bank A/c	57,600
			Dec.31	By Branch Expenses A/c	
				Discount Allowed	1,400
				Bad debts	300
Dec31	To Branch Stock A/c	60,000		By Balance c/d	6,700
		66,000			66,000

Branch Account

	Rupees		*Rupees*
Opening Debtors	6,000	Cash Received	60,600
Opening Stock (at cost)	1,800	Goods Returned	0
Goods sent to branch (at Inv.)	72,000	Goods sent to branch (loading)	18,000
Cash sent to branch	15,000	Closing Debtors	6,700
		Closing Stock (at cost)	9,000
		Income Statement (loss)	500
	94,800		**94,800**

Branch
Income Statement

		Rupees
Sales		63,000
Cost of goods sold		
Opening stock (at cost)	1,800	
Goods received from head office (at cost)	54,000	
Closing stock (at cost)	9,000	(46,800)
Gross profit		16,200
Operating expenses		
Cash expenses	15,000	
Bad debts	300	
Discount allowed	1,400	(16,700)
Loss transferred to head office Income Statement		(500)

LESSON # 15

BRANCH ACCOUNTING (Cont.)

Whole Sale Branch

Sometimes, the head office (specifically dealing the manufacturing activities) sells goods to actual consumers through its retail shops. In this case, the head office sends goods to the branches at wholesale prices which cost plus a percentage of profit. The branch is likely to sell those goods at retail prices which are more than the wholesale prices. The real profit earned by the branch is the difference between the retail selling price and the wholesale price. For example the cost price of an article is Rs. 100, the wholesale price, Rs. 160 and the retail selling price, Rs. 180. Where an article is sold by the branch, the actual profit is Rs. 180 – 100 = Rs. 80 but the branch's profit is Rs. 180 – 160 = Rs. 20.

This system of accounting is followed for dependent branches where these are treated as profit centre only. The real cost of the branch is the whole sale price of the goods sent. But, we must remember that wholesale prices are fixed above cost. Therefore, if all the goods that have been sent to branch are sold no problem arises. The real problem arises when a part of stock remains unsold at the branch, which includes an element of profit that could not be realized by the head office. Such unrealized profit is reversed in the books of head office by recording this accounting entry:

Income Statement a/c Dr. *(Wholesale price less cost price)*
Stock Reserve a/c Cr.

In the balance sheet the branch stock is shown at cost i.e. after deducting stock reserves.

Solved Questions

White limited has retail branch at Gujranwala. Goods are sold on 60% profit on cost. The wholesaler price is cost pus 40%. Goods are invoiced from Calcutta head office to Gujranwala branch at wholesale price. From the following particulars, ascertain the profit made at head office and branch for the year ended 31.12.2007. You are required to calculate the profit of head office and the profit of branch also.

Particulars	Head office (Rs.)	Branch (Rs.)
Stock on 1.1.2007	175,000	----------
Purchases	1,050,000	----------
Goods sent (invoice price)	378,000	----------
Expenses (Selling)	56,000	7,000
Sales	1,071,000	350,000
Stock on 31.12.2007	420,000	63,000

Solution:

Particulars	Head office (Rs.)		Branch (Rs.)	
Sales				350,000
Goods sent to branch	1,071,000			
Sales	378,000	1,449,000		
Less: Cost of Goods Sold				
Opening stock	175,000			
Add: Purchases/				
Received from H.O	1,050,000		378,000	
Less: Closing Stock	420,000	805,000	63,000	315,000
Gross Profit		**644,000**		**35,000**
Less: Expenses		56,000		7,000
Less: unrealized profit		18,0000		-------
Net profit		**570,000**		**28,000**

Unrealized profit = 63,000/140* 40 = Rs. 18,000

Unrealized profit=

$$\frac{\text{Branch closing stock}}{\text{Cost + Loading}} \text{ x Loading}$$

INDEPENDENT BRANCH

Steps involved in preparing accounts of independent branch

- Reconciliation
- Adjustment
- Incorporation

Reconciliation

Reconciliation of the balance of head office account appearing in the books of Branch with the balance of branch account appearing in the books of head office

Reasons of Difference

The two balances might be different because of following reasons:

1. Cash in transit
2. Goods in transit
3. Mistake committed by either party

NOTE: Accounting entry for reconciliation will be passed in the books of either party

Accounting Entries

Cash in transit
Cash in transit A/C
Branch A/C or Head office A/C

Goods in transit
Goods in transit A/C
Branch A/C or Head office A/C

Mistakes
Account to be rectified
Branch A/C or Head office A/C

Branch A/C or Head office A/C
Account to be rectified

Adjustments on the books of both parties

Certain information are required to be adjusted in the books of both the parties (head office and branch). These include:

1. Allocation of head office expense
2. Depreciation on branch assets
3. Inter branch transfers

Accounting Entries

Books of head office
Allocation of head office expense
Branch A/C
Specific Expense A/C
Depreciation of branch assets
Branch A/C
Provision for depreciation A/C
Inter branch transfers
Receiving Branch A/C
Transferring Branch A/C

Books of branch
Allocation of head office expense
Specific Expense A/C
Head office A/C
Depreciation of branch assets
Depreciation Expense A/C
Head office A/C

<u>Inter branch transfers</u>

Books of Transferring Branch

Head office A/C

Goods returned to head office

Books of Receiving Branch

Goods received from head office

Head office A/C

<u>Incorporation</u>

Meanings:

Incorporation of branch trial balance into the books of head office. (Consolidation)

Note: Accounting entries for incorporation are passed in the books of head office only

<u>Accounting Entries</u>

To incorporate Branch other income

Branch A/C

Profit & Loss A/C (income)

To incorporate Branch Assets

All assets (individually)

Branch A/C

To incorporate Branch Liabilities

Branch A/C

All Liabilities (individually)

Note: After passing the accounting entries for incorporation the branch account Appearing in the trial balance of head office will give Nil Balance.

LESSON # 16

BRANCH ACCOUNTING
(Incorporation of branch)

Solved Questions

The following is the Trial Balance of Murree Branch as on 31st December, 2007.

Particulars	Dr. (Rs.)	Cr. (Rs.)	Particulars	Dr. (Rs.)	Cr. (Rs.)
Lahore head office	3,240		Debtors	3,700	
Stock 1st Jan. 2007	6,000		Creditors		1,850
Purchases	97,800		Rent	1,960	
Goods received from H O	19,000		Sundry office expenses	1,470	
Sales		138,000	Cash at bank	1,780	
Goods supplied to head office / Sales to H O		6,000	Furniture	6,000	
Salaries	4,500		Depreciation on Furniture	400	
				145,850	145,850

Other Information:

Stock at branch on 31st December 2007 was valued at Rs. 7,700. Murree Branch Account in the head office books on 31st December, 2007 stood at Rs. 460 (debit balance). On 28th December, 2007 the head office forwarded goods of the value of Rs. 3,700 to the branch where they were on 3rd January, 2007.

Solution

1- Reconciliation entry

Goods in Transit A/c	3,700	
To Murree Branch A/c		3,700
(Being goods sent to branch on 28th December, received on 3rd January, 2007)		

2-

Murree
Income Statement
For the year ended 31st December, 2007

Sales		138,000
Goods supplied to H O		6,000
		144,000
Less CGS		
Opening Stock	6,000	
Add Purchases	97,800	

Goods received from H O	19,000	
Less Closing Stock	7,700	
		115,100
Gross Profit		28,900
Less operating Expenses		
Salaries	4,500	
Rent	1,960	
Sundry Office Expenses	1,470	
Depreciation on Furniture	400	
		8,330
Net Profit		20,570

Balance sheet of Murree Branch
As on 31st December, 2007

Asset	Amount Rs.	Liabilities	Amount Rs.
Fixed Assets:		**Head Office:**	
Furniture	6,000	Opening Balance (Cr.) 460	
Current Assets:		Add: Profit 20,570	21,030
Closing stock	7,700	Creditor	1,850
Debtors	3,700		
Goods in transit	3,700		
Cash at bank	1,780		
Total	22,880	Total	22,880

In the books of Head Office

Date	Particulars	L.F.	Dr. Rs.	Cr. Rs.
2006 Dec.31	Meerut Branch A/c		20,570	
	To General Profit & Loss A/c			20,570
	(being the incorporation of branch net profit)			
	Murree Branch Furniture A/c		6,000	
	Murree Branch Debtors A/c		3,700	
	Murree cash in transit A/c		3,700	
	Murree Branch Stock A/c		7,700	
	Murree Branch Cash A/c		1,780	
	To Murree Branch A/c			22,880
	(Being the incorporation of branch assets)			
	Murree Branch A/c		1,850	
	To Murree Branch Creditors A/c			1,850
	(Being the incorporation of branch liability)			

B:

If additional information is given as:

Advertisement expenses allocated by HO Rs. 1,000 Depreciation charged by HO on branch equipments @10% using straight line method.

Solution:

Head office	**Branch**
Branch A/c 1,000	Advertisement A/c 1,000
Advertisement A/c 1,000	Head office A/c 1,000
Branch A/c 500	Provision for dep. A/c 500
Provision for dep. A/c 500	Head office A/c 500

Murree Branch Account
(In the books of head office)

Particulars	Rs.	Particulars	Rs.
Balance b/d	460	Balance c/f	1,960
Advertisement	1,000		
Depreciation expense	500		
Total	**1,960**	**Total**	**1,960**

Head office Account
(In the books of branch)

Particulars	Rs.	Particulars	Rs.
Balance c/f	1,960	Balance b/d	460
		Advertisement	1,000
		Depreciation expense	500
Total	**1,960**	**Total**	**1,960**

Murree
Income Statement
For the year ended 31st December, 2007

		(Rs.)
Sales	138,000	
Goods supplied to H O	6,000	
		144,000
Less CGS		
Opening Stock	6,000	
Add Purchases	97,800	
Goods received from H O	19,000	

Less Closing Stock	7,700	
		115,100
Gross Profit		**28,900**
Less operating Expenses		
Salaries	4,500	
Rent	1,960	
Sundry Office Expenses	1,470	
Depreciation on Furniture	400	
Advertisement on Equipment	1,000	
Depreciation on Furniture	500	
		9,830
Net Profit		**19,070**

Balance sheet
Murree Branch
As on 31st December, 2007

Asset	Rs.	Liabilities	Rs.
Fixed Assets:		**Head Office:**	
Furniture	6,000	Opening Balance (Cr.) 460	
Current Assets:		Add: advertisement 1,000	
Closing stock	7,700	Depreciation 500	1,960
Debtors	3,700	Add: Profit	19,070
Goods in transit	3,700	Creditor	1,850
Cash at bank	1,780		
Total	**22,880**	**Total**	**22,880**

Incorporation of branch net profit

Murree branch A/c 19,070
Profit & Loss A/c 19,070

Incorporation of branch Assets

Murree branch goods in transit A/c	3,700	
Murree branch furniture A/c	6,000	
Murree branch debtors A/c	3,700	
Murree branch stock A/c	7,700	
Murree branch cash A/c	1,780	
Murree branch A/c		22,880

Incorporation of branch Liabilities

Murree branch A/c	1,850	
Murree branch creditors A/c		1,850

ESSENTIALS OF PARTNERSHIP

The law governing partnership is contained in the Partnership Act, 1932. Section 4 of the Act defines partnership as "the relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all".

The following are the essential elements of partnership:

1. There must be an agreement entered into by all the persons concerned.
2. The agreement must be to share the profits of a business.
3. The business must be carried on by all or any of them acting for all.

All these elements must be present before a partnership can come into existence. If any of them is not present, there cannot be formed a partnership.

Solved Questions

	Rs.
Net Profit	70,000
Mr. A`s Capital	100,000
Mr. B`s Capital	200,000
Interest on Capital @ 10%	
Additional Salary to A	2,000

Calculate the Profit for both (A & B) the partners.

Particulars	**A**	**B**	**Total**
Net Profit	----	----	70,000
Interest on capital	10,000	20,000	(30,000)
Partner salary	24,000	----	(24,000)
			16,000
			(16,000)
Profit sharing **A 16,000 x3/5** **B 16,000 x 2/5**	9,600	6,400	16,000
	43,600	24,600	---

LESSON # 17

ESSENTIALS OF PARTNERSHIP

Partnership agreement:

Partnership is the result of an agreement. The agreement among the partners that sets out the terms on which they have agreed to form a partnership is called partnership agreement. It may be in writing or by words of mouth or be implied from the course of conduct of the parties. It is desirable to have the partnership agreement in writing to avoid future disputes. The document in writing containing the various terms and conditions as to the relationship of the partners to each other is called the 'partnership deed'. The following clauses are normally included in partnership agreement.

1. Name under which business of the firm is to be carried on.
2. Nature of partnership business.
3. The capital of the firm and the proportion in which it is to be contributed by each partner.
4. Ratio in which profits and losses are to be shared by partners.
5. Rate at which interest is to be allowed on the capital and charged on the drawings.
6. Amount, which each partner is allowed to withdraw in anticipation of, profits from the business for private expenses and the timing of such drawings.
7. Amount of salaries and other allowances if any payable to partners.
8. Commencement and duration of partnership.
9. Whether the capital accounts are to be fixed or fluctuating.
10. Valuation of goodwill at the time of retirement or death of a partner.
11. The method of ascertaining the amount due to the retiring partner or the representative of a deceased partner at the time of retirement or death and the manner in which the amount due will be paid.
12. Keeping of proper books of accounts and preparation of balance sheet.
13. Audit of the accounts of the firm and the manner of appointment of auditor.
14. Right and duties of partners.
15. Arbitration clause, laying down the procedure to be followed for the settlement of disputes among the partners.

Partner`s Capital Account:

There are two accounting treatments available for the distribution of profit in partnership accounts.

1. Fluctuating Capital.
2. Fixed Capital.

The concept of fluctuating and fixed capital can be understood with the help of example discussed in the last lesson`s solved question.

Fluctuating Capital:

Particulars	A	B	Particulars	A	B
Drawings Balance c/f	30,000 123,600	30,000 211,400	Opening capital b/f Profit	110,000 43,600	215,000 26,400
	153,600	**241,400**		**153,600**	**241,400**

Fixed Capital:

Particulars	A	B	Particulars	A	B
Balance c/f	100,000	200,000	Opening capital b/f	100,000	200,000
	100,000	**200,000**		**100,000**	**200,000**

Current Account:

Particulars	A	B	Particulars	A	B
Drawings Balance c/f	30,000 23,600	30,000 11,400	Opening capital b/f Profit	10,000 43,600	15,000 26,400
	100,000	**200,000**		**100,000**	**200,000**

Owner's Capital (Balance Sheet)

A		
Capital	100,000	
Current A/c	23,600	
		123,600
B		
Capital	200,000	
Current A/c	11,400	
		211,400
		335,000

Solved Questions

Tariq and Saeed have been in partnership for one year, sharing profits and losses in the ratio of Tariq 3/5 & Saeed 2/5. They are entitled to 5% per annum interest on capitals. Tariq and Saeed have the capital of Rs. 2, 000 and Rs. 6,000 respectively. Saeed is entitled of salary Rs.500. They also decided to charge interest on drawings, Tariq being charged Rs.50 and Saeed Rs.100. The net profit, before any distributions to the partners, amounted to Rs.5, 000 for the year ended 31 December 2007.

Solution:

Total		**(Rs)**
Net Profit		5,000
Add: Interest on drawings		
Tariq	50	
Saeed	100	150
		5,150
Less: Salary saeed	500	
Interest on capital	400	
		900
Balance of profit		4,250

Profit sharing

Tariq 4,250 x3/5 = 2,550
Saeed 4,250 x 2/5 = 1,700
4,250

Particulars	Tariq	Saeed
Portion of profit	2,550	1,700
Interest on capital	100	300
Salary	---	500
	2,650	**2,500**
Less Interest on drawings	50	100
	2,600	**2,400**

Capital Account

Particulars	Tariq	Saeed	Particulars	Tariq	Saeed
Balance c/f	2,000	6,000	Opening balance	2,000	6,000
	2,000	6,000		2,000	6,000

Current Account

Particulars	Tariq	Saeed	Particulars	Tariq	Saeed
Interest on drawings	50	100	Interest on capital	100	300
Balance c/f	2,600	2,400	Salary	---	500
			Profit	2,550	1,700
	2,650	2,500		2,650	2,500

LESSON # 18

PARTNERSHIP ACCOUNTS (Cont.)

Changes in partnership firm

Subsequent to the formation of a partnership firm, a different accounting treatment is required when any of the following changes occur in the constitution of the partnership (Partnership deed) these changes might occur because of the following reasons:

- Admission of a new partner
- Retirement of an existing partner
- Death of a partner

Admission of a new partner

A new partner may be admitted for different reasons such as personal influence, need of more capital, or special skills.

At the time of admission of a new partner, certain adjustments are necessary in the books of accounts; among those calculation of good will is very important.

Admission of Partners (Issues)

1. Change of profit sharing ratio
2. Revaluation of assets and liabilities or revaluation of Net Assets
3. Calculation of goodwill
4. Accounting treatment of goodwill

Journal entries for the introduction of the capital:

1. <u>Introduction of capital by new partner in term of cash:</u>
   Cash Account xxx
   Partner's Capital Account xxx
2. <u>Introduction of capital in shape of assets:</u>
   Stocks xxx
   Furniture xxx
   Machinery xxx
   Partner's Capital Account xxx

The admission of a new partner may have an effect on the following items also

1. Interest on capital
2. Partner's salary
3. Profit sharing ratio

Change in profit sharing ratio:

Solved Questions

Old partner's profit sharing ratio

A	3/5
B	2/5

C entered as a new partner. He will get 1/6 profit share.

Required:

What will be the new profit sharing ratio?

Solution:

Shares of A , B& C:

Balance share = 1- 1/6 = 5/6
A's Share = 3/5 = 5/6 x 3/5 = 3/6
B's Share = 2/5 = 5/6 x 3/6 = 2/6
C's Share = 1/6

New profit sharing ratio:

3/6 : 2/6 : 1/6
3 : 2 : 1

Solved Questions

If the A and B are partners sharing profits in ratio of 3: 2 respectively. They admit C for share of 1/4. Then find out the new profit sharing ratios.

Solution:

Share of A , B and C:

= 1 – 1/4= 3/4
A = 3/4 x 3/5 = 9/20
B = 3/4x 2/5 = 6/20
C =1/4 x 5/5 = 5/20

9/20 : 6/20 : 5/20
New profit sharing ratios = 9 : 6 : 5

Solved Questions

If the A and B are partners sharing profits in ratio of 3: 2 respectively. They admit C for share of 1/4. It also further decided that the remaining share will be distributed among A and B in equally proportion. Then find out the new profit sharing ratios.

Solution:

A & B profit sharing ratio= 3:2
Offer to C = 1/4
Balance for A & B = 1 – 1/4 = 3/4

A's share = 3/4 x 1/2 = 3/8
B's share = 3/4 x 1/2 = 3/8

A	:	B	:	C
3/8		3/8		1/4

C's share = 1/4 x 2/2 = 2/8
New profit sharing ratio

A	**:**	**B**	**:**	**C**
3		**2**		**2**

Calculation of sacrifice ratio:
On the admission of a partner in a firm, loss is suffered by old partners. The old partner may sacrifice either in their old sharing ratio or in some other ratio. Sacrifice made by the old partner can be found by deducting their new share from the old share.

Solved Questions

A and B are partners who share the profits in the ratio of 3/5 and 2/5 respectively they admit C into partnership and the profit sharing ratio is agreed at 3/8 : 3/8: 2/8 respectively. Calculate the sacrifice ratio of old partners

Solution:

A's sacrifice ratio
Old ratio – New ratio
3/5 – 3/8
24 -15
40
= 9/40
B's sacrifice ratio
Old ratio – New ratio
2/5 – 3/8
16 -15
40
1/40

Sacrifice ratio = 9:1

Revaluation of Assets & Liabilities

When a new partner is admitted into the partnership firm, he acquires the ownership rights of the assets and also makes himself responsible for the liabilities of the firm. It is, therefore, desirable both from the point of view of the incoming partner as well as the existing partner that the assets and the liabilities appearing in the balance sheet on the date of admission of a new partner should be properly valued.

Three probabilities of revaluation:

1. No change in the value
2. Increase in the value
3. Decrease in the value

Revaluation journal entries

Increase in assets

Assets A/c xxx

Revaluation A/c xxx

Decrease in assets

Revaluation A/c xxx

Assets A/c xxx

Increase in liabilities

Revaluation A/c xxx

Liabilities A/c xxx

Decrease in liabilities

Liabilities A/c xxx

Revaluation A/c xxx

Solved Questions

If:

Increase in assets Rs. 10,000

Decrease in assets Rs. 2,000

Increase in liabilities Rs. 3,000

Increase in liabilities Rs. 500

Pass the necessary journal entries for the above information and prepare the revaluation account

Solution:

Increase in assets

Assets A/c 10,000

Revaluation A/c 10,000

Decrease in assets

Revaluation A/c 2,000

Assets A/c xxx 2,000

Increase in liabilities

Revaluation A/c 3,000

Liabilities A/c 3,000

Decrease in liabilities

Liabilities A/c 500

Revaluation A/c 500

Revaluation Account

Particulars	Rs.	Particulars	Rs.
Assets (Dec.)	2,000	Assets (Inc.)	10,000
Liabilities (Inc.)	3,000	Liabilities(Dec.)	5,00
Balance	5,500		
	10,500		10,500

A & B old ratio = 3:2

A's share = 5,500 x 3/5 = 3,300

B's share = 5,500 x 2/5 = 2,200

Accounting Entry

Revaluation A/c 5,500

Old partner's capital A/c 5,500

(Old sharing ratio)

Goodwill

Goodwill may arise from such attributes of a business as good reputation, good customer relationship, strategic location, skill of its employees, dynamic management, durability of its products, effective advertisement, patented manufacturing process, outstanding credit rating, training program of the employees, and good relationship with suppliers and employees, etc.

Goodwill may be described as the aggregate of those intangible attributes of a business that contribute to the superior earning capacity of the business. Goodwill is the outcome of an impression created in the mind of each customer and related persons.

Average Profit Method for calculating goodwill:

After calculating average profit, it is multiplied by a number (times) 3, or 4, or 5, whatever, as agreed. The product will be the value of the goodwill.

For example:

Goodwill is three times of the average profit of previous five years.

Let's suppose:

Average profit = 100 / 5 = 20

Goodwill = 20 x 3 = 60

LESSON # 19

PARTNERSHIP ACCOUNTS (Cont.)

Valuation of Goodwill

Methods to be adopted in valuing goodwill will depend upon the circumstances of each particular case. At the time of valuation of goodwill, the partnership deed should be examined and valuation should be done in such a manner as must have been agreed upon by the partners.

Goodwill Calculation methods

1. Average profit method
2. Super profit method
3. Market capitalization method

Average Profit Method

Under this method, at first, average profit is calculated on the basis of the past few years' profits. At the time of calculating average profit, precaution must be taken in respect of any abnormal items of profit or loss which may affect future profit. It should be mentioned that average profit is based on simple average method.

Solved Problem No 1:

Years	Profit Rs.
1st year	20,000
2nd year	40,000
3rd year	50,000
4th year	70,000
Total	180,000

Goodwill of the firm is equal to the three years purchase of the last four years average profits:
Average profit = 180,000 / 4 = Rs. 45,000
Goodwill = 45,000 x 3 = Rs. 135,000

Super Profit Method

Super profit is the excess of actual profit (average profit) over the normal profit of an entity. A common method of valuation of goodwill is the super profit method. A business unit may possess some advantages which enable it to make extra profits over and above the amount that would be earned if the capital of the business was invested elsewhere with similar risks. These extra profits, generally expressed as super profits, can be valued, and goodwill is the value of the few years' purchase of super profit.
In this method, super profits are taken as the basis for calculating goodwill in place of average profit.

Certain steps are followed in calculating goodwill under super profit method, these are as under:

1. Calculate Capital of the firm
2. Calculate normal profit by multiplying firm's capital with normal rate of return
3. Calculate average profit of the firm
4. Calculate super profit by subtracting normal profit from the average profit
5. Multiply the super profit by the number of year's purchase (number of times)
6. The product will be called goodwill.

Let's suppose:

Normal profit = 200,000 x 18% = 36,000
Super profit = Average profit – Normal profit
= 45,000 – 36,000 = 9,000
Goodwill = 9,000 x 3 = Rs. 27,000

Market Capitalization Method

Under this method the value of the firm is first determined based on the market capitalization rate using the following formula:

$$\frac{\text{Average profit of the firm}}{\text{\% of market rate of return}} \times 100$$

The above formula will give an estimate of the firm's value in the market. By subtracting the book value of the net assets (owners' equity/capital) of the firm from the above calculated value we shall get the amount of goodwill.

Suppose average profit of the firm is Rs. 45,000 and the market rate of return is 18% and the capital (net assets) of the firm is Rs. 200,000.
Then the good will of the firm will be calculated as under:

Goodwill = 45,000 / 18 x 100 = 250,000
= 250,000 -200,000
= Rs. 50,000

Accounting treatment of goodwill

Since the goodwill of a partnership firm belongs to the old partners and no one else, it is apparent that some adjustments must be made to the Capital accounts of the old partners upon the admission of a new partner so that the incoming partner will not take a share of the goodwill belonging to old partners without payment. The amount that the incoming partner pays for goodwill is known as premium for goodwill. This goodwill can be treated in the books of account in any of the following manner:

Goodwill Raised
Scenario-1

When the incoming partner cannot bring cash as premium for goodwill

Here, the capital accounts of the old partners are artificially inflated towards the right of the goodwill, without any cash contribution. The idea is that if the business were sold immediately after the admission of the new partner and the goodwill as well as other assets are realized at their book value, the old partners would automatically receive cash for their share of the goodwill since the amounts attributable to them in respects of the goodwill are now included in their respective capital accounts.

In this case, goodwill account is to be raised in the books of account at its full value by debiting the goodwill account and crediting the old partners' capital accounts in old ratio.

Journal Entry

Goodwill A/c	135,000	
A's capital A/c		81,000
B's capital A/c		54000

Working

A's share = 135,000 x 3/5 = 81,000

B's share = 135,000 x 2/5 = 54,000

Important Note

Following should be taken in to account when doing the above treatment for goodwill:

1. If goodwill already appears in the Balance Sheet which is equal to full value of goodwill so calculated, then no entry is required to be passed.
2. If goodwill already appears in the Balance Sheet which is less than the full value of goodwill then goodwill is to be raised for the balance (full value of goodwill calculated less goodwill already appearing in the Balance sheet)
3. If goodwill already appears in the Balance sheet which is more than the full value of goodwill, then excess goodwill is to be written off. The journal entry will be as under:

Old partners' capital accounts	Dr	
Goodwill accounts		Cr

   (Being the value of the goodwill written down to its calculated value)

Goodwill Raised & Written-Off
Scenario-2

When the incoming partner cannot bring anything as premium for goodwill but no goodwill is to appear in the books:

Since the value of the goodwill constantly changes and partners may not wish that an account should remain in the books, goodwill is raised in the books first and, thereafter it is written off.

Journal Entry (Goodwill raised)

Goodwill A/c	135,000	
A's capital A/c		81,000
B's capital A/c		54000

Journal Entry (Goodwill raised & written off)

A's capital A/c	67,500	
B's capital A/c	45,000	
C's capital A/c	22,500	
Goodwill A/c		135,000

A's benefit

Old ratio (Cr)	81,000
New ratio (Dr)	67,500
(Cr)	13,500

B's benefit

Old ratio (Cr)	54,000
New ratio (Dr)	45,000
(Cr)	9,000

A's benefit + B's benefit
13,500 + 9,000 = Rs. 22,500

C's share = 22,500
C's share = 135,000 x 1/6 = Rs. 22,500

Goodwill Brought in Cash
Scenario-3

When the required amount of premium for goodwill is brought in by the incoming partner and the money is retained in the business to increase the cash resources:
In this situation, premium for goodwill is to be shared by the old partners in the sacrificing ratio. The sacrificing ratio is to be calculated by deducting the new ratio from the old ratio for each partner. It should be noted that when the profit sharing ratio between the old partners does not change as between themselves, this old profit sharing ratio is their sacrificing ratio.

Goodwill brought in cash

Bank A/c	22,500	
C's premium for goodwill A/c		22,500

Distribution of goodwill (sacrifice ratio)

C's premium for goodwill A/c	22,500	
A's capital A/c		13,500
B's capital A/c		9,000

A's share = 22,500 x 3/5 = 13,500
B's share = 22,500 x 2/5 = 9,000

Goodwill Brought in Cash & Withdrawn
Scenario-4

When the required amount of premium for goodwill is brought in by the new partners and this amount is immediately withdrawn by the old partners:

Goodwill brought in cash

Bank A/c	22,500	
C's premium for goodwill A/c		22,500

Distribution of goodwill (sacrifice ratio)

C's premium for goodwill A/c	22,500	
A's capital A/c		13,500
B's capital A/c		9,000

Goodwill withdrawn

A's capital A/c	13,500	
B's capital A/c	9,000	
Bank A/c		22,500

LESSON # 20

PARTNERSHIP ACCOUNTS (Cont.)

Solved Questions

Laiquee, Imran and Ishtiaq are in partnership. They shared profit in the ratio 2:5:3. It is decided to admit Amir. Amir will bring Rs. 4,000 cash into the business for capital. It is agreed that goodwill was worth Rs. 10,000, but that is not to be brought into business record. The new profit sharing ratio is to be 3:4:2:1.

The balance sheet before Amir was introduced as a new partner was as follow:

Assets	**(Rs.)**
Building	8,000
Machinery	3,000
Stock	2,000
Cash	2,500
	15,500
Less Creditors	3,500
Net Assets	**12,000**
Capital	**(Rs.)**
Laiquee	3,000
Imran	5,000
Ishtiaq	4,000
	12,000

After the admission of Amir Assets are revalued:

Assets	**(Rs.)**
Building	10,000
Machinery	2,500
Stock	1,800

Required:

1. Record necessary accounting entries
2. Prepare capital Accounts
3. Post admission balance sheet

Solution:

Introduced capital by Amir

Cash A/c	4,000	
Amir's capital		4,000

Goodwill raised

Goodwill A/c	10,000		
		Laiquee capital A/c	2,000
		Imran capital A/c	5,000
		Ishtiq capital A/c	3,000

Revaluation of Assets

Building A/c	2,000		
		Revaluation A/c	2,000

Revaluation A/c	700		
		Machine A/c	500
		Stock A/c	200

Transfer of revaluation balance

Revaluation A/c	1,300		
		Laiquee capital A/c	260
		Imran capital A/c	650
		Ishtiq capital A/c	390

Capital Account

Particulars	Laiquee	Imran	Ishtiaq	Amir	Particulars	Laiquee	Imran	Ishtiaq	Amir
Balance c/f	5,260	10,650	7,390	4,000	Balance b/f	3,000	5,000	4,000	----
					Cash	----	----	----	4,000
					Goodwill	2,000	5,000	3,000	----
					Revaluation	260	650	390	---
	5,260	10,650	7,390	4,000		5,260	10,650	7,390	4,000

Post Admission Balance Sheet

Assets	(Rs.)
Goodwill	10,000
Building	10,000
Machine	2,500
Stock	1,800
Cash	6,500
	30,800
Liabilities & Capital A/c	**(Rs.)**
Laiquee	5,260
Imran	10,650
Ishtiaq	7,390
Amir	4,000
	27,300
Creditors	3,500
	30,800

Working:

Revaluation Account

Particulars	Rs.	Particulars	Rs.
Machine	500	Building	2,000
Stock	200		
Balance	1,300		
	2,000		2,000

Cash Account

Particulars	Rs.	Particulars	Rs.
Opening Balance	2,500	Closing Balance	6,500
Amir's capital	4,000		
	6,500		6,500

Cash	**(Rs.)**
Opening cash balance	2,500
Add capital introduced by Amir	4,000
Closing Balance	**6,500**

Building	**(Rs.)**
Opening balance	8,000
Add Revaluation (Inc.)	2,000
Closing Balance	**10,000**

Machine	**(Rs.)**
Opening balance	3,000
Less Revaluation (Dec.)	500
Closing Balance	**2,500**

Stock	**(Rs.)**
Opening balance	2,000
Less Revaluation (Dec.)	200
Closing Balance	**1,800**

Income statement of partnership firm:

Particulars	Rs.
Sales	160,000
Less cost of goods sold	120,000
Gross profit	40,000
Less operating Exp.	
Administrative Exp.	15,000
Selling & Distribution Exp.	6,000
Net profit	**19,000**

Solved Questions

Two partners A & B were sharing profit ratio 3:2. "A" gets salary of Rs. 2,800 per annum. After six months, C was admitted as a new partner and shared profit 1/5. According to new profit sharing ratio, A and B will get equal share. The new profit ratio is 2:2:1. C will also get salary Rs. 2,400 per annum.

- Total sales Rs. 160,000
- Sales of first six months Rs. 96,000
- Sales of next six months Rs. 64,000

Required: Distribute Rs. 19,000 profit among partners.

Solution:

Particulars	Total	First 6 months	Next 6 months
Sales	160,000	96,000	64,000
Less cost of goods sold	120,000	-----	-----
Gross profit	40,000	24,000	16,000
Less operating Exp.			
Administrative Exp.	15,000	7,500	7,500
Selling & Distribution Exp.	6,000	3,600	2,400
Net profit	19,000	12,900	6,100

Profit Distribution

First six months ending 30-06-07

Particulars	A	B	Total
Net profit			12,900
Less Partner salary (2,800 x 6/12)	1,400	----	1,400
			11,500
Profit share			
A : 11,500 x 3/5	6,900		
B: 11,500 x 2/5		4,600	(11,500)
	8,300	**4,600**	**Nil**

Next six months ending 31-12-07

Particulars	A	B	C	Total
Net profit				6,100
Less Partners salary (2,800 x 6/12)	1,400	----	1,200	2,600
				3,500
Profit share	1,400	1,400	700	(3,500)
	2,800	**1,400**	**1,900**	**Nil**

Total Profit Distribution

	A	B	C
First six months	8,300	4,600	---
Next six months	2,800	1,400	1,900
	11,100	**6,000**	**1,900**

Working

Gross Profit:

First six months

40,000 x 96,000 / 160,000 = 24,000

Next six months

40,000 x 64,000 / 160,000 = 16,000

Selling & Distribution:

First six months
6,000 x 96,000 / 160,000 = 3,600
Next six months
6,000 x 64,000 / 160,000 = 2,400

Profit Sharing

A = 3,500 x 2/5 = 1,400
B = 3,500 x 2/5 = 1,400
C = 3,500 x 1/5 = 700

Retirement of Partner

Issues Relating to Retiring Partner

Step 1. Calculation of goodwill

Step 2. Revaluation of goodwill/raise the goodwill

Step 3. Revaluation of net assets

Step 4. Preparation of partner's capital account

Step 5.Transfer of retiring partner's capital account into his loan account

Step 6. Make part payment or full payment of his loan account (depending upon the cash availability)

Step 7. Prepare post retirement balance sheet

Let us understand the accounting treatment by retiring Laiquee (Solved Question # 1):

Total Profit Distribution:
Transfer capital account to loan account
Retiring partner capital A/c
Retiring partner Loan A/c
Transfer Laiquee's capital account to loan account
Laiquee's capital A/c 5,260
Laiquee's loan A/c 5,260
Part payment of Laiquee loan

Laiquee's loan A/c	2,000	
Cash A/c		2,000

Post Retirement
Balance Sheet

Assets

Goodwill		10,000
Building		10,000
Machine		2,500
Stock		1,800
Cash (6,500 – 2,000)		4,500
		28,800
Liabilities & Capital Account		
Imran	10,650	
Ishtiaq	7,390	
Amir	4,000	
		22,040
Laiquee loan (5,260 – 2,000)	3,260	
Creditors		3,500
		28,800

Death of Partner

Diseased Partner's Executor Account

Particulars	Amount	Particulars	Amount
Drawings	xxx	Opening Balance	xxx
Interest on drawings	xxx	Cash A/c	xxx
		Current A/c	xxx
		Profit share	xxx
		Goodwill	xxx
		Interest on capital	
	xxx		**xxx**

LESSON # 21

COMPANY ACCOUNTS

How a company differs from other organizations? This is the question that will make able the students/readers to understand company accounts. In the upcoming section of this chapter, emphasis will be put on the points of difference from accounting perspective.

Company style of business entity is a bigger setup comparing with the sole proprietorship and partnership. People with business ideas join their hands with people having money. Jointly they form a business in which the investors (normally) do no take interest in the day to day management affairs.

Salient Features of Limited Liability Companies

Following are the salient features that make a limited liability company different from other business entities.

1) Separate legal entity

Unlike sole proprietorship and Partnership organizations the Company style of business is an incorporated organization that enjoys a separate legal entity. It means that from the legal point of view company and owners of the company are two different persons.

This concept is often confused with the "Business entity concept" which is merely an accounting concept and is used to record financial information of an entity. Whereas, "Separate legal entity" signifies that a company has a legal status and it can sue and can be sued in its own name.

2) Limited liabilities

Owners of a Company style of business enjoy an advantage that if a company runs into financial difficulties, they cannot be forced to make further contributions to the company. Even they are not asked to make good any financial losses suffered by the company.

Liabilities of the owners of a company are limited to the amount of paid up share capital (amount contributed by them). Maximum risk exposed to an owner of a company is the loss of contributed capital money.

3) Board of directors

Management affairs of a company are run by a board of directors that is elected or appointed by the owners. The board of directors runs the company on behalf of its owners, in a way it can be said that directors act like stewards.

Directors are responsible for decision making, for running day to day business affairs, for managing financial issues.

4) Sources of finance

Like other business organizations a company also gets its finances from owners and lenders but the circle of its owners and lenders is very large.

5) Capital from owners

At the time of its incorporation the company makes an estimate of the total amount of capital that will be required in the business. This capital is split into shares and hence is known as share capital. People (investors) who want to become owner of the company contribute in the share capital. Contributors of the share capital are known as share holders or members of the company. A limited liability company is jointly owned by its members.

6) Borrowings from lenders

Large business projects are undertaken by the company style of business which need huge amount of finance. Such financial requirements are often cannot be met with the contributed share capital alone. For this purpose a company borrows finances from the financial institutions (like Banks etc.) and also a company can borrow from public in general by issuing loan/debenture certificates. Holders of these certificates are known as debenture holders.

7) Legal formalities

Company style of business entity undertakes huge ventures that involve contracts with suppliers, customers, lender and so many other concerns. Also it has large number of share holders. This might create certain difficulties to the management and to the related parties as well. Therefore incorporation of Limited Liability Company requires certain legal formalities and is tied up in more tight regulations to run the entity, which are not required to be abided by the sole proprietorship and partnership style of business entities.

8) Reporting requirements

As a limited liabilities company is involved in transactions with a huge number of stake holders, therefore its directors are required to publish and circulate financial statements with regular intervals which may be a quarter, six months or a year, depending upon the nature of the company.

Finances of a Limited Liability Company

A company gathers its finances from two sources:

1. Owned Equity
2. Borrowed Equity

1) Owned Equity

Owned equity comprises of:

a) Equity share capital (contributed by the member)
b) Reserves (realized/unrealized profits)

    i. Capital Reserves
        - Share premium (unrealized profit)
        - Revaluation reserve (unrealized profit)
        - Capital redemption reserve (realized profit)

ii. Revenue Reserves
- Retained/Accumulated profits (realized profits)
- General reserves (realized profits)
- Named/Specific reserves (realized profits)
  - Plant replacement reserve
  - Dividend equalization reserve

All of the categories mentioned above will be discussed in details along with accounting entries in the forthcoming part of this chapter. Following table will help in understanding the difference between equities of different entities and how owners are differently identified.

Particulars	**Sole proprietorship**	**Partnership**	**Company**
Owners' Equity	Capital + Net profit - Drawings	Capital Account ± Current Account	Share Capital Reserves
Owners	**Proprietor**	**Partner**	**Member**

2) Borrowed Equity

Borrowed equity comprises of:

a) Borrowings as Loan from the financial institutions
b) Borrowings as Debt certificates issued to the financers/lenders

Accounting for Share Capital and Reserves

Keeping in view the rules of Dr and Cr for the items of owners' equity, (increase Cr. and decrease Dr.) the accounting entries for the transactions relating to the movement in owners' equity are as under:

Accounting for issue of Share Capital

For issue of share capital at nominal value (at par) against cash consideration:

Bank a/c
    Share Capital a/c

For issue of share capital at nominal value (at par) against non cash consideration:

Assets a/c (like fixed assets or stock)
    Share Capital a/c

For issue of share capital at a premium

Bank a/c
    Share Capital a/c
    Share Premium a/c

Share premium

Companies having strong background often issue their shares at a price that is more than the nominal (face) value. Excess of the issue price over the nominal value is known as share premium.

Note: Remember one very important tip; share capital a/c always credits with its nominal (face) value only, any excess received as resources will be credited to the share premium a/c.

Solved Questions

Rafi Ltd Co issues 100,000 ordinary share capital @ Rs 10 each with a premium @ Rs 7 per share.

Record the above transaction in the books of accounts.

Working:	RS.
100,000 @ Rs. 10	1,000,000
100,000 @ Rs. 7	700,000
	1,700,000

Accounting Entry:

Bank a/c	1,700,000	
Share Capital a/c		1,000,000
Share Premium a/c		700,000

Ledger Accounts:

Share Capital a/c

Particulars	Rupees	Particulars	Rupees
		Bank a/c	1,000,000

Share Premium a/c

Particulars	Rupees	Particulars	Rupees
		Bank a/c	700,000

Bank a/c

Particulars	Rupees	Particulars	Rupees
Share Capital a/c	1,000,000		
Share Premium a/c	700,000		

Accounting for movements in Reserves

Reserves are profits that are retained in the company (not distributed to its shareholders). To understand the accounting entries for movement in Reserves following details will be very much helpful.

Reserves

Capital Reserves

Those profits which are not distributed To the share holders as cash dividend

Share Premium

Revaluation Reserve

Capital Redemption Reserve

Revenue Reserves

Those which are distributable to share-holders as cash dividend.

General Reserve

Named/Specific Reserve

Plant Replacement Reserve

Dividend Equalization Reserve

Retained Profits

Profits

Realized Profits

- Share Premium
- Revaluation Reserve

Un-Realized Profits

Profit after tax

Transfer of profits as Reserves

Capital Redemption Reserve

General Reserve

Named Reserve

Retained Profits

Part of profit paid to share holder as cash dividend

Above diagram clearly shows that all reserves except share premium and revaluation reserves are created out of the profits realized during the year. We may say that reserves are the profits set aside for some specific purpose or otherwise. Accounting entry for such setting aside of profits is:

Profit & loss a/c Dr
Reserves a/c Cr

A standard format of balance sheet, Income Statement & Statement of changes in equity of a company looks like some what as under:

Limited Liability Company
Balance Sheet
As on December 31, 2009

		Rs.		Rs.
Assets				
Non Current Assets				***
Current Assets			***	
Current Liabilities		(***)		***
				***
Financed By (sources of finance)				
Owners' Equity				
Ordinary Share Capital		***		
Reserves				
Capital Reserves	***			
Revenue Reserves	***	***		***
Non-Current Liabilities				
Loan from financial institutions			***	
Loan Stocks/Term Finance Certificates			***	
				***

Balance sheet shows financial position of an entity. Upper part of the balance sheet shows resources of an entity. Lower part of the balance sheet clearly shows the sources of finance.

Income Statement
For the year ended on 31st Dec----

Sales	xxx
Less Cost of goods sold	xxx
Gross profit	xxx
Less Operating expenses	
Administrative expenses	xxx
Selling & distribution	xxx
	xxx
Profit from operations	xxx
Add other incomes	xxx
Less Financial expenses	xxx
Income before tax	xxx
Less Income tax	xxx
Profit after tax	**xxx**

Part of statements of Changes in Equity

Opening retained profit	xxx
Less Dividend payment	xxx
Less transfer to reserves	xxx
Closing retained profit	**xxx**

LESSON # 22

COMPANY ACCOUNTS (Cont.)

Components of financial statements

As per International Accounting Standards there are five components of financial statements:

1. Balance Sheet
2. Income Statement
3. Statement of Changes in Equity
4. Cash Flow Statement
5. Notes

Here we will discuss all in detail except cash flow statement.

1) Balance Sheet

It has already been discussed in the preceding section that balance sheet of an entity shows financial position, which comprises of resources and source. A very simple equation of balance sheet is:

Assets = Owners' Equity + Liabilities.

Where Assets are the resources and Owners' Equity and Liabilities are the sources.

Limited Liability Company
Balance Sheet
As on December 31, 2009

		Rs.		*Rs.*
Assets (Resources)				
Non Current Assets				
Fixed Assets				
Tangible Assets		***		
Intangible Assets		***		***
Long Term Investments		***		
Long Term Loans		***		
Long Term Advances, Deposits & Prepayments			***	***
Current Assets			***	
Current Liabilities		(***)		***
Capital Employed				***
Financed By (Sources)				
Owners' Equity				
Ordinary Share Capital		***		
Reserves				
Capital Reserves	***			
Revenue Reserves	***	***		

Non Current Liabilities				
Loan Stocks/Term Finance Certificates	***			
Loan from financial institutions	***			
Finance lease liability		***		***
Capital Employed			***	

Approved by Chief Executive and a Director

Classification of assets in the balance sheet is on the base of permanency order. This is known as marshaling. In a company balance sheet grouping and marshaling is strictly followed. It is clearly presented in the balances sheet that assets are broadly classified into Non-Current Assets and Current Assets. Non-Current Assets are then grouped into fixed and other non-current assets. Fixed assets are further classified into fixed tangible and fixed intangible assets.

a) Fixed Tangible Assets

These are the property, plant and equipment that are held by the entity a) for production or selling of goods or services, b) for administrative purposes, or c) for rental to others. These are expected to be useful for the entity for more than one accounting year.

Examples include: land & Building, Plant & Machinery, Furniture & fixtures, Motor Vehicles, Office equipments etc.

b) Fixed Intangible Assets

These are the identifiable, non monetary asset in control of the entity that have no physical existence and are expected to be useful for the entity for more than one accounting year.

Examples include: Trademark, Copy right, Patents, Designs etc.

c) Long term Investment

These are the investments made by the company in other entities for more than one accounting year.

Examples include: Investments in equity instruments or debt instruments of other entities.

d) Long term loans

These are the loans given to the third parties on long term basis, receivable after the expiry of more than one accounting year.

e) Long term advances, deposits, and prepayments

These are the security deposits, fixed deposits, advances given to the suppliers of assets, and prepayments on long term basis.

f) Current Assets

These are the assets recoverable and tradable within the normal operating cycle of an entity that is 12 months after the balance sheet date in normal circumstances. Cash and cash equivalents are also current assets.

g) Current Liabilities

These are the obligations that are payable within the normal operating cycle of an entity that is 12 months after the balance sheet date in normal circumstances. This also includes bank overdraft.

2) Income Statement

Income Statement is prepared to know the financial performance of an entity. In an Income Statement; expenses for the year are subtracted from the incomes earned during the year. Both incomes and expenses are measured according to the accrual concept, whereas, profit are measured according to the matching concept.

According to the IAS 1 Income Statement can be prepared using ether:

1. Function of expenses method, or
2. Nature of expenses method

a) Function of expenses method

According to the functions of expenses method the expenses are divided into five groups based on their functions:

- Cost of sales
- Administrative
- Selling and marketing
- Financial
- Income Tax

Incomes are also divided into two groups:

- Sales revenue (operating income)
- Other incomes (non-operating incomes)

Limited Liability Company
Income Statement
For the Year ended December 31, 2006
(Function of expenses method)

	Rs.	***Rs.***
Sales revenue		***
Cost of goods sold		(***)

Gross profit		***
Operating expenses		
Administrative expense	***	
Selling & Marketing expenses	***	(***)
Profit from operations		***
Other income		***
Financial expenses		(***)
Profit before tax		***
Income tax expense		(***)
Profit after tax		***

b) Nature of expense method

According to the nature of expense method all expenses are aggregated in the incomes statement and are matched with the total incomes for the year. Since both incomes and expenses are of different nature therefore this method of preparing Income Statement is known as nature of expense method.

Limited Liability Company
Income Statement
For the Year ended December 31, 2006
(Nature of expense method)

	Rs.	*Rs.*
Incomes		
Sales revenue	***	
Other incomes	***	***
Expenses		
Increase/decrease in inventory	***	
Raw materials and consumables	***	
Employees' salaries and wages	***	
Utility bills	***	
Other business operation expenses	***	(***)
Financial expenses		(***)
Profit before tax		***
Income tax expense		(***)
Profit after tax		***

3) Statement of Changes in Equity

Statement of changes in equity is prepared to know the movement in the items of owners' equity. There might be two types of the statement:

1. Statement that shows the movement in the retained profits only
2. Statement that shows the movement in all the items of owners' equity

Limited Liability Company
Statement of changes in equity
For the year ended December 31, 2006
(Showing movement in the retained profits only)

	Rs.	Rs.
Retained profits b/f		***
Profit after tax		***
Dividend paid	***	
Transfer to reserves	***	(***)
Retained profits c/f		***

(Showing movement in all items of owners' equity)

	Share Capital	Share Premium	Revaluation Reserve	Named Reserve	Retained Profits	Total
Opening Balance	***	***	***	***	***	***
Fresh issue of shares		***	***			***
Revaluation of Assets				***		***
Profit after tax					***	***
Dividend paid					(***)	(***)
Transfer to named reserves				***	(***)	_
Bonus Share	***	(***)		(***)	(***)	-_
Totals	***	***	***	***	***	***

Solved Questions

Simple Co. has been trading for a number of years manufacturing domestic appliances. Its trial balance for the year ending 31 August 2005 is noted below, along with some additional information.

Simple Co.
Trial Balance
As at 31st August 2005

	Dr. (Rs. 000)	Cr. (Rs. 000)
Sales		14,345
Opening inventories	1,456	
Purchases	4,239	
Manufacturing wages	2,386	
Other manufacturing costs	646	
Selling and distribution costs	1,895	
Administration costs	998	
Interest expense	400	
Interim dividend paid	900	
Long-term investments	900	
Non-current assets at cost	6,579	
Depreciation		2,756

Trade receivables	1,923	
Prepayments	489	
Staff loans	12	
Bank and cash balances	267	
Bank overdraft		450
Trade payables		534
Accruals		123
Debenture redeemable in 2009		3,000
Two million ordinary shares of 25 paisa each		500
Share premium		250
Retained profits: 1 September 2004		1,132
	23,090	**23,090**

Additional Information:

1. Closing inventories have been counted and valued at Rs. 978,000.
2. The tax charge for the year has been estimated at Rs. 879,000.
3. An interim dividend of 45 paisa per share was paid. A final dividend of 75 paisa per share has been proposed.
4. All other routine adjustments have been made (e.g. depreciation, bad debts).
5. Transfer Rs. 600,000 to debenture redemption reserve.

Required:

Prepare Simple Co.'s income statement, balance sheet and statement of changes in equity for the year ending 31 August 2005.

Solution

Simple Co.
Income statement
For the year ending 31st August 2005

	Rs. 000
Sales	14,345
Cost of sales	(7,749)
Gross profit	6,596
Sales and distribution	(1,895)
Administration	(998)
Profit from operations	3,703
Interest received/paid and similar items	(400)
Profit before tax	3,303
Income tax expense	(879)
Profit for the year	2,424

Statement of changes in equity
Year ending 31st August 2005

	Shares capital (Rs.000)	Shares premium (Rs.000)	Debenture redemption reserve (Rs.000)	Retained earnings (Rs.000)	Total (Rs.000)
Opening	500	250		1,132	1,882
Profit for the year				2,424	2,424
Transfer to reserve			600	(600)	-
Dividends				(900)	(900)
Closing	500	250	600	2,056	3,406

Simple Co.
Balance Sheet
As at 31st August 2005

Assets		**(Rs. 000)**	**(Rs. 000)**
Non-current assets			
Investments			900
Tangible non-current assets	Note 2		3,823
			4,723
Current Assets			
Inventories		978	
Trade & other receivable	(1,923+12)	1,935	
Prepayments		489	
Cash		267	
			3,669
Total Assets			**8,392**
Equity and Liabilities			
Equity			
Share capital			500
Share premium			250
Debenture redemption reserve			600
Retained earnings			2,056
Total Equity			3,406
Non-Current Liabilities			3,000
Current Liabilities			
Bank overdrafts		450	
Trade and other payables		534	
Accruals		123	
Income tax		879	
			1,986
Total Equity and Liabilities			8,392

**** Notes to the Accounts***

Note 1 Dividend

	Rs. 000
Interim dividend paid of 45 paisa per share	900
Final dividend proposed of 75 paisa per share	1,500

Note 2 Tangible non-current assets

	Rs. 000
Cost or valuation	6,579
Depreciation	(2,756)
Net book value	3,823

(W1) Cost of Sales

	Rs. 000
Opening inventories	1,456
Purchases	4,239
Manufacturing wages	2,386
Other manufacturing costs	646
Less: closing inventories	(978)
	7,749

Solved Questions

Straight Co. has been trading for a number of years manufacturing steel girders. Its trial balance for the year-ending 31st March 2006 is noted below, along with some additional information.

Straight Co.
Trial Balance
As at 31st March 2006

	Dr. (Rs. 000)	**Cr. (Rs. 000)**
Sales		28,353
Opening inventories	3,206	
Purchases	8,162	
Manufacturing wages	7,333	
Other manufacturing costs	974	
Selling and distribution costs	2,020	
Administration costs	635	
Investment income		246
Interest paid on the bank overdraft	50	
Interim dividend	800	
Long-term investment	2,885	
Fixed assets at cost	15,753	
Depreciation		4,396

Trade receivables	2,967	
Prepayments	132	
Staff loans	23	
Bank and cash balances	110	
Bank overdraft		1,978
Trade payables		756
Accruals		423
10% Debenture redeemable in 2005		3,000
Four million ordinary shares of 50 paisa each		2,000
Share premium		300
Retained profits: 1st April 2005		3,598
	45,050	**45,050**

Additional Information:

1. Closing inventories have been counted and valued at Rs. 1,263,000.
2. The tax charge for the year has been estimated at Rs. 1,924,000.
3. A final dividend of sixty paisa per share has been proposed.
4. No interest has been paid or charged on the debenture. The debenture was raised on 1st April 2005. This will have to be accrued for.
5. All other routine adjustments have been made (e.g. depreciation, bad debts).

Required:

Prepare Straight Co. income statement, balance sheet and statement of changes in equity for the year ending 31st March 2006. You should answer in Rs. 000s.

Solution

Straight Co.
Income Statement
For the year ending on 31st March 2006

		Rs. 000
Sales		28,353
Cost of sales		(18,412)
Gross profit		9,941
Sales and distribution		(2,020)
Administration		(635)
Profit from operations		7,286
Investment income	Note 2	(104)
Profit before tax		7,182
Income tax expense		(1,924)
Profit for the year		5,258

Statement of changes in equity
Year ending 31st March 2006

Particulars		Shares capital (Rs.000)		Shares premium (Rs.000)		Retained earnings (Rs.000)		Total (Rs.000)
Opening		2,000		300		3,598		5,898
Profit for the year		--		--		5,258		5,258
Dividends		--		--		(800)		(800)
Closing		2,000		300		8,056		10,356

Straight Co.
Balance Sheet
As at 31st March 2006

Assets		**(Rs. 000)**	**(Rs. 000)**
Non-current assets			
Investments			2,885
Tangible non-current assets	Note 3		11,357
			14,242
Current Assets			
Inventories		1,263	
Trade & other receivable	(2,967+23)	2,990	
Prepayments		132	
Cash		110	
			4,495
Total Assets			**18,737**
Equity and Liabilities			
Equity			
Share capital			2,000
Share premium			300
Retained earnings			8,056
Total Equity			10,356
Non-Current Liabilities			3,000
Current Liabilities			
Bank overdrafts		1,978	
Trade and other payables		756	
Accruals	(300 + 423)	723	
Income tax		1,924	
			5,381
Total Equity and Liabilities			19,737

<u> Notes to the Accounts</u>*

Note 1 Dividend

	Rs. 000
Interim dividend paid of 20 paisa per share	800
Final dividend proposed of 60 paisa per share	2,400

Note 2 Interest received and similar items

	Rs. 000
Investment income	246
Debenture interest expense (Rs. 3,000 @ 10%)	(300)
Bank interest expense	(50)
Net book value	(104)

Note 3 Tangible non-current assets

	Rs. 000
Cost or valuation	15,753
Depreciation	(4,396)
Net book value	11,357

(W1) Cost of Sales

	Rs. 000
Opening inventories	3,206
Purchases	8,162
Manufacturing wages	7,333
Other manufacturing costs	974
Less: closing inventories	(1,263)
	18,412

LESSON # 23

MORE ABOUT COMPANY ACCOUNTS

Rights Issues of Shares

Any subsequent issue of shares against consideration is rights issue. A rights issue of shares is a simple and most economical way of raising finance. It is an issue of share in which the existing shareholders have an anticipatory right to subscribe for the new shares. In a rights issue, a warrant is sent to the existing shareholders, which entails them to take up a specified number of shares at a specified price. The price of the shares so offered is higher than the face value but below the market price to make the offer fascinating.

An existing share holder who does not wish to exercise any or all of the rights is at liberty to sell them to third parties who can purchase such shares at the same offer price.

Accounting entries to record the rights issue of share is exactly the same as those we have already learned to pass when share are issued at premium.

Bank a/c
    Share Capital a/c
    Share Premium a/c

Comparison between Rights Issue and Initial Public Offer (IPO)

Rights Issue	Initial Public Offer
1. A rights issue is made to existing shareholders	1. Initial Public Offer is made to the public at large
2. There is no chance of over subscription	2. There is a chance of over subscription; hence the floatation cost is high.
3. Price of the rights issue is kept lesser than the market price	3. Initial public offer is generally made on face value

Solved Questions

Right Co Ltd has 80,000 Rs. 10 ordinary shares in issue. They were originally issued at a premium of Rs. 4 per share. The current market price of these shares is Rs. 35 each. Right Co Ltd has announced a 1rights share for every 4 shares held at Rs. 30 per share.

Required:

1. Prepare relevant ledger accounts to record the above transaction
2. Prepare extracts of balance sheet showing share capital and share premium a/c
3. Babar owned 3,200 shares in Right Co Ltd before the rights issue. How many numbers of shares will he own after the rights issue? What will be his share of the voting right in the Company before and after the rights issue?

Solution:

Share Capital a/c

Particulars	Rupees	Particulars	Rupees
		Opening balance b/f	800,000
Closing balance c/f	1,000,000	Bank a/c (rights issue)	200,000

Share Premium a/c

Particulars	Rupees	Particulars	Rupees
		Opening balance b/f	320,000
Closing balance c/f	720,000	Bank a/c (rights issue)	400,000

Bank a/c

Particulars	Rupees	Particulars	Rupees
Share Capital a/c	200,000		
Share Premium a/c	400,000		

Working:

Existing shares 80,000
Opening balance of share capital 80,000 x 10 = 800,000
Opening balance of share premium 80,000 x 4 = 320,000

Rights shares 80,000 x ¼ = 20,000
Face value 20,000 x 10= 200,000
Premium 20,000 x 20= 400,000

Balance Sheet (extracts)

	After	**Before**
Share Capital	1,000,000	800,000
Share Premium	720,000	320,000
	1,720,000	**1,120,000**

Before the rights issue Babar owned 3,200 shares out of a total of 80,000 shares. This gave him 4% of the voting rights in the company. The 1 for 4 rights issue gives him another 800 shares and increases his share holding to 4,000. He now owns 40,000 shares out of 100,000 shares, which is again 4%.

Bonus Issue of Shares

Bonus issue of shares is made when the company has build up substantial reserves. Issue of bonus share is made to the existing shareholders without receiving any consideration. In bonus issue of share a part of company's reserves are reclassified as share capital. This is also known as capitalization of reserves or scrip issue.

There are a number of reasons for issue of bonus shares.

1. Increasing the number of shares in issue will make it easier to divide the shares between a larger numbers of shareholders. This is useful when a company wants to bring in news shareholder.
2. Increasing the value of the company's share capital will strengthen the balance sheet. This is useful if a company has grown rapidly, and the share capital is out of proportion to the net assets of the entity.
3. The market price of each share will fall. This makes the shares more affordable, and encourages more people to buy shares. This is the most common reason for publicly quoted company to make a bonus issue.

Solved Questions

Bonus Co Ltd has 50,000 Ordinary Shares in issue for Rs. 10 each. It decides to issue bonus shares 2 for every 5 shares held. Share premium will be utilized for the issue.

Balance sheet of Bonus Co Ltd immediately before the bonus issue is as follows:

	Rupees
Ordinary Share Capital	500,000
Share Premium	380,000
Retained profits	570,000
	1,450,000

Share Capital a/c

Particulars	**Rupees**	Particulars	**Rupees**
		Opening balance b/f	500,000
Closing balance c/f	700,000	Share premium a/c	200,000

Share Premium a/c

Particulars	**Rupees**	**Particulars**	**Rupees**
Share Capital a/c	200,000	Opening balance b/f	380,000
Closing balance c/f	180,000		

Retained profits a/c

Particulars	**Rupees**	**Particulars**	**Rupees**
Share Premium a/c	570,000	Opening balance b/v	570,000

Balance sheet of Bonus Co Ltd immediately after the bonus issue is as follows:

	Rupees
Ordinary Share Capital	700,000
Share Premium	180,000
Retained profits	570,000
	1,450,000

Returns on Financial Sources

Company style of business entity obtains finances from two sources; Owners' Capital and Lenders' Capital. Both of the financers are paid in terms of returns on their respective capitals. Return on owners' capital is known as dividend and return on lenders' capital is known as interest/markup.

Dividends

Company style of business entity does not allow its owners (shareholders) to draw cash or non cash resources from the entity like sole proprietorship and partnership business organizations. As a replacement for drawings the shareholders are paid dividends.

Dividend is the return on finances received from the equity participants (ordinary shareholders). Dividends may be paid after declaration of the current year's profits and may also be paid during the accounting year as interim dividend based on expectation of the profits.

Declaration of dividends depends upon the availability of profits where as payment of dividends depends upon the availability of cash resources. So, in order to pay dividends, the company must have sufficient distributable profits as well as cash resources. Therefore, it is only the board of directors who takes decision that how much dividends should be paid to the shareholders. Although the decision of dividends is taken by the directors but it is formally approved by the shareholder in the annual general meeting after they have gone through the annual report.

Calculation of dividends

Amount of dividend can be determined in either of the two ways:

1. As a percentage of the amount of issued and paid-up share capital
2. As rupees/paisa per number of issued and paid-up share capital

***Example*:**

Ordinary share capital of a company is 100,000 number of ordinary share of Rs. 10 each and dividend is paid to shareholders either; as 7% of the ordinary share capital issued or as Paisa 50 per share.

If dividend is paid as a percentage

The amount of dividend is Rs. 1,000,000 x 7% = Rs. 70,000

If dividend is paid as paisa per share

The amount of dividend is 100,000 x 0.50 = Rs. 50,000

Accounting for dividends

For dividends paid (interim dividends and previous year's proposed dividends)

Dividends a/c
    Bank a/c

Debit to the dividend a/c is recognized as a decrease in equity (retained earnings) and is presented in the statement of changes in equity.
Credit to bank a/c is recognized as a decrease in cash resources kept in the bank.

For dividends proposed by the directors
Where directors of an entity propose dividends after the balance sheet date (closing date of the year), such dividends are not recognized as a liability and so are not recognized as a decrease in equity. This is so because such proposed dividends do not meet the criterion of a present obligation to be a liability. Such dividends are disclosed in the notes in accordance with the requirements of IAS 1 and IAS 10.

Example:
Pleasure Co. Ltd paid Rs. 55,000 during the year ending on December 31, 2009 as interim equity dividends.
On March 21st, 2010, directors of the company proposed and declared final equity dividends of Rs. 135,000 in addition to the already paid.

Presentation:

Statement of changes in equity
For the year ended 31-12-2009
(Extract)

	Rupees
Opening balances (retained profits)	???????
Dividend paid	(55,000)

Balance Sheet
As on 31-12-2009
(Extract)

	Rupees
Current Assets	
Bank balance (decreases by Rs. 55,000)	???????

Notes
For the year ended 31-12-2009
(Extract)

Proposed Dividends
Dividends proposed for the year is Rs. 135,000.

LESSON # 24

COMPANY ACCOUNTS (Cont.)

Interest on Debentures/Loan notes

Debentures, loan notes, loan bonds, or loan stocks are the lenders' capital. These are the long term loans and have charge on the non-current assets of the entity through a trust. Money against these loan certificates is collected from the general public. Against the capital money received, the company pays interest to the lenders.

A company style of business entity also receives money from the financial institutions as loan. This loan is also a long term loan and is subject to interest on it. This loan is secured against non-current assets or inventories of the entity either through mortgage, pledge, or hypothecation.

Interest on these sources of finance is calculated on the amount due for the period (time) dues. It means that if the loan was of Rs. 200,000 and an installment of Rs. 50,000 has been paid, the interest will be calculated on the amount due i.e. Rs. 150,000. It further means that if the loan was taken on 1st of October, 2009 and the accounting year ends on 31st of December, 2009, the interest will be calculated for the three (3) months i.e. October, November, & December.

Calculation of interest/markup

<u>Basic Scenario</u>

		Rupees
5% Debentures	opening balance 1-1-09	25,000
	Issued during the year	20,000
	Closing balance 31-12-09	45,000

<u>Scenario I</u>

If the fresh issue of 5% Debentures took place on January 1st, 2009

Interest on debentures 5% of Rs. 25,000 for full year	1,250
Interest on debentures 5% of Rs. 20,000 for full year	1,000
Financial charges for the year	2,250

<u>Scenario II</u>

If the fresh issue of 5% Debentures took place on July 1st, 2009

Interest on debentures 5% of Rs. 25,000 for full year	1,250
Interest on debentures 5% of Rs. 20,000 for six months	500
Financial charges for the year	1,750

Changed Scenario

		Rupees
5% Debentures	opening balance 1-1-09	25,000
	Redemption during the year	15,000
	Closing balance 31-12-09	10,000

Scenario III

If the redemption of 5% Debentures took place on January 1st, 2009

Interest on debentures 5% of Rs. 10,000 for full year	500
Financial charges for the year	500

Scenario IV

If the redemption of 5% Debentures took place on July 1st, 2009

Interest on debentures 5% of Rs. 10,000 for full year	500
Interest on debentures 5% of Rs. 15,000 for six months	375
Financial charges for the year	875

Scenario V

If the redemption of 5% Debentures took place on December 31st, 2009

Interest on debentures 5% of Rs. 25,000 for full year	1,250
Financial charges for the year	1,250

Accounting for Interest/markup

For the amount of interest/markup paid during the year

Financial charges a/c
    Bank a/c

Debit to the financial charges a/c is recognized as an expense in the incomes statement and is presented as deduction form operating profits before charging income tax. Credit to bank a/c is recognized as a decrease in cash resources kept in the bank.

For the amount of interest/markup due on balance sheet date

Financial charges a/c
    Accrued/owing financial charges a/c

Debit to the financial charges a/c is included in the interest/markup paid and then recognized as an expense in the incomes statement. Total financial charges, paid and due, are presented as deduction form operating profits before charging income tax.

Credit to accrued/owing financial charges a/c is recognized as a current liability in balance sheet, as it meets all the criteria to be a liability.

Example:

Pleasure Co. Ltd paid Rs. 25,000 during the year ending on December 31, 2009 as interest on loan. On closing date Rs. 10,000 interest on loan is still due.

Presentation:

Income Statement
For the year ended 31-12-2009
(Extract)

	Rupees
Profit from operations	*****
Other incomes	*****
Financial charges	(35,000)
Profit before tax	*****
Income tax	(****)
Profit after tax	*****

Balance Sheet
As on 31-12-2009
(Extract)

	Rupees
Current Assets	
Bank balance (decreases by Rs. 25,000)	???????
Current Liabilities	
Interest accrued/owing	10,000

Income Tax Expense

Income tax expense is a charge on the realized profits earned by an entity. This is calculated in accordance with the Income Tax Ordinance 2001 and its accounting treatments are set out in IAS 12.

Income tax expense for the year comprises of:

- Current tax, and
- Deferred tax

Current tax:

Current tax is the income tax on current year's taxable profits that is levied by the income tax authorities. The income tax authorities come to know the profits of an entity when the income tax return is submitted. Income tax return for the year is prepared by the tax accountant of the entity after the financial statements have been approved and published, obviously in these financial statements the current year's income tax expense is calculated on estimated bases. Such estimated amount of income tax is known as provision for income tax. Hence, in the income statement, the income tax expense representing current tax will be an estimated amount with an adjustment of the difference between actual and estimated amount of previous year's income tax expense.

Example:

Years	2007	2008	2009
	Rupees	*Rupees*	*Rupees*
Profit before tax	50,000	60,000	40,000
Income Tax rate	40%	40%	40%
Provision for tax	20,000	24,000	16,000
Actual Tax levied		22,000	23,000

Accounting Entries

<u>For the year 2007</u>

Income tax expense a/c	20,000	
Provision for tax a/c		20,000

It is assumed that the year 2007 is first year of the business and for the profits of the year 2007 the estimated amount of the income tax expense is worked out as Rs. 20,000. Debit to the income tax expense a/c is subtracted from the profit before tax. Whereas, credit to provisions for tax a/c is recognized as a current liability, because the entity has a present obligation to pay tax in future against current year's profits.

<u>For the year 2008</u>

Provision for tax a/c	20,000	
Income Tax expense a/c	2,000	
Bank a/c		22,000
Income tax expense a/c	24,000	
Provision for tax a/c		24,000
Income statement a/c	26,000	
Income tax expense a/c		26,000

Obligation against the previous year's income tax expense is settled in the current year. Amount of income tax paid in excess to the previous years' estimated (provision for) income tax is charged to the current year's income statement as a part of current year's income tax expense.

In the above case Rs. 22,000 income tax was paid against the provision for income tax Rs. 20,000 created last year, the excessive amount of income tax paid during the current year for the previous year is Rs. 2,000 known as under-provision. This Rs. 2,000 (under-provision) is closed into the income statement for the current year along with the current year's provision of Rs. 24,000 as an expense. So, the total amount of income tax expense for the year 2008 is Rs. 26,000.

For the year 2009

Provision for tax a/c	24,000	
Income Tax expense a/c		1,000
Bank a/c		23,000
Income tax expense a/c	16,000	
Provision for tax a/c		16,000
Income statement a/c	15,000	
Income tax expense a/c		15,000

When the amount of income tax paid in the current year is lesser than the previous years' estimated (provision for) income tax the difference is known as over provision, which is subtracted from the current year's provision for income tax as an adjustment.

In the above case Rs. 23,000 income tax was paid against the provision for income tax Rs. 24,000 created last year, the lesser amount of income tax paid is Rs. 1,000. This under-provision of Rs. 1,000 is subtracted form the current year's provision for income tax of Rs. 16,000 and the balance of Rs. 15,000 is closed into the income statement for the current year as an expense.

Working in support of the above accounting:

	2007 *Rupees*	**2008** *Rupees*	**2009** *Rupees*
Income Statement			
Provision for current year's tax	20,000	24,000	16,000
Add Under provision		2,000	
Less Over provision			(1,000)
Income tax expense for the year	20,000	26,000	15,000
Balance Sheet			
Current Liabilities			
Provision for income tax	20,000	24,000	16,000

Deferred tax:

Deferred tax is an accounting adjustment that is used to match the tax effects with accounting profits.

Accounting entries:

<u>For creating provision for deferred tax</u>

Income tax expense a/c
    Deferred tax liability a/c

<u>For increasing the provision for deferred tax</u>

Income tax expense a/c
    Deferred tax liability a/c

<u>For decreasing the provision for deferred tax</u>

Deferred tax liability a/c
    Income tax expense a/c

Presentation in Financial Statements

Balance Sheet
As on 31-12-2009
(Extract)

Liabilities	***Rupees***
Non-Current Liabilities	
Deferred tax liability	****
Current Liabilities	
Provision for income tax	****

Income Statement
For the year ended 31-12-2009
(Extract)

Profit before tax			****	
Income tax expense				
Current tax				
Provision for current year's tax	***			
Add under-provision	***			
Less over-provision	(***)	****		
Deferred tax				
Deferred tax liability increased by		****		
Deferred tax liability decreased by		(***)	(****)	
Profit after tax				****

Solved Questions

Amjad Ltd. is preparing its accounts for 20X2. A summarized trial balance is noted below:

	Rs. 000	Rs. 000
Profits before tax and dividends		1,036
Total assets	2,292	
Sundry current liabilities		241
Income tax	25	
Provision for deferred tax		47
Long-term loan		200
Ordinary shares		100
Opening retained earnings		693
	2,317	2,317

Notes:

a. No dividends have been paid or proposed.
b. Last year's income tax was settled at Rs. 238,000. The under provision is noted on the trial balance.
c. The provision for deferred tax should be adjusted to a closing balance of Rs. 33,000.

Required:
Prepare an income statement, statement of changes in equity and balance sheet with for Amjad Ltd. for 20X2.

Solution:

Amjad Ltd.: Income Statement for 20X2

		Rs. 000
Profit before tax		1,036
Taxation	(Note 1)	(364)
Profit after tax		672

Amjad Ltd.: Statement of changes in equity (extract)

	Rs. 000
Opening retained earnings	693
Profit for the year	672
Closing retained earnings	1,365

Balance Sheet for 20X2

	Rs. 000	Rs. 000
Total Assets		2,292
Equity and Liabilities		
Equity		
Ordinary shares		100
Retained earnings		1,365
		1,465
Non-Current Liabilities		
Deferred tax (Note 2)	33	
Long-term loan	200	
		233
Current Liabilities		
Sundry	241	
Income tax	353	
		594
		2,292

Note 1 – Tax Charge

	Rs. 000
Income tax charge on the profits for the year at XX %	353
Under (over) provision for tax in previous years	25
Deferred tax charge (credit)	(14)
	364

Note 2 – Provision for deferred tax

	Rs. 000
Opening provision	47
Charge (credit) for the year	(14)
Closing provision	33

Solved Questions

TAXATION – X LTD

X Ltd. is preparing its accounts for the year ended 31 December 20X6. The deferred tax account as at 31 December 20X5 was Rs. 50,000. A provision of Rs. 70,000 for deferred tax will be required at the year-end. The current income tax charge provision for the year is Rs. 60,000. Prepare the relevant extracts from the income statement, balance sheet and the notes to the accounts.

Solution:

TAXATION – X LTD
Extract from the income statement
For the year ended 31 December 20X6

	Rs.	Rs.
Taxation		
Income tax at X%	60,000	
Deferred taxation	20,000	
Tax charge		80,000

Extract from balance sheet
As at 31 December 20X6

	Rs.
Non-current liabilities	
Deferred taxation (Note 1)	70,000
Current liabilities	
Income tax	60,000

Notes to the accounts

1. Deferred taxation

	Rs.
Balance brought forward	50,000
Transfer from income statement	20,000
Balance carried forward	70,000

LESSON # 25

IASB'S FRAMEWORK

IASB stands for International Accounting Standard Board; it is an independent, privately funded accounting standard setter organization. IASB develops Accounting Standards that harmonize the accounting practices globally.

Objective:

Main objective of the framework is to provide a rational and sensible guide for preparing accounting standards and applying them accordingly. This framework is used preparation and presentation of financial statements.

Purpose of IASB's Framework:

It provides assistance in:

- Development of new IFRS (International Financial Reporting Standards)
- Review of existing IAS (International Accounting Standards)
- Promoting Harmonization
- Developing National Standards

Components of Financial Statements and their objectives

The framework is concerned with "general purpose financial statements". Components of financial statements include:

1. Balance Sheet
    - Balance sheet is prepared to know the financial position

2. Income Statement
    - Income statement shows financial performance/profitability

3. Statement of Changes in Equity
    - This statement is prepared to show the movement in different heads of owners' equity

4. Cash Flow Statement
    - It is prepared to know the cash inflows and outflows during the year divided into operating, investing and financing activities

5. Notes
    - Notes are prepared to disclose significant accounting policies selected and applied in preparing the financial statement. It also contains some imperative disclosures to make financial statements understandable.

Users of the financial statements

Communication of the financial information flows towards the users of the financial statements.

- Shareholders (assess the ability of enterprise to pay the dividend)
- Lenders (determine the ability of enterprise to pay their loan and interest)
- Employees (concerned about their pay, retirement benefits etc.)
- Govt. agencies (determine tax, regulate the activities)
- Public (enterprises make substantial contribution to the local economy)
- Suppliers (evaluate whether the entity will be fine as a customer and pay its dues)
- Customers (decide whether the company will be able to continue producing and supplying goods with the same quality)

Underlying Assumptions

1) ***Accrual Basis***

Accrual concept is used to measure the incomes and expenses of the entity. According to the accrual concept incomes and expenses are not measured at the amount of cash received or paid during the year but for incomes the measurement basis are earnings and for expenses measurement basis are incurrence. They are recorded in the accounting records and reported in the financial statement for the period to which they relate.

2) ***Going Concern***

Going concern means that the entity will continue its operations for the foreseeable future and there is no intention to liquidate it or to significantly curtail its operations.

Qualitative Characteristics of Financial Statements

Qualitative characteristics are the attributes that make the information provided in financial statements useful to the users.

Qualitative characteristics that make the financial information useful

<u>Materiality</u>

It is threshold quality which must be checked before studying the further qualitative characteristics.

Information is material if its omission/misstatement could influence the economic decisions of users taken on the basis of financial statements.

1) ***Relevance***

Information must be relevant to the decision making needs of users. It helps users to evaluate past, present or future events. It also helps users to confirm or correct past evaluations.

What makes financial information relevant?

Predictive role

Current level/structure of asset holding issued to predict the ability of the entity to take advantages of opportunities and its ability to react to adverse situation.

Confirmative role

Some information plays confirmatory role as outcome of the planned operations. Information about financial position and past financial performance is used as predicting future financial position and performance.

2) ***Reliability***

Information may be relevant but so unreliable in nature that its recognition may be potentially misleading.

What makes financial information reliable?

Faithful representation

Information must represent faithfully the transactions it purports to represent in order to be reliable.

Substance over form

It is the principle that transactions and other events are accounted for and presented in accordance with their economic substance (economic reality) and not merely their legal form.

Neutrality

Information must be free from bias and should not be focused on predetermined results.

Prudence

Financial information presented in the financial statements relating to the assets and incomes should not be overstated and relating to the liabilities and expenses should not be understated.

Completeness

Financial information must be complete in terms of cost measurement and documentation. Omission may cause information to be misleading.

Qualitative characteristics that make the presentation useful

1) ***Comparability***

Users should be able to compare an entity's performance over time and to compare one entity's performance with other.

Consistency

To make the financial statements comparable, accounting policies and classifications should be consistent over the years. Requirements of the applicable accounting standards should also be applied consistently.

Disclosure of accounting policies

Significant accounting policies should be disclosed in the notes. This makes the financial statements comparable with financial statements of other entities.

2) ***Understandability***

Financial statements should be presented in such a way that these are understood by a user having average knowledge of commerce and business.

Readily understandable by users

Users are assumed to have basic knowledge of accounting to understand the published financial statements.

Aggregation and classification

Presentation of financial information in the financial statements should be aggregated if these are not material. Information relating to the same class should be classified in one group.

Constraints to relevancy and reliability of financial information

Quality of relevancy and reliability depends upon three constrains:

1) ***Balance between qualitative characteristics***

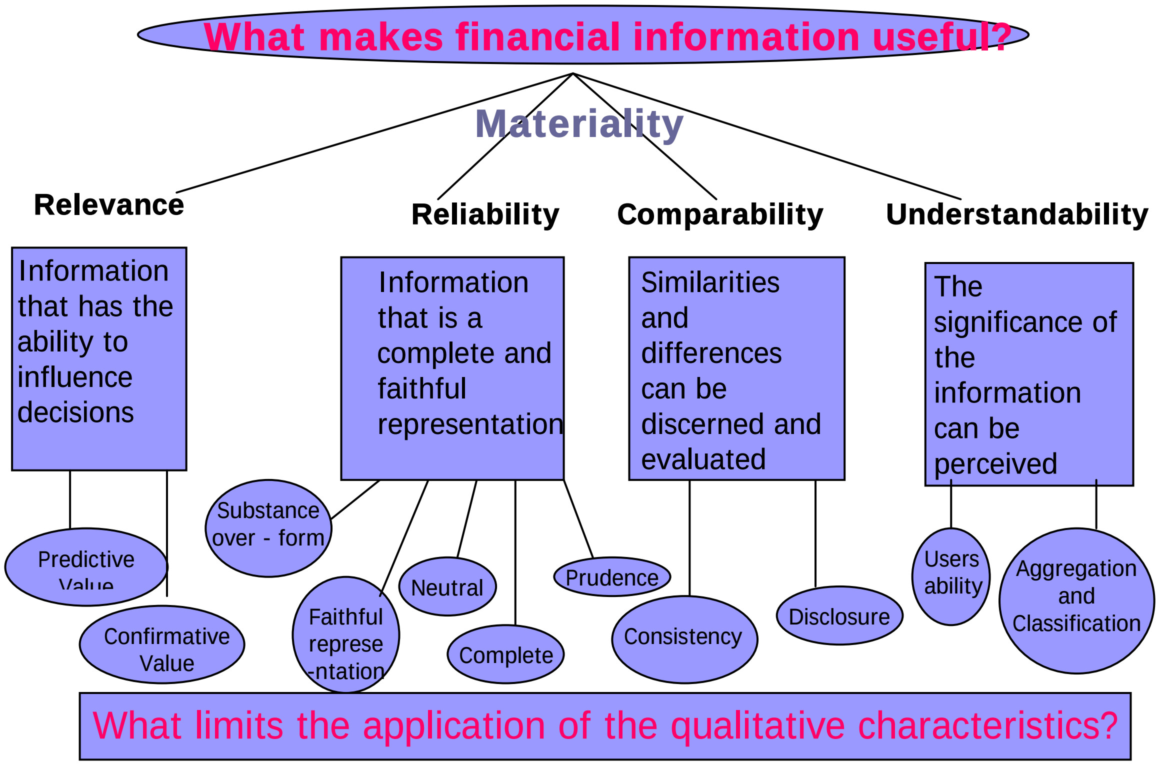
Relevance and reliability are often in conflict. For example; market values of fixed tangible assets more relevant than historical cost, but these are less reliable.

2) ***Timeliness***

If there is unjustified delay in the reporting of information it may lose its relevancy. Information may be reported on a timely basis when all aspects of the transaction are not known, thus compromising reliability.

3) Balance between cost and benefit

When information is provided, its benefits must exceed the costs of obtaining and presenting it.

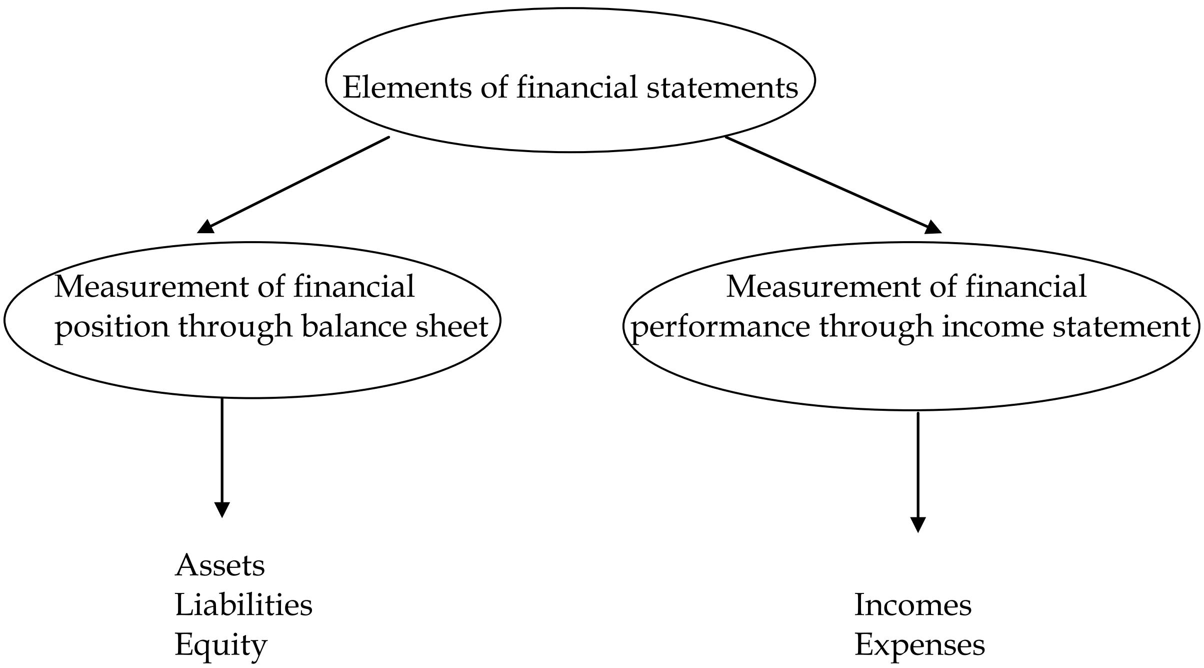


- **Balance Between the Qualitative Characteristics**
- **Balance between the Benefit and Cost**
- **Timeliness**

LESSON # 26

ELEMENTS OF FINANCIAL STATEMENTS

Financial information of an entity are classified into five main heads, these main heads are elements of financial statements.



Assets:

These are the resources in control of the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

Points to remember:

1. Resources in control
2. Past event
3. Future inflow

Liabilities:

These are the present obligations of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

Points to remember:

1. Present obligation
2. Past event
3. Future outflow

Equity:
It is the residual interest in the assets after deducting all its liabilities. In other words, equity is what is left when all liabilities have been settled.

Points to remember:

1. Equity contributed
2. Reserves created

Incomes:

Incomes establish increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity other than those relating to contributions from equity participants.

Incomes include:

1. Revenue
    a. Sales of goods
    b. Sales of services
    c. Returns on investments
2. Gains
    a. Disposal of assets at a value higher than its carrying amount
    b. Discharge of liabilities at a value lesser than its carrying amount

Expenses:

Expense is decrease in economic benefits during the accounting period in the form of outflows or decrease in assets or incurrence of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

Expenses include:

1. Revenue Expenses
    a. Expenses that arise in the course of ordinary activities of an entity.
2. Losses
    a. Disposal of assets at a value lesser than its carrying amount.
    b. Discharge of liabilities at a value higher than its carrying amount.

General Recognition Criteria

An item should be recognized in the Financial statements if:

1. It means one of the definitions of element;
2. It is probable that any future economic benefit, associated with the item will flow to or from the entity (for example, Income is recognized when a Sales is made, not when an order is received).

3. The item has a cost or value that can be measured with reliability.

Measurement of the Elements of Financial Statements

A number of different measurement bases are employed to different degrees and combinations in financial statements. These include:

1. **Historical Cost**

Assets are recorded at the amount of cash paid to acquire them. Sometimes the terms cash equivalents or fair value at acquisition will be used instead.
Liabilities are recorded at the proceeds received in exchange for the obligation on the date of transaction.

2. **Current Cost**

Assets are carried at their current purchase price.
Liabilities are carried at the undiscounted amount currently required to settle them.

3. **Realizable Value**

Assets are carried at the amount, which could currently be obtained by an orderly disposal.
Liabilities are carried at their settlement values, the amount to be paid to satisfy them in the normal course of business.

4. **Present Value**

Assets are carried at the present discounted value of the future net cash inflows that the item is expected to generate in the normal course of business.
The most common measurement basis adopted by the entity in preparing financial statements is historical cost. This is usually combined with other bases.

Capital Maintenance

1. Financial capital maintenance
2. Physical capital maintenance

LESSON # 27

IAS 10 – EVENTS AFTER THE BALANCE SHEET DATE

Before starting discussion on the IAS 10 that is about the events that occur after the balance sheet date, let us differentiate between the:

- Draft Financial Statements and
- Published Financial Statements

Draft financial statements:

Draft financial statements are one that are prepared by the accounts department, audited by the external auditors and put in front of the board of directors for approval.

Published financial statements:

Published financial statements are one that has been approved by the board of directors and has also been published for issuance to the shareholders of the company.

Here we must also discuss different dates that are pertinent to the **IAS 10** for better understanding.

- Balance Sheet Date
- Date of the Board of Director's Meeting (BOD)
- Date of the Annual General Meeting (AGM)

Balance sheet date:

It is the closing date on which the balance sheet is prepared. This is the closing date of the accounting year.

Date of BOD meeting:

It is the date in which the directors approve the financial statements of the company. This date is obviously after the balance sheet date but before the date of annual general meeting (AGM). The BOD meeting should be held at least 21 days before the date of the annual general meeting. Because members of the company should receive 21 days notice of the AGM along with the published financial statements.

Date of AGM:

It is the date that should not be after the expiry of four months (in Pakistani scenario according to the requirements of the securities and exchange commission of Pakistan-SECP) and six months (in international scenario according to the provisions of IAS-1)

Note:

The BOD holds meeting after the balance sheet date but before the annual general meeting.

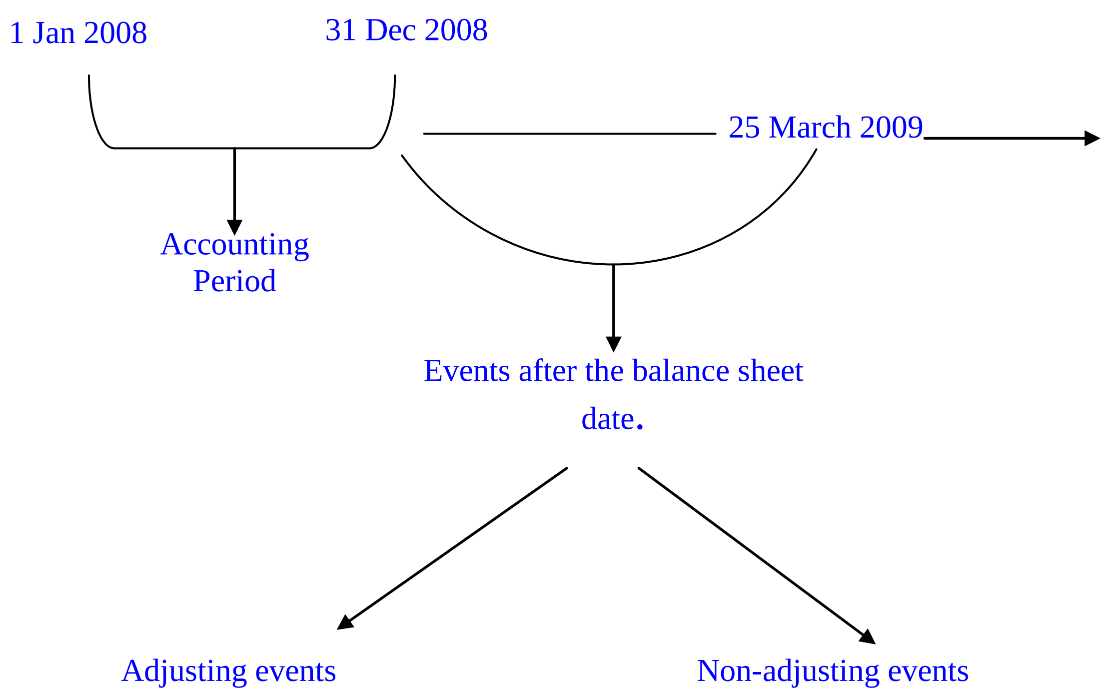
Events after the balance sheet date

These are those events, favorable and unfavorable, that occur between the balance sheet date and the date when the financial statements are authorized for issue. Two types of events can be identified:

(a) Those events that provide evidence of conditions that existed at the balance sheet date (adjusting events after the balance sheet date); and

(b) Those events that are indicative of conditions that arose after the balance sheet date (non-adjusting events after the balance sheet date).

Following figure will help to under stand the events after the balance sheet date;



In this figure balance sheet date is December 31, 2008 and the date of BOD meeting is March 25, 2009. So the events that occur in between these two dates will be the events after the balance sheet date.

Explanation:

A Good Stock costing Rs. 100,000 was written down to NRV of Rs. 97,500 at the Balance Sheet date. After the Balance Sheet date it is sold for Rs. 96,000.

The condition of stock at the balance sheet date has not changed till sale and the future event provides evidence regarding the decline in its value. Thus, it is an adjusting event after the balance sheet date.

On the other hand, a Good Stock costing Rs. 200,000 was written down to NRV of Rs. 197,000 at the balance sheet date. After the balance sheet date the stock was spoiled and sold for only Rs.10, 000 as scrap.

In this case the condition of spoilage did not exist at the balance sheet date. This spoilage is indicative of condition that arose after the balance sheet date. So, this is a non-adjusting event after the balance sheet date.

Example-1:

Classify the following events after the balance sheet date as adjusting or non-adjusting:

(a) Creative Textile (Private) Limited decided to takeover Saga Sports (Private) Limited after the balance sheet date.

(b) QSA Surgical announces a plan to discontinue its Marala Branch after the balance sheet date.

(c) Sale of inventory after the balance sheet date below its cost and also below its NRV (Inventory was measured at NRV on the Balance Sheet Date).

(d) Changes in tax rates after the balance sheet date having a significant effect on current and deferred tax assets and liabilities.

(e) A doubtful customer defaults after the balance sheet date; provision for such customer has been made @ 10%.

(f) Asset purchased on 27th December 2004, invoice has been received on 5th January 2005. The year ends on 31st December 2004.

(g) The discovery of fraud that shows that the financial statements are incorrect.

Solution:

Adjusting events after the balance sheet date.

(c), (e), (f), (g)

Non-adjusting events after the balance sheet date.

(a), (b), (d)

The process involved in authorizing the financial statements for issue will vary depending upon the management structure, statutory requirements and procedures followed in preparing and finalizing the financial statements.

In some cases, an entity is required to submit its financial statements to its shareholders for approval after the financial statements have been issued. In such cases, the financial statements are authorized for issue on the date of issue, not the date when shareholders approve the financial statements.

Example-2:

The management of an entity completes draft financial statements for the year to 31st December 2005 on 28th January 2006. On 18th February 2006, the board of directors reviews the financial statements and authorizes them for issue. The entity announces its profit and selected other financial information on 19th February 2006. The financial statements are made available to shareholders and others on 1st March 2006. The shareholders approve the financial statements at their annual meeting on 15th April 2006 and the approved financial statements are then filed with a regulatory body on 17th April 2006.

The financial statements are authorized for issue on 18th February 2006 (date of board authorization for issue).

In some cases, the management of an entity is required to issue its financial statements to a supervisory board (made up solely of non-executives) for approval. In such cases, the financial statements are authorized for issue when the management authorizes them for issue to the supervisory board.

Example-3:

On 18th February 2002, the management of an entity authorizes financial statements for issue to its supervisory board. The supervisory board is made up solely of non-executives and may include representatives of employees and other outside interests. The supervisory board approves the financial statements on 26th February 2002. The financial statements are made available to shareholders and others on 1st March 2002. The shareholders approve the financial statements at their annual meeting on 15th April 2002 and the financial statements are then filed with a regulatory body on 17th April 2002.

The financial statements are authorized for issue on 18th February 2002 (date of management authorization for issue to the supervisory board).

RECOGNITION AND MEASUREMENT:

Adjusting Events after the Balance Sheet Date:

An entity shall adjust the amounts recognized in its financial statements to reflect adjusting events after the balance sheet date.

Example-4:

A customer was considered doubtful at the balance sheet date. A provision for such customer was made @ 50%. After the balance sheet date, customer was declared as insolvent based on his financial position on year end.

Required: What will be the accounting treatment?

Solution:

This is an adjusting event after the balance sheet date and should be recognized in the financial statements. At the balance sheet date, 100% provision shall be made against that debtor i.e. provision is to be increased by further 50%.

Example-5:

A customer was doubtful at the balance sheet date. A provision for such customer was made @ 5%. After the balance sheet date, customer paid 85% of the total amount.

Required: What will be the accounting treatment?

Solution:

This is an adjusting event. This event shall be recognized in the financial statements. At the balance sheet, provision shall be made @ 15% i.e. Additional 10% provision shall also be recorded.

Non-adjusting Events after the Balance Sheet Date:

An entity shall not adjust the amounts recognized in its financial statements to reflect

Non-adjusting events after the balance sheet date.

Example-6

An asset, whose book value is Rs. 89,000, was destroyed by fire after the balance sheet date.

Required:

(i) Identify event type

(ii) What will be accounting treatment?

Solution:

(i) This is non-adjusting event as the condition arose after the balance sheet date.

(ii) An entity shall not recognize such event in the financial statement. It shall only be disclosed.

Examples are:

a) Decline in market value of investments between the balance sheet date and the date when the financial statements are authorized for issue.

b) Loss of stock after the date of financial statements.

The following are the examples of non-adjusting events after the balance sheet date that would generally result in disclosure:

(a) A major business takeover after the balance sheet date or disposing of a major subsidiary;

(b) Announcing a plan to discontinue an operation;

(c) Major purchases of assets, classification of assets as held for sale, other disposals of assets, or expropriation of major assets by government;

(d) The destruction of a major production plant by a fire after the balance sheet date;

(e) Announcing, or commencing the implementation of, a major restructuring;

(f) Abnormally large changes after the balance sheet date in asset prices or foreign exchange rates;

(g) changes in tax rates or tax laws enacted or announced after the balance sheet date that have a significant effect on current and deferred tax assets and liabilities;

(h) Entering into significant commitments or contingent liabilities, for example, by issuing significant guarantees; and

(i) Commencing major litigation arising, solely out of events that occurred after the balance sheet date.

Dividends

If an entity declares dividends to holders of equity instruments after the balance sheet date, the entity shall not recognize those dividends as a liability at the balance sheet date.

If dividends are declared (i.e. the dividends are appropriately authorized and no longer at the discretion of the entity) after the balance sheet date but before the financial statements are authorized for issue, the dividends are not recognized as a liability at the balance sheet date because they do not meet the criteria of a present obligation in IAS-37. Such dividends are disclosed in the notes in accordance with IAS-1 Presentation of Financial Statements.

Example-7:

Mobitel Private Limited announces dividend to its shareholders amounting to Rs.1,500,000 after the Balance Sheet Date. The closing balance of Retained Earnings is Rs. 7,000,000 including above dividend.

Required: Effect of the above on Financial Statements

Solution:

It shall be disclosed in the notes to the accounts as follows:

Proposed Dividend

Dividend proposed for the year is Rs. 1,500,000.

Going Concern

An entity shall not prepare its financial statements on a going concern basis if management determines after the balance sheet date either that it intends to liquidate the entity or to cease trading, or that it has no realistic alternative but to do so.

Deterioration in operating results and financial position after the balance sheet date may indicate a need to consider whether the going concern assumption is still appropriate. If the going concern assumption is no longer appropriate, the effect is so pervasive that this Standard requires a fundamental change in the basis of accounting, rather than an adjustment to the amounts recognized within the original basis of accounting.

Example-8:

Elahi (Private) Limited is in the course of finalizing its financial statements for the year ended 30th June 2004.

Due to market competition and loss of customers, company intends to cease its business and liquidate the company.

Should the company prepare financial statement on a going concern basis?

Solution:

The company should not prepare the financial statement on a going concern basis. It must also disclose the fact that financial statements are not prepared on a going concern basis. The amounts appearing in Financial Statements would also be adjusted appropriately according to new basis of accounting i.e. current market values.

IAS – 37 PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS

DEFINITIONS:

The following terms are used in this Standard with the meanings specified:

Provision:

A provision is a liability of uncertain timing or amount. For a provision following points must be kept in mind:

- Present obligation
- Arising from the past event
- Probable outflow of resources in future
- Amount can be estimated reliably.

Provision is created for two motives:

- One to reduce Assets
- Second to create a liability against losses

Provision that is created for reduction in assets is of two types:

1. Provision against receivables (also known as contra to receivables – Provision for doubtful debts)
2. Provision against the expiry of economic benefits of fixed assets (Provision for depreciation/amortization).

IAS 37 does not talk about the provisions created to reduce the carrying amount of assets. It only talks about the provision that is created to recognize a liability against probable losses.

Liability:

A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. Definition of liability can be divided into three parts:

- Present obligation
- Arising from the past event
- Probable outflow of resources in future

LESSON # 28

IAS – 37 PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS

Obligation Event:

An obligating event is an event that creates a legal or constructive obligation that results in an entity having no realistic alternative but to settle that obligation.

- **Legal Obligation:**

A legal obligation is an obligation that derives from:

a) A contract (through its explicit or implicit terms);
b) Legislation; or
c) Other operations of law.

- **Constructive Obligation:**

A constructive obligation is an obligation that derives from an entity's actions where:

a) By an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities.
b) As a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

Contingent Liability:

A contingent liability is:

a) A possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or
b) A present obligation that arises from past events but is not recognized because:

    i. It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation.
    ii. The amount of the obligation cannot be measured with sufficient reliability;

Contingent Assets:

A contingent asset is a possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

Treatment of Liabilities, Accruals & Provisions:

Liabilities can be categorized as:

1. Certain liability — example is Creditors against supplies
2. Virtually certain liability — example is Accruals against expenses
3. Uncertain liability — example is Provision against expected losses

	Liabilities (certain)	***Accruals (virtually certain)***	***Provisions (uncertain)***
Status	Present obligation	Present obligation	Present obligation
Arising from	Past events	Past events	Past events
Outflow of resources embodying economic benefits	Probable	Probable	Probable
Measurement of amount	Certain	Virtually certain	Uncertain (However a reliable estimate can be made)
Accounting treatment	Dr. Purchases Cr. Creditors	Dr. Expense Cr. Accrual/Owings	Dr. Loss (Expenses) Cr. Provision for the Loss

Virtually certain:

Something that involve a minor degree of estimation. An example of such would be the amount payable in Utility Bills. The expense on the bill is for one month; however the meter is read a couple of days after the month including charges for those extra days as well.

Identifying Contingent Liabilities:

Following table will help to identify whether the obligation is a contingent liability or not in accordance with the definition of IAS 37.

	Case 1	***Case 2***	***Case 3***
Status	Possible obligation	Present obligation	Present obligation
Arising from	Past events	Past events	Past events

Outflow of resources embodying economic benefits	Will be confirmed upon the occurrence or non-occurrence of future events, not in the control of the entity	Probable	Not probable
Amount	a] Future events are not remote b] Future events are remote	Cannot be measured reliably	a] Probability is not remote b] Probability is emote
Accounting treatment	a] Disclosed in notes b] Not disclosed in notes	Disclosed in notes	a] Disclosed in notes b] Not disclosed in notes

Accounting Requirements for recognizing Liabilities and Assets:

Recognizing liabilities and assets means to record relevant accounting heads in the books of accounts. IASB frame work and relevant Accounting Standards provide guidelines for recognizing liabilities and assets at different stages.

Following table will explain that which type of liabilities and assets will be treated in what way.

Stage	***Liabilities***	***Assets***
Certain	Recognize	Recognize
Virtually certain (Accruals/Owings)	Recognize	Recognize
Uncertain (Probable/Provision)	Recognize	Do not recognize Disclose only
Contingent	Do not recognize Disclose only	Do nothing
Remote	Do nothing	Do nothing

Do nothing:

'Do nothing' means that the event is to be ignored while preparing the financial statements. Even a disclosure of the same is not required in the notes to the accounts.

Recognizing different transactions/events in Accordance with IAS 37:

Expense/Loss (Status)	*Measurement of amount*	*Status/Recognize as*	*Accounting entry*
Identified as present obligation	Certain (Invoice/supporting documents based)	Liability	Dr. Expense Cr. Payable
Identified as present obligation	Virtually certain (Invoice/supporting documents based)	Accrued liability	Dr. Expense Cr. Accrual/Owings
Identified as present obligation	Uncertain (amount can be estimated reliably with probable outflow of resources)	Provision liability	Dr. Expense (Loss) Cr. Provision for loss
Identified as present obligation	Uncertain (amount can not be estimated reliably although there is a probability of outflow of resources)	Contingent liability	No entry. Disclose only
Identified as present obligation	Uncertain (without any probability of outflow resources)	Contingent liability	No entry. Disclose only
Unidentified ***(possible obligation)***	Uncertain (possible outflow of resources are based on future events not in control of the entity)	Contingent liability	No entry. Disclose only
Unidentified ***(remote obligation)***	Uncertain	No recognition	No entry. No disclosure

Liability	Creditors	Accrued Expense	Provision liability	Contingent liability	Contingent liability	Contingent liability
	Certain	Virtually certain	Uncertain	Uncertain	Uncertain	Possible
1: Present obligation	✓	✓	✓	✓	✓	X
2: Arising from past events	✓	✓	✓	✓	✓	✓
3: Probable outflow of resources embodying economic benefit in future	✓	✓	✓	✓	X	✓
4: Reliable estimation of the amount (can be measured reliably)	As per Invoice received	As per previous Invoice	✓	X	-	-/ X/ ✓
5: Accounting treatment	Expense/Resources Payable A/C	Expense A/C Accrual A/C	Losses against warranty Dr. Provision for Warranty Cr.	No entry only disclosure is required	No entry only disclosure is required	No entry only disclosure is required

<u>Provisions and Other Liabilities:</u>

Provisions can be distinguished from other liabilities such as trade payables and accruals because there is uncertainty about the timing or amount of the future expenditure required in settlement. By contrast:

a) Trade payables are liabilities to pay for goods or services that have been received or supplied and have been invoiced or formally agreed with the supplier; and

b) Accruals are liabilities to pay for goods or services that have been received or supplied but have not been paid, invoiced or formally agreed with the supplier, including amounts due to employees (for example amounts relating to accrued vacation pay).

Although it is sometimes necessary to estimate the amount or timing of accruals, the uncertainty is generally much less than for provisions. Accruals are often reported as part of trade and other payables, whereas provisions are reported separately.

<u>Relationship between Provisions and Contingent Liabilities:</u>

This Standard distinguishes between:

a) Provisions – which are recognized as liabilities (assuming that a reliable estimate can be made) because they are present obligations and it is probable that an outflow of resources embodying economic benefits will be required to settle the obligations; and
b) Contingent liabilities – which are not recognized as liabilities because they are either:

   i. Possible obligations, as it has yet to be confirmed whether the entity has a present obligation that could lead to an outflow of resources embodying economic benefits; or
   ii. Present obligations that do not meet the recognition criteria in this Standard (because either it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation, or a sufficiently reliable estimate of the amount of the obligation cannot be made).

RECOGNITION:

Provisions:

A provision shall be recognized when:

a) An entity has a present obligation (legal or constructive) as a result of a past event;
b) It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
c) A reliable estimate can be made of the amount of the obligation.

If these conditions are not met, no provision shall be recognized.

Present Obligation:

In rare cases it is not clear whether there is a present obligation. In these cases, a past event is deemed to give rise to a present obligation if, taking account of all available evidence, it is more likely than not, that a present obligation exists at the balance sheet date.

In almost all cases it will be clear whether a past event has given rise to a present obligation. In rare cases, for example in a law suit, it may be disputed either whether certain events have occurred or whether those events result in a present obligation. In such a case, an entity determines whether a present obligation exists at the balance sheet date by taking into account of all available evidence, including for example, the opinion of experts. The evidence considered includes any additional evidence provided by events after the balance sheet date. On the basis of such evidence:

a) Where it is more likely than not, that a present obligation exists at the balance sheet date, the entity recognizes a provision (if the recognition criteria are met); and
b) Where it is more likely that no present obligation exists at the balance sheet date, the entity discloses ability, unless the possibility of an outflow of resources embodying economic benefits is remote.

Past Events:

A past event that leads to a present obligation is called an obligating event. For an event to be an obligating event, it is necessary that the entity has no realistic alternative to settling the obligation created by the event. This is the case only:

a) Where the settlement of the obligation can be enforced by law; or
b) In case of a constructive obligation, the event creates valid expectations in other parties that the entity will discharge the obligation.

Probable Outflow of Resources Embodying Economic Benefits:

For a liability to qualify for recognition there must be not only a present obligation but also the probability of an outflow of resources embodying economic benefits to settle that obligation. For the purpose of this Standard, an outflow of resources or other event is regarded as probable if the event is more likely than not to occur i.e. the probability that the event will occur is greater than the probability that it will not. Where it is not probable that a present obligation exists, an entity discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote.

Reliable Estimate of the Obligation:

The use of estimates is an essential part of the preparation of financial statements and does not undermine their reliability. This is especially true in the case of provisions, which by their nature are more uncertain than most other balance sheet items.

Contingent Liabilities:

An entity shall not recognize a contingent liability. A contingent liability is disclosed unless the possibility of an outflow of resources embodying economic benefits is remote.
Contingent liabilities may develop in a way not initially expected. Therefore, they are assessed continually to determine whether an outflow of resources embodying economic benefits has become probable. If it becomes probable that an outflow of future economic benefits will be required for an item previously dealt with as a contingent liability, a provision is recognized in the financial statements of the period in which the change in probability occurs (except in the extremely rare circumstances where no reliable estimate can be made).

Example-1:

Extract from Notes to the Accounts:

a) Guarantees issued by banks on behalf of the company;
b) Claims against the company were not acknowledged as debt by the company. As the management is confident that the matter would be settled in her favor; consequently no provision has been made in the financial statements in respect of the disputed liabilities.

Contingent Assets:

An entity shall not recognize a contingent asset. Contingent assets usually arise from unplanned or other unexpected events that give rise to the possibility of an inflow of economic benefits to the entity. An example is a claim that an entity is pursuing through legal processes, where the outcome is uncertain.
Contingent assets are not recognized in financial statements since this may result in the recognition of income that may never be realized. However, when the realization of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate.
A contingent asset is disclosed where an inflow of economic benefits is probable.

Example-2:

The company has filed a suit against SA Ltd. claming damages amounting to Rs. 600,000. The legal advisors of the company are of the opinion that the company will win the case.

MEASUREMENT:

Best Estimate:

The amount recognized as a provision shall be the best estimate of the expenditure required to settle the present obligation at the balance sheet date.
The estimates of outcome and financial effect are determined by the judgment of the management of the entity, supplemented by experience of similar transactions and in some cases, reports from independent experts. The evidence considered includes any additional evidence provided by events after the balance sheet date.

Example-3:

An entity sells goods with a warranty under which customers are covered for the cost of repairs of any manufacturing defects that become apparent within the first six months after purchase. If minor defects were detected in all products sold, repair costs of Rs. 1 million would result. If major defects were detected in all products sold, repair costs of Rs. 4 million would result. The entities past experience and future expectations indicate that, for the coming year, 75 percent of the goods sold will have no defects, 20 percent of the goods sold will have minor defects and 5 percent of the goods sold will have major defects. In accordance with 3.1.4.2, an entity assesses the probability of an outflow for the warranty obligations as a whole.

The expected value of the cost of repairs is:
(75% of Nil) + (20% of Rs. 1 m) + (5% of Rs. 4 m) = Rs. 400,000.

CHALLANGES IN PROVISION:

Provision shall be reviewed at each balance sheet date and adjusted to reflect the current best estimate. If it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision shall be reversed.

USE OF PROVISIONS:

A provision shall be used only for expenditures for which the provision was originally recognized.
Only expenditures that relate to the original provision are set against it. Setting expenditures against a provision that was originally recognized for another purpose would conceal the impact of two different events.

Solved Questions

A damage claim of Rs. 15 million for breach of contract has been served on the company. The company's legal counsel is of the view that it is probable that the damages will be awarded to plaintiff. So, the company makes a provision. In the next year the case is decided in the favor of the plaintiff. The company has to pay Rs. 12

million. Another suit filed against the company is also decided in this year. The company has to pay Rs. 2 million in respect of this case.

Required: How will you account for above two payments?

Solution:

i. The first payment of Rs. 12 million shall be charged to provision and remaining provision should be reversed.

Provision for claim	15,000,000	
Cash		12,000,000
Profit & Loss (Reversal of provision)		3,000,000

ii. The second payment of Rs. 2 million shall be charged to P & L Account separately.

Damages Expenses (P & L A/c)	2,000,000	
Cash		2,000,000

<u>Application of the Recognition and Measurement Rules:</u>

Future Operating Losses:

a) Provisions shall not be recognized for future operating losses.
b) Future operating losses do not meet the definition of a liability and the general recognition criteria set out for provisions.
c) An expectation of future operating losses is an indication that certain assets of the operation may be impaired. An entity tests these assets for impairment under IAS-36 Impairment of Assets.

Onerous Contracts:

If an entity has a contract that is onerous, the present obligation under the contract shall be recognized and measured as a provision.

LESSON # 29

IAS 8
ACCOUNTING POLICIES, CHANGES IN ACCOUNTING ESTIMATES AND ERRORS

This standard shall be applied in selecting and applying accounting policies, and accounting for changes in accounting policies, changes in accounting estimates and corrections of prior period errors.

DEFINITIONS:

The following terms are used in this standard with the meanings specified:

Accounting policies:

These are the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements.

Change in accounting estimate:

It is an adjustment of the carrying amount of an asset or a liability, or the amount of the periodic consumption of an asset, that results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities. Changes in accounting estimates result from new information or new developments and, accordingly, are not corrections of errors.

Example-1:

English Limited acquired an asset. The company estimates its useful life 5 years i.e. future economic benefits shall be drawn from the asset in next 5 years.

This is an accounting estimate.

After 2 years, the company estimates its remaining useful life 4 years. There is a change in total useful life of the asset in third year.

This change is a change in accounting estimate.

Material:

a) Omissions or misstatements of items are material if they could, individually or collectively; influence the economic decisions of users taken on the basis of the financial statements.
b) Materiality depends on the size and nature of the omission or misstatement judged in the surroundings circumstances.
c) The size or nature of the item, or a combination of both, could be the determining factor.

Example-2:

Ihsan Sports Private Limited is in the course of finalizing its financial statement for the year ended 30th June. 2004.

The following information is available from draft financial statements: -

Sales Rs. 200,000,000

Gross profit Rs. 50,000,000

Net profit Rs. 20,000,000

a) Sales made during the month of June are omitted from above records amounting to Rs. 10,000,000.
b) Purchase of stationery on 30th June amounting to Rs. 5,000 is also omitted from above records.

Required: Which items are materials with respect to the above drafts of financial statements?

Solution:

- Sale omitted are 5% of total sales recorded, while stationery purchased is 0.0025%
- Sales omitted are 50% of net profit while stationery purchased is 0.025%.

So, sales omitted are material, which could influence the economic decisions of users. But stationery is not a material because the amount is immaterial with respect to sales and net profit.

Prior period errors:

These are omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that was available when financial statements for those periods were authorized for issue; and could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.

Such errors include the effects of:-

a) Mathematical mistakes;
b) Mistakes in applying accounting policies;
c) Oversights; or
d) Misinterpretations of facts; and
e) Fraud

Retrospective application:

This application is applying a new accounting policy to transactions, other events and conditions as if that policy had always been applied i.e. effect of change in accounting policy regarding previous period is to be calculated.

Retrospective restatements:

Retrospective restatements is correcting the recognitions, measurement and disclosure of amounts of elements of financial statements as if a prior period error had never occurred i.e. correction of error is to be made by restating the previous income statement and opening balance of previous periods' retained earnings.

Prospective application:

It is change in accounting policy and of recognizing the effect of a change in an accounting estimate, respectively, is:

a) Applying the new accounting policy to transactions, other events and conditions occurring after the date as at which the policy is changed; and
b) Recognizing the effect of change in the accounting estimates in the current and future periods affected by the change.

ACCOUNTING POLICIES:

Selection and Application of Accounting Policies:

When a Standard or an Interpretation specifically applies to a transaction, other event or condition, the accounting policy or policies applied to that item shall be determined by applying the Standard or Interpretation and considering any relevant Implementation Guidance issued by the IASB for the standard or interpretation.

In the absence of a Standard or an Interpretation that specifically applies to a transaction, other event or condition, management shall use its judgment in developing and applying an accounting policy that results in information that is:

a) Relevant to the economic decision-making needs of users; and
b) Reliable i.e. the financial statements:

    i. Represent faithfully the financial position, financial performance and cash flows of the entity. Reflect the economic substance of transactions, other events and conditions, and not merely the legal form;
    ii. Are neutral, i.e. free from bias;
    iii. Are prudent; and
    iv. Are complete in all material respect.

Accounting policies are selected and applied in accordance with a particular standard e.g. FIFO or Weighted Average for inventory measurement. If there is no specific policy in the standard, interpretation or any guidance issue by IASB, the policy selected should fulfill the requirements given in the above paragraph.

In making the judgment described in above paragraph, the management shall refer to, and consider the applicability of, the following sources in descending order:

a) The requirements and guidance in Standards and Interpretations dealing with similar and related issues; and
b) The definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the Framework.

Consistency of Accounting Policies:

a) An entity shall select and apply its accounting policies consistently for similar transactions, other events and conditions, unless a Standard or an Interpretation specifically requires or permits categorization of items for which different policies may be appropriate.
b) If a Standard or an Interpretation requires or permits such categorization, an appropriate accounting policy shall be selected and applied consistently to each category.

CHANGES IN ACCOUNTING POLICIES:

An entity shall change an accounting policy only if the change:

a) Is required by Standard or an Interpretation; or
b) Result in the financial statements providing reliable and more relevant information.

Example-4:

i. Lasani Private Limited has the following LIFO (an allowed alternative treatment of previous IAS-2) for Inventory measurement. Now the entity is required to adopt FIFO or weighed Average method for Inventory measurement (as per the revised IAS-2).

This is a change in accounting policy required by standard.

ii. Pak Limited has been recognizing revenue on dispatch of goods to customers. The company has now decided to recognize revenue on approval of goods by the customer. This change was due to unreliable courier service. The products delivered were not received in good condition by the customers and the company used to take back these damaged goods.

This is a change in accounting policy, which provides more reliable and relevant information about the effects of the transactions.

The following are not considered as changes in accounting policies:-

a) The application of an accounting policy for transactions, other events or conditions that differ in substance from those previously occurring; e.g. loans were used for qualifying assets first time in current year. Previously loans were used for purchase of vehicles and furniture etc.
b) The application of a new accounting policy for transactions; other events or conditions that did not occur previously or were immaterial e.g. policy for borrowing costs, loan taken in current year first time.

The initial application of a policy to revalue assets in accordance with IAS 16 Property, Plant and Equipment or IAS 38 Intangible Assets is a change in an accounting policy to be dealt with as a revaluation in accordance with IAS 16 or IAS 38, rather than in accordance with this Standard.

APPLYING CHANGES IN ACCOUNTING POLICES:

a) An entity shall account for a change in accounting policy, if the change is required by a standard, as per transitional provision, if any, given in the Standard.
b) An entity shall account for a change in accounting policy retrospectively if:

    i. The change is required by a Standard and where no specific transitional provision given in Standard, or
    ii. Change in accounting policy is voluntary.

***Retrospective application**:*

When a change in accounting policy is applied retrospectively, the entity shall adjust.

a) The opening balance of each affected component of equity for the earliest prior period presented; and
b) The other comparative amounts disclosed for each prior period presented as if the new accounting policy had always been applied.

Solved Questions

During 2004, Aslam Engineering Ltd changed its accounting policy for the treatment of borrowing costs that are directly attributable to the construction of commercial building to serve as their head office power station. In previous periods, Aslam Engineering Ltd had capitalized such costs. Aslam Engineering Ltd has now decided to treat these costs as an expense, rather than capitalize them. Management judges that the new policy is preferable because it results in a more transparent treatment of finance costs and is consistent with local industry practice, making Aslam Engineering Ltd financial statements more comparable.

Aslam Engineering Ltd capitalized borrowing costs incurred of Rs. 2,600 during 2003 and Rs. 5,200 in periods before 2003. All borrowing costs incurred in previous years in respect of the building under construction were capitalized.
Aslam Engineering Ltd accounting records for 2004 show profit before interest and income taxes of Rs. 30,000, interest expense of Rs. 3,000 (which relates only to 2004); and income taxes of Rs. 8,100.
Aslam Engineering Ltd has not yet recognized any depreciation on the building under construction because it is not yet in use. In 2003, Aslam Engineering Ltd reported:

	Rs.
Profit before interest and income taxes	18,000
Interest expense	-
Profit before income taxes	18,000
Income taxes	(5,400)
Profit	12,600

2003 opening retained earnings was Rs. 20,000.and closing retained earnings was Rs.32, 600

Aslam Engineering Ltd tax rate was 30 percent for 2004, 2003 and prior periods.
Aslam Engineering Ltd had Rs. 10,000 of share capital throughout, and no other components of equity except for retained earnings.

Solution:

Aslam Engineering Ltd
Extract from the Income Statement

	2004	**(Restated) 2003**
	Rs.	**Rs.**
Profit before interest and income taxes	30,000	18,000
Interest expense	(3,000)	(2,600)
Profit before income tax	27,000	15,400
Income tax	(8,100)	(4,620)
Profit	18,900	10,780

Aslam Engineering Limited
Statement of Retained Earnings

	(Restated) Retained Earnings Rs.
Balance at 31 December 2002	20,000
Effect of change in accounting policy (Note)	(3,640)
Balance at 31 December 2002 (restated)	16,360
Profit for the year ended 31 December 2003 (restated)	10,780

Balance at 31 December 2003	27,140
Profit for the year ended 31 December 2004	18,900
Balance at 31 December 2004	46,040

Note:

Effect of change in accounting policy is the de-capitalization of interest (net of income taxes of Rs. 1,560).

Solved Questions

Servis Shoes Limited has prepared the following information for the year ended 31

March 2005.

Profit & Loss Account

	2005 Rs	2004 Rs.
Sales	75,000	72,750
Cost of sales	(50,000)	(48,500)
Gross profit (1/3 of sales)	25,000	24,250
Operating expenses	(7,500)	(7,750)
	17,500	16,500
Income tax @ 30%	(5,250)	(4,950)
Net Profit	12,250	11,550

Statement of Retained Earnings

	2005 Rs.	2004 Rs.
Balance as at opening date	11,000	7,500
Profit for the year	12,250	11,550
	23,250	19,050
Dividend	10,250	(8,050)
Balance as at closing date	**13,000**	**11,000**

The company used to account for revenue on dispatch of goods. The company observes that the sales returns are increasing year by year. Due to a dishonest employee, quantity received by customers was often less than quantity dispatched.

Along-with administrative action the company also changed its policy for recognition of revenue and decided to account for revenue after receiving acknowledgment from customer.

Relevant amounts for the previous years; since the changed policy was adopted is Rs. 9,000 decrease in sales, resulting in a decrease of Rs. 3,000 in profit before tax.

For the current year 2005, goods dispatched by the company amounted to Rs. 1,500 which were acknowledged in next period, are included in profit & loss account already prepared. For previous year 2004, this amount was Rs. 1,000.

Required: Account for the above change in Accounting policy.

Solution:

Service Shoes Limited
Profit & Loss Account
For the year ended 31 March 2005

	2005 Rs.	(Restated) 2004 Rs.
Sales (W-1)	74,500	71,750
Cost of sales - Balancing figure	(49,667)	(47,833)
Gross profit (1/3 of sales)	24,833	23,917
Operating expenses	(7,500)	(7,750)
	17,333	16,167
Income Tax @ 30%	(5,200)	(4,850)
Net profit	12,133	11,317

Service Shoes Limited
Statement of Retained Earnings (Extract)
For the year ended 31 March

	(Restated) Rs.
Balance as at 31.3.2003 (W-2)	5,400
Profit for the year 2004 (restated)	11,317
	16,717
Dividend	(8,050)
Balance as at 31.3.2004	8,667
Profit for the year 2005	12,133
	20,800
Dividend	(10,250)
Balance as at 31.3.2005	10,550

Workings:

(W-1) Adjusted sales for:

	2005 Rs.	2004 Rs.
Sales before change in Accounting policy	75,000	72,750
(Decrease) in sales	(1,500)	(1,000)
Increase in sales	1,000	-

	Adjusted sales	74,500	71,750
(W-2)	Adjustment in opening retained profits as on 31.3.2003		7,500
	Profit before tax	3,000	
	Income Tax effect 30%	(900)	(2,100)
			5,400

If retrospective application is impracticable then change in accounting policy will be applied prospectively from the year when it is practicable to change.

LESSON # 30

IAS 8
ACCOUNTING POLICIES, CHANGES IN ACCOUNTING ESTIMATES AND ERRORS

CHANGES IN ACCOUNTING ESTIMATES:

As a result of the uncertainties inherent in business activities, many items in financial statements cannot be measured with accuracy but can only be estimated. Estimation involves judgments based on the latest available and reliable information. For example, estimates may be required for:

a) Doubtful debts,
b) Inventory obsolescence;
c) The fair value of financial assets or financial liabilities;
d) The useful lives of, and expected pattern of consumption of the future economic benefits embodied in depreciable asset, and
e) Warranty obligations.

The effect of a change in an accounting estimate, other than a change to which following paragraph applies, shall be recognized prospectively by including it in profit or loss in:

a) The period of the change, if the change affects that period only; or
b) The period of the change and future period, if the change affects both.

To the extent that a change in an accounting estimate gives rise to changes in assets and liabilities, or relates to an item of equity it shall be recognized by adjusting the carrying amount of the related asset, liability or equity item in the period of the change.

a) Prospective recognition of the effect of a change in an accounting estimate means that the change is applied to transactions, other events and conditions from the date of the change in estimate.
b) A change in an accounting estimate may affect only the current period's profit or loss, or the profit or loss of both the current period and future periods.

For example, a change in the estimate of the amount of bad debts affects only the current period's profit or loss and therefore is recognized in the current period only. However, a change in the estimated useful life of, or the expected pattern of future economic benefits embodied in a depreciable asset affects depreciation expense for the current period and future periods during the asset's remaining useful life. In both cases, the effect of the change relating to the current period is recognized as income or expense in the current period. The effect, if any, on future periods is, recognized as income or expense in those future periods.

Solved Questions

Idrees Sports Private Limited purchased an asset with followings details:

Cost Price	=	Rs. 2,500,000
Estimated useful life	=	10 years
Estimated residual value	=	Rs. 100,000

In third year, the company estimates the useful life of its asset at 6 years with residual value of Rs. 220,000. The company depreciates its asset on straight line method.

Required: Account for the above Accounting Estimates in the Financial Statements of Idrees Sports Private limited, in the third year.

Solution:

Idress Sports Private Limited
Extract from cost of goods sold statement

	Rs
Manufacturing Expenses	
Depreciation (W-2)	300,000

Note: This change in Accounting Estimate has been accounted for prospectively.

Working:

(W-1)

Year	*Cost*	*Depreciable Amount*	*Depreciation Rate (W-3)*	*Depreciation Amount*	*Book Value*
	(Rs)	(Rs)	%	(Rs)	(Rs)
1	2,500,000	2,400,000	10%	240,000	2,260,000
2.		2,400,000	10%	240,000	2,020,000

(W-2)

Year	**Carrying Amount**	**Depreciable Amount**	**Depreciable Rate**	**Depreciation**	**Book Value**
	Rs	***Rs***	***%***	***Rs***	***Rs***
	(2,020,000 – 220,000)				
3	2,020,000	1,800,000	16.67%	300,000	1,720,000
4			16.67%	300,000	1,420,000
5			16.67%	300,000	1,120,000
6.			16.67%	300,000	820,000
7.			16.67%	300,000	520,000
8			16.67%	300,000	220,000

(W-3) Depreciation rate in first two years

$$\text{Depreciation Rate} = \frac{1}{\text{Estimated useful life}} \times 100$$

$$\text{Depreciation Rate} = \frac{1}{10} \times 100$$

$$\text{Depreciation Rate} = 10\%$$

(W-4) Depreciation rate from third year

$$\text{Depreciation Rate} = \frac{1}{\text{Estimated useful life}} \times 100$$

$$\text{Depreciation Rate} = \frac{1}{6} \times 100$$

$$\text{Depreciation Rate} = 16.67\%$$

Disclosure:

An entity shall disclose the nature and amount of change in an accounting estimate that has an effect in the current period or is expected to have an effect in future periods, except for the disclosure of the effect on future periods when it is impracticable to estimate that effect.

If the amount of the effect in future periods is not disclosed because it is impracticable, an entity shall disclose that fact.

Errors:

a) Errors can arise in respect of the recognition, measurement, presentation or disclosure of elements of financial statements.
b) Financial statements do not comply with IFRSs if they contain either material errors or immaterial errors made intentionally to achieve a particular presentation of an entity's financial position, financial performance or cash flow.
c) Potential current period errors discovered in that period are corrected before the financial statements are authorized for issue. However, material errors are sometimes not discovered until a subsequent period, and these prior period errors are corrected in the comparative information presented in the financial statements for that subsequent period.

If it is not impracticable, an entity shall correct prior period errors retrospectively in the first set of financial statements authorized for issue after their discovery by:

a) Restating the comparative amounts for the prior period(s) presented in which the error occurred; or
b) If the error occurred before the earliest prior period presented, and then restating the opening balances of assets, liabilities and equity for the earliest prior period presented.

Solved Questions

During 2008, Saleem Co discovered that some products that had been sold during 2007 were incorrectly included in inventory at 31 December 2007 at Rs. 6,500.

Saleem Co's accounting records for 2008 show sales of Rs. 104,000, cost of goods sold of Rs.86,500 (including Rs. 6,500) for the error in opening inventory), and income taxes of Rs. 5,250.

In 2007, Saleem Co's reported:

	2007
	Rs.
Sales	73,500
Cost of goods sold	(53,500)
Profit before income taxes	20,000
Income taxes	(6,000)
Profit	14,000

2007 opening retained earnings was Rs. 20,000 and closing retained earning was Rs.34, 000.

Saleem Company's income tax rate was 30 percent for 2008 and 2007. It had no other income or expenses

Saleem Company's had Rs. 50,000 of share capital throughout and no other components of equity except for retained earnings.

Solution:

Saleem Co's

Extract from the Income Statement

		(Restated)
	2008	**2007**
	Rs.	**Rs.**
Sales	104,000	73,500
Cost of goods sold	(80,000)	(60,000)
Profit before income taxes	24,000	13,500
Income taxes	(7,200)	(4,050)
Profit	16,800	9,450

Saleem Co's

Statement of Changes in Equity

		2008	2007
	Rs.	**Rs.**	**Rs.**
Opening Balance (Retained Profit b/f)		34,000	20,000
Adjustment in opening retained profit	6,500		
Income tax effect at 30%	(1,950)	4,550	
Adjusted Retained profit		29,950	
Profit after tax for the current year		16,800	9,450
Closing Balance at (Retained Profit c/f)		46,250	29,450

LESSON # 31

BORROWING COST (IAS 23)

This standard deals with the cost (interest/financial charges) of such borrowings that are made for purchase, acquisition or construction/production of assets.

DEFINITIONS:

Two very important terminologies of this standard need explanation, before going into the further details.

1) **Borrowing Costs:**

These are interest and other costs incurred by an entity in connection with the borrowing of funds.

Examples of Borrowing Costs:

(a) Interest on bank overdrafts and short-term and long term borrowings;
(b) Amortization of discounts or premiums relating to borrowings;
(c) Amortization of ancillary costs incurred in connection with the arrangement of borrowings (*e.g. processing fee, lawyer's consultation etc.*);
(d) finance charges in respect of finance leases recognized in accordance with IAS 17, Leases; and
(e) Exchange difference arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest cost.

2) **A qualifying asset:**

It is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

Examples of Qualifying Assets:

a) Manufacturing plants
b) Power generation facilities
c) Investment properties
d) Those inventories which are routinely manufactured or produced in large quantities on a repetitive basis and assets ready for their intended use or sale when acquired are not qualifying assets.

Solved Questions

Identify which of the followings are qualifying assets:

(a) Power plant being in the process of manufacturing.
(b) Inventories routinely manufactured;
(c) Asset ready for use;

(d) Inventories requiring a substantial period for manufacturing.
(e) Special order for a special inventory that will be manufactured in 5 months.

Solution:

(a) Qualifying Asset;
(b) Not Qualifying Asset;
(c) Not Qualifying Asset;
(d) Qualifying Asset;
(e) Qualifying Asset.

Accounting for borrowing costs:

1) Benchmark Treatment:

Recognition:

Under the benchmark treatment borrowing costs are recognized as an expense in the period in which they are incurred regardless of how the borrowings are applied.

Disclosure:

The financial statements shall disclose the accounting policy adopted for borrowing costs (*e.g. Interest, markup, profit and other charges on borrowings are charged to income*).

2) Allowed Alternate Treatment:

Recognition:

Borrowing costs shall be recognized as an expense in the period in which they are incurred, except to the extent that borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset shall be capitalized as part of the cost of that asset.

Borrowing costs eligible for capitalization:

The borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made. When an entity borrows funds specifically for the purpose of obtaining a particular qualifying asset, the borrowing costs that directly relate to that qualifying asset can be readily identified.

Solved Questions

Mega Limited is engaged in the production of power generation plants, which is to be used by the company.
The company borrows Rs.20, 000,000 @ 10% for construction of the plant.
The company wants to adopt the policy for accounting treatment of interest expense on such borrowings.

What options are available to the company under IAS-23, Borrowing Costs?

Solution:

Benchmark Treatment:

Interest expense is recognized as an expense in the period in which it is incurred. Therefore, the company under benchmark treatment should recognize the interest of Rs. 2,000,000 as an expense.

Allowed Alternative Treatment:

Under allowed alternative treatment, the interest expense of Rs. 2,000,000 shall be capitalized in the cost of the asset.

Specific Borrowings:

Where funds are borrowed specifically for a qualifying asset, the amount of borrowing cost (less temporary investment income if any) shall be capitalized as a cost of such asset.

Temporary Investment Income:

When all of the borrowed funds are not utilized at once for acquisition, development or construction of qualifying asset, the unutilized amount of the borrowed fund is invested temporarily(for a little time period) in some securities. The return on such investments is known as temporary investment income.

Solved Questions

Swan Limited borrowed a loan from bank @ 12% per annum amounting to Rs.1, 000,000 for the construction of power generation facilities of the company. The loan was received on January 01 and utilized Rs. 300,000 on Qualifying Asset. On January 01, the company deposited the remaining amount in a bank yielding interest @ 6%. Whole of the amount is withdrawn and paid to contractor on March 01. The company returned the loan to bank after 9 months i.e. on October 01. You are required to calculate the amount of borrowing cost eligible for capitalization.

Hint:

Borrowing period 9 months
Investment period 2 months

Solution:

	Rs.
Interest paid to bank	
$1{,}000{,}000 \times 12\% \times \frac{9}{12}$	90,000
Less: Interest income	
$700{,}000 \times 6\% \times \frac{2}{12}$	(7,000)
Borrowing cost eligible for capitalization	83,000
Capital expenditure (Rs. 1,000,000 + 83,000)	**1,083,000**

General Borrowings:

The amount to be capitalized shall be computed on the basis of capitalization rate, which shall be the weighted average of the borrowing costs applicable to the outstanding borrowing during the period, i.e.

$$\text{Capitalization rate} = \frac{\text{Total Borrowing Cost incurred}}{\text{Weighted Borrowings Outstanding}} \times 100$$

This rate when applied on the expenditure incurred on Qualifying Asset on a time basis gives the amount of borrowing cost to be capitalized.
The capitalization should not exceed the amount of borrowing costs actually incurred,

Solved Questions

MCQ (Private) Limited has the following loans outstanding as at December 31, 2005.

	Rs.
Loan – 1 @ 6% (Due since opening date)	300,000
Loan – 2 @ 8% (Taken on 1 April, 2005)	200,000
Loan – 3 @ 9% (Taken on 1 July, 2005)	150,000

The company spent following amounts on construction of an asset.

January 31, 2005	70,000
April 1, 2005	80,000
December 1, 2005	10,000

Calculate

(i) Capitalization Rate
(ii) Borrowing cost eligible for capitalization.

Solution:

(i) Capitalization rate 7% (W-1)
(ii) Borrowing cost eligible for capitalization Rs.9, 136 (W-2)

Working:

(W-1) Capitalization Rate.

Loan	**Amount Rs.**		**W Avg. Rs.**	**Rate**	**Interest Rs.**
Loan – 1	300,000		300,000	6%	18,000
Loan – 2	200,000	(9/12)	150,000	8%	12,000
Loan – 3	150,000	(6/12)	75,000	9%	6,750
	650,000		525,000		36,750

$$\text{Capitalization rate} = \frac{\text{Total Interest}}{\text{Weighted Average Loan}} \times 100$$

$$= \frac{36{,}750}{525{,}000} \times 100$$

Capitalization rate = 7%

(W-2) Borrowing cost eligible for capitalization.

Expenditure	**Incurred on**	**Rate**	**Period**	**Capitalization Rs.**
70,000	January 31, 2005	7%	11/12	4,492
80,000	April 01, 2005	7%	9/12	4,200
10,000	December 01, 2005	7%	1/12	58
160,000				8,750

	Rupees
Total borrowing cost	**36,750**
Borrowing cost eligible for capitalization	**(8,750)**
Borrowing cost chargeable as expense	**28,000**

Capital Expenditure	**Rs.**
Incurred cost	**160,000**
Borrowing cost eligible for capitalization	**8,750**
Total	**168.750**

Solved Questions

MCQ (Private) Limited has the following loans outstanding as at December 31, 2005.

	Rs.
Loan – 1 @ 6% (Due since opening date)	300,000
Loan – 2 @ 8% (Due since opening date)	200,000
Loan – 3 @ 9% (Due since opening date)	150,000

The company spent following amounts on construction of an asset.

January 31, 2005	70,000
April 1, 2005	80,000
December 1, 2005	10,000

Calculate (i) Capitalization Rate
(ii) Borrowing cost eligible for capitalization.

Solution:

(i)	Capitalization rate	7.31% (W-1)
(ii)	Borrowing cost eligible for capitalization	Rs.9, 136 (W-2)

Working:

(W-1)

Loan	**Amount Rs.**	**Rate**	**Interest Rs.**
Loan – 1	300,000	6%	18,000
Loan – 2	200,000	8%	16,000
Loan – 3	150,000	9%	13,500
	650,000		47,500

$$\text{Capitalization rate} = \frac{\text{Total Interest}}{\text{Total Loan}} \times 100$$

$$= \frac{47{,}500}{650{,}000} \times 100$$

Capitalization rate = 7.31%

(W-2) *Borrowing cost eligible for capitalization.*

Expenditure *Rupees*	**Incurred on**	**Rate**	**Period**	**Capitalization** *Rupees*
70,000	January 31, 2005	7.31%	11/12	4,689
80,000	April 1, 2005	7.31%	9/12	4,386
10,000	December 1, 2005	7.31%	1/12	61
160,000				9,136

	Rupees
Total borrowing cost	**47,500**
Borrowing cost eligible for capitalization	**(9,136)**
Borrowing cost chargeable as expense	**38,364**
Capital Expenditure	
Incurred cost	**160,000**
Borrowing cost eligible for capitalization	**9,136**
Total	**169,136**

Solved Questions

Sublime Sports Limited is currently manufacturing its power plants.

Up-to December 31, 2003, the company has incurred costs totaling Rs.500, 000 on production of one of its plant.

The following loans are outstanding:

	Rs.
Loan from MCB @ 9%	500,000
Loan from HBL @ 10%	625,000
Loan from UBL @ 11%	375,000

Loan from HBL was taken on July 1, 20x3 other loan were brought forward from previous year.

Expenditure on plant incurred as follows:

	Rs.
May 31, 2003	300,000
July 31, 2003	200,000

You are required to calculate:

(a) Capitalization rate of the company;

(b) Total borrowing cost to be capitalized for the year 2003.

Solution:

(a) Capitalization rate 9.8947% (W-1)

(b) Total borrowing cost eligible for capitalization Rs. 25,562 (W-2)

Workings:

(W-1)

	Principal		W Avg. Loan *Rupees*	Rate	Interest *Rupees*
Loan from MCB	500,000	12/12	500,000	9%	45,000
Loan from HBL	625,000	6/12	312,500	10%	31,250
Loan from UBL	375,000	12/12	375,000	11%	41,250
			1,187,500		117,500

$$\text{Capitalization rate} = \frac{\text{Total interest}}{\text{Weighted average loan}} \times 100$$

$$= \frac{117{,}500}{1{,}187{,}500} x100$$

Capitalization rate = 9.8947%

(W-2) Total borrowing cost to be capitalized.

	Expenditure	Incurred on	Rate	Period	Capitalization
	300,000	May 31, 2003	9.8947%	7/12	17,316
	200,000	July 31, 2003	9.8947%	5/12	8,246
Rupees	500,000			***Rupees***	25,562

LESSON # 32

EXCESS OF THE CARRYING AMOUNT OF THE QUALIFYING ASSET OVER RECOVERABLE AMOUNT

When the carrying amount or the expected ultimate cost of the qualifying asset exceeds its recoverable amount or net realizable value, the carrying amount is written down or written off in accordance with the requirements of other Standards. In certain circumstances, the amount of the write down or write-off is written back in accordance with those other Standards.

Commencement of capitalization:

The capitalization of borrowing costs as part of the cost of a qualifying asset shall commence when:

(a) Expenditures on the asset are being incurred;
(b) Borrowing costs are being incurred; and
(c) Activities that are necessary to prepare the asset for its intended use or sale are in progress.

Solved Questions

Silver Star (Private) Limited engaged in manufacturing of surgical items. Currently the company is manufacturing its power plant. The company started the project on February 01, with its own funds. Later on due to shortage of funds, the company takes a loan to sponsor the project on May 01. The first payment out of the loan on the plant is made on June 01.

Required:

When should the company commence capitalization of borrowing cost on the plant?

***Solution*:**

The necessary three conditions for commencement of capitalization are fulfilled on June 01, so capitalization should commence on **June 01**.

Treatment of Subsidies by the Government:

Expenditures on a qualifying asset include only those expenditures that have resulted in payments of cash, transfers of other assets or the assumption of interest bearing liabilities. Expenditures are reduced by any progress payments received and grants received in connection with the asset. The average carrying amount of the asset during a period, including borrowing costs previously capitalized, is normally a reasonable approximation of the expenditures to which the capitalization rate is applied in that period.

Solved Questions

Pak Solutions Limited is engaged in the production of plants. The company is currently manufacturing a plant for internal use.
Following expenditures were made:

	Rupees
Payment to vendors for material	500,000
Depreciation of equipment used for manufacturing of plant	20,000
Wages paid	300,000
Utilities to be paid	80,000

Government granted a subsidy to the company for manufacturing of plant amounting to Rs.200, 000.

Required:

Assuming that the company funds the project by obtaining a loan, calculate the amount to be used as cost of the asset for computing the borrowing cost eligible for capitalization.

Solution:

Amount on which capitalization should be made:

	Rs.
Payment to vendors for materials	500,000
Wages paid	300,000
Depreciation of equipment	20,000
Utilities to be paid	80,000
	900,000
Less: Govt. subsidy	(200,000)
	700,000

The activities necessary to prepare the asset for its intended use or sale encompass more than the physical construction of the asset. They include technical and administrative work prior to commencement of physical construction, such as the activities associated with obtaining permits prior to the commencement of the physical construction.

Suspension of capitalizing borrowing cost:

Capitalization of borrowing costs shall be suspended during extended periods in which active development is interrupted.
Capitalization is not suspended when a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale e.g. the extended period during which high water level delay construction of a bridge.

Solved Questions

Shahid & company is constructing an asset for their own use in the business. The production of asset started on September 30, 2006. Due to some internal problems of the company, the construction remained suspended from November 01 to November 31. The asset was completed on December 31. The asset was constructed by utilizing the borrowed funds.

Required:

Calculate the period for which capitalization should be made.

Solution:

The active development started on September 30, and continued till October 31, and then after stoppage construction again started on December 1 till December 31.
Therefore, the borrowing cost should be capitalized for two months and shall remain suspended for one month.

Cessation of Capitalization:

Capitalization of borrowing costs shall cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

Solved Questions

Haroon Limited is constructing an asset for its internal use. The construction started on March 01, 2009. The asset was completed on July 31, 2009. It was put into use on September 15. The production was started from such asset on November 1.

Required:

You are required to state when capitalization of borrowing cost should be ceased.

Solution:

The asset was completed on July 31, 20x9. It was ready for use although the production from such asset was not started. Thus capitalization of borrowing cost should cease on July 31, 2009.

Modification work after completion:

An asset is normally ready for its intended use or sale when the physical construction of the asset is complete even though routine administrative work might still continue. If minor modifications, such as the decoration of a property to the purchaser's or user's specification, are all that are outstanding, this indicates that substantially all the activities are complete.

Solved Questions

Zeshan Limited is engaged in production of an asset. The production started on July 31, 2007. The production completed on July 31, 2008.
The works manager checked the asset and requested some minor modifications. These modifications were completed on August 30, 2008. The asset delivered to works manager on September 10, 2008. The production started from such asset on October 01, 2008.

Required:

When should capitalization cease.

Solution:

The capitalization should cease on July 31, 2008, as substantially the activities have been completed on this date.

Completion of work in parts:

When the construction of qualifying asset is completed in parts and each part is capable of being used separately while construction continues on other parts, capitalization of borrowing costs shall cease when substantially all the activities necessary to prepare that part for its intended use or sale are completed.
A business centre comprising several buildings, each of which can be used individually is an example of a qualifying asset for which each part is capable of being used while construction continues on other parts.
An example of a qualifying asset that needs to be completed in full, before any other part can be used, is an industrial plant involving several processes which are carried out in sequence at all parts of the plant within the same site, such as a steel mill.

Solved Questions

Sialkot (Pvt.) Limited contracted with B Limited to build a group of factory buildings. Each building is capable of being used separately.
Sialkot (Pvt.) Limited capitalizes its borrowing costs in accordance with Allowed Alternative Treatment of IAS-23, Borrowing Costs.

Required:

Advice the company to capitalize its borrowing costs based on the period when all the buildings are ready for use or based on the period when each building is ready for use.

Solution:

As each component of the contract is capable of being used separately, the borrowing costs should be capitalized based on the period of construction of each building.

Disclosures:

Following should be disclosed in the financial statements:

(a) The accounting policy adopted for borrowing costs;
(b) The amount of borrowing costs capitalized during the period; and
(c) The capitalization rate used to determine the amount of borrowing costs eligible for capitalization.

Disclosure:

(i) Borrowing costs are recognized as an expense in the period in which these are incurred, except to the extent that borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset is capitalized as part of the cost of that asset.
(ii) The amount of borrowing costs capitalized during the period is Rs. 75,145.
(iii) Capitalization rate for the year used to capitalize borrowing costs is 9.15%.

EARNINGS PER SHARE (IAS – 33)

Earnings per Share is an accounting ratio that improves comparison of the performance of different entities in the same period and of the same entity in different accounting periods.

Methods for the Calculation of EPS:

1. Basic EPS
2. Diluted EPS

Formula for Basic "Earning Per Shares":

$$\frac{\text{Earnings available for distribution to ordinary shareholders}}{\text{Weighted Average No. of ordinary share outstanding during the period}}$$

Solved Questions

1 Jan. Opening balance 200,000 shares
10 Oct. Further issued 200,000 shares
Find the No. of weighted shares outstanding at 31 Dec.

Solution:-

Opening balance	200,000 shares
Further issued 200,000 x 3/12	50,000 shares
Total weighted shares	$\boxed{250,000}$

LESSON # 33

EARNINGS PER SHARE (IAS – 33)

International Accounting Standard (IAS) 33 provides complete guidelines regarding calculation and presentation of EPS. Only listed companies need to present EPS. Where a non listed company chooses to present EPS in its financial statements, it must do so in accordance with IAS 33.

Profits available for distribution to ordinary shareholders:

This is the current year's profit figure which is obtained after subtracting all types of expenses (cost of goods sold, administrative, selling, financial and income tax expenses) out of all the incomes (revenues and gains) recognized during the year. This is also known as the profit after tax.

Weighted average number of ordinary shares outstanding during the year:

This is the figure that needs calculation; these are the weighted average of ordinary shares that remained outstanding during the year. This figure is obtained after making certain adjustments concerning increase or decrease in the number of ordinary shares in accordance with the time period due.
The time-weighting factor is the number of days the shares were outstanding compared with the total number of days in the period.

A very simple example to understand the concept of weighted average is as under:

FS Company Limited

		Number of Ordinary Shares
January 1, 2007	Opening Balance b/f	200,000
September 30, 2007	Issue of ordinary share capital	200,000
December 31, 2007	Closing Balance c/f	**400,000**

Weighted Average number of ordinary share capital outstanding during the year:

200,000	(outstanding for full year)	200,000
200,000 x 3/12	(outstanding for Oct. Nov. & Dec.)	50,000
Weighted average number of ordinary share capital outstanding		**250,000**

Another example to understand weighted average calculations:

Jubilation Co., a listed company, has the following share transactions during the year ending on December 31, 2007.

Date	Details	Shares Issued	Treasury shares*	Shares Outstanding
Jan 1, 2007	Balance b/f	200,000	30,000	170,000
May 31, 2007	Fresh Issue	80,000	-	250,000
Dec 1, 2007	Treasury shares		25,000	225,000
Dec 31, 2007	Balance c/f	**280,000**	**55,000**	**225,000**

**Treasury shares are the company's own shares held by the company itself*

Weighted average number of shares

Shares Outstanding	weight in months	weighted average
170,000	5/12	70,833
250,000	6/12	125,000
225,000	1/12	18,750
		214,583

Alternative calculation:

Number of shares	weight in months	weighted average
170,000	12/12	170,000
80,000	7/12	46,666
(25,000)	1/12	(2,083)
		214,583

Shares are usually included in the weighted average number of shares from the date on which the consideration is receivable which is usually the date of issue.
Ordinary shares issued as purchase consideration in an acquisition should be included as of the date of acquisition because the acquired entity's results will also be included from that date.

Solved Questions

Famous Co. is a company with an issued and paid up capital of 100,000 ordinary shares of Re. 1 each and 20,000 10% debentures of Re. 1 each. The company manufactures electrical appliances.
During its accounting year ending on December 31, 2007 the company had operating expenses of Rs. 50,000 the gross profit was Rs. 200,000. The company paid the 10% interest on debentures and declared an ordinary dividend of 40 paisa per share.
Assuming an income tax rate of 30% on the given figures show the trading results and EPS of the company.

Solution:

Famous Co
Income Statement
For the year ended December 31, 2007

	Rupees
Gross profit	200,000
Operating expenses	(50,000)
Profit from operations	150,000
Interest on debentures	(2,000)
Profit before tax	148,000
Income tax	(44,400)
Profit after tax	**103,600**

Earnings per share

$\frac{\text{Rs. } 103{,}600}{100{,}000}$ = Rs. 1.036 per share

Solved Questions

In addition to the information given in the above problem assume the Famous Co also issued further 40,000 ordinary shares on July 1, 2007.

Solution:

Weighted average number of ordinary shares

		Rupees
Balance on Jan 1, 2007		100,000
Issued on July 1, 2007	40,000 x 6/12	20,000
Weighted average		**120,000**

Earnings per share

$\frac{\text{Rs. } 103{,}600}{120{,}000}$ = Rs. 0.863 per share

LESSON # 34

Earnings per Share (IAS 33)

Solved Questions

On September 30, 2008, Blue-moon Co made an issue at full market price of 1,000,000 ordinary shares. The company's accounting year runs from January 1 to December 31. Relevant information for the year 2007 and 2008 is as follows:

	2008	**2007**
Shares in issue as on December 31	9,000,000	8,000,000
Profits after tax (in Rupees)	3,300,000	3,280,000

Required:

Calculate EPS for the year 2008 and corresponding figure for 2007

Solution:

Weighted average number of shares

		2008	**2007**
Shares in issue on opening date		8,000,000	8,000,000
Fresh issue	1,000,000 x 3/12	250,000	
Weighted average		**8,250,000**	**8,000,000**
Earnings		**3,300,000**	**3,280,000**
Earnings per share		Rs. 3,300,000 / 8,250,000	Rs. 3,280,000 / 8,000,000
		40 paisa	41 paisa

"Despite an increase in total earnings by Rs. 20,000 in the year 2008, the EPS is not as good as in the year 2007, because there was extra capital employed for the last 3 months of the year 2008".

Events that cause a change in number of ordinary shares:

There are few events that cause a change in number of ordinary shares in issue other than the issue of share against inflow of resources. These include:

- Capitalization of reserves or issue of bonus shares.
- Bonus element in rights issue of share capital to the existing share holders.

In these events it is necessary to make adjustments in the denominator of the EPS formula so that the current and comparative EPS figures are meaningful.

Bonus Issue of Share Capital:

Bonus issue of share capital causes an increase in the number of ordinary shares without corresponding increase in the financial resources of the entity. Bonus shares are issued against capitalization of the reserves kept in the owners' equity. Because of the bonus issue the total amount of net assets of owners' equity remains the same as it was prior to the issue.

As the increase in ordinary share capital does not bring financial resources in the business, and this change in share capital causes a decrease in the EPS comparing with the previous year's EPS, therefore this problem is solved by adjusting the number of ordinary shares outstanding before the event for the proportionate change in the number of shares outstanding as if the event had occurred at the beginning of the earliest period reported.

Solved Questions

Great Master Co had 400,000 shares in issue, until on September 30, 2009 it made a bonus issue of 100,000 shares. Calculate the EPS for the year 2009 and the corresponding figure for the year 2008 if total earnings were Rs. 80,000 in the year 2009 and Rs. 75,000 in the year 2008. The company's accounting year runs from January 1 to December 31.

Solution:

	2009	***2008***
	Rupees	***Rupees***
Earnings (in Rupees)	**80,000**	**75,000**
Number of share on January 1	400,000	400,000
Bonus Issue during the year 2009	100,000	100,000
Total number	**500,000**	**500,000**
EPS	**16 paisa**	**15 paisa**

The number of shares in the year 2008 must also be adjusted if the figures for EPS are to remain comparable.
Because if the number of shares in the year are not adjusted with the number of bonus share issued in the year 2009 then the results will be very much distorted.

Like the EPS in the year 2008 will then be $\frac{\text{Rs. } 75{,}000}{400{,}000}$ = 18.75 paisa

This working shows that the company's earnings were more than the current year's earnings, which is not true in fact. The company earned Rs. 80,000 profit with the same amount of financial resources in terms of the share capital which it had in the year 2007, when the profits were Rs. 75,000, therefore how come it can be said that the year 2007 was better than the year 2008.

To fix this problem there are two alternatives, either to calculate EPS in both years with a denominator of 400,000 number of shares it will give comparable results, or to calculate EPS in both years with a denominator of 500,000 number of shares. Later approach is recommendable because doing this will not require further adjustments in the subsequent years when the actual number of ordinary share are 500,000.

Rights Issue of Share Capital:

A rights issue of share capital is an issue of new shares to existing shareholders at a price below the current market value. The offer of new shares is made on the basis of a number of new shares for every number of shares currently held, e.g. a 1 for 3 rights issue is an offer of 1 new share at the offer price for every 3 shares currently held. This means that there is a bonus element included in the rights issue.
To arrive at figures for EPS when a rights issue is made, we need to calculate first of all the *theoretical ex-rights price*. This is a weighted average value per share; concept of theoretical ex-right price will become clear after doing the following problem.

Solved Questions

On January 1, 2008, Egg Co has 10,000 shares in issue. On June 30, 2008 it proposes to make a 1 for 4 rights issue at a price of Rs. 3 per share. The market value of existing shares on June 30, 2008, before the issue is made is Rs. 5 (this is cum right value also known as with right value). Calculate the theoretical ex-rights price per share.

Solution:

Number of shares held @ Market price	4 x Rs. 5	20
Number of shares offered @ Offer price	1 x Rs. 3	3
Theoretical price of 5 shares		23

Theoretical ex-right price per share $\frac{23}{5}$ = Rs. 4.60/sh

This calculation can alternatively be performed as under

Number of shares held @ Market price	10,000 x Rs. 5	50,000
Number of shares offered @ Offer price	2,500 x Rs. 3	7,500
Theoretical price of 12,500 shares		57,500

Theoretical ex-right price per share $\frac{57,500}{12,500}$ = Rs. 4.60/sh

Procedure to calculate EPS:

1. Calculate theoretical ex-rights price
2. Determine the bonus element in rights issue
3. Add the bonus element in the outstanding number of ordinary shares of current year and also add the same figure in the outstanding number of ordinary shares of the previous year
4. Calculate the weighted average number of shares representing the resources element in the rights issue and add this figure in the current year's outstanding number of ordinary shares
5. Calculate EPS

LESSON # 35

Solved Questions

Continuing the above example in solved problem # 2, earnings of the Egg Co for the years 2007 and 2008 were Rs. 20,000 and Rs. 22,000 respectively.
Calculate EPS for the year 2008 and its corresponding figure for 2007.

Solution:

Rights issue	2,500 shares
Offer price	Rs. 3 per share
Market price	Rs. 5 per share
Theoretical ex-right price	Rs. 4.60 per share
Total amount of investment	2,500 @ Rs. 3 = Rs. 7,500
Consideration element	Rs. 7,500/Rs. 4.60 = 1,630 shares
Bonus element	2,500 – 1,630 = 870 shares

Schedule of weighted average number of shares outstanding during the year

	2008	**2007**
Opening balance	10,000	10,000
Rights issue		
Bonus element	870	870
Consideration/resource element		
1,630 x 6/12	815	
Weight average	**11685**	**10,870**
Earnings per share	22,000 / 11,685	20,000 / 10,870
EPS	**Rs. 1.88**	**Rs. 1.84**

Solved Questions

A company produced the following net profit figures for the years ending December 31;

	Rs.
2006	110,000
2007	150,000
2008	180,000

On January 1, 2007 the number of shares outstanding was 500,000. During 2007 the company announced a rights issue with the following details.

Rights:	1 new share for each 5 outstanding
Exercise price	Rs. 5 per share

Last date to exercise rights	March 1, 2007 (10 months outstanding)
Market price on March 1, 2007	Rs. 11

Required:

Calculate EPS for the years 2006, 2007 and 2008.

Solution:

Theoretical ex-right price	Shares	Value Rs.
Number of shares held @ market price	500,000 @ Rs. 11	5,500,000
Number of shares offered @ offer price	100,000 @ Rs. 5	500,000
Theoretical value of	600,000	6,000,000

Theoretical ex-right price $\frac{\text{Rs. } 6{,}000{,}000}{600{,}000}$ = Rs. 10 per share

Bonus element	
Total investment	Rs. 500,000
Number of shares out of the market at offer price	Rs. 500,000/Rs, 10
Consideration element	50,000 shares
Bonus element (Total rights issue – consideration element)	50,000 shares

Schedule of weighted average number of shares outstanding during the year

Outstanding number on opening date	500,000	500,000	600,000
Bonus element	50,000	50,000	
Consideration/resources element (50,000 x 10/12)			41,667
Weighted average	**550,000**	**591,667**	**600,000**
EPS	$\frac{110{,}000}{550{,}000}$	$\frac{150{,}000}{591{,}667}$	$\frac{180{,}000}{600{,}000}$
	Rs. 0.20	**Rs. 0.2535**	**Rs. 0.30**

DILUTED EARNINGS PER SHARE

At the end of an accounting period, a company may have in issue some securities which do not (at present) have any claim to a share of equity earnings, but may give rise to such a claim in the future. These securities include:

a) A separate class of equity shares which at present is not entitled to any dividend, but will be entitled after some future date
b) Convertible Debentures or convertible preferred shares which give their holders the right at some future date to exchange their securities for ordinary shares of the company, at a pre-determined conversion rate
c) Option or warrants

In such circumstances, the future number of ordinary shares in issue might increase. This in turn results in a fall in the EPS. In other words, a future increase in the number of ordinary shares will cause a dilution of equity, and it is possible to calculate diluted earnings per share (i.e. the EPS that would have been obtained during the financial period if the dilution had already taken place). This will indicate to investors the possible effects of a future dilution.

Earnings:

The earnings calculated for basic EPS should be adjusted by the post-tax (including deferred tax) effect of

a) Any dividends on dilutive potential ordinary shares that were deducted to arrive at earnings for basic EPS
b) Interest recognized in the period for the dilutive potential ordinary shares
c) Any other changes in income or expenses (fee and discount, premium accounted for as yield adjustments) that would result from the conversion of the dilutive potential ordinary shares

The conversion of some potential ordinary shares may lead to changes in other income or expenses. For example, the reduction of interest expense related to potential ordinary shares and the resulting increase in net profit for the period may lead to an increase in the expense relating to non-discretionary employee profit sharing plan. When calculating diluted EPS, the net profit or loss for the period is adjusted for any such consequential changes in income or expense.

Per Share:

The number of ordinary shares is the weighted average number of ordinary shares calculated for basic EPS plus the weighted average number of shares that would be issued on the conversion of all the dilutive potential ordinary shares into ordinary shares.

It should be assumed that diluted ordinary shares were converted into ordinary shares at the beginning of the period or, if later, at the actual date of issue.

Solved Questions

Basic EPS of a company is Rs. 1.05 per share based on earnings of Rs. 105,000 and 100,000 ordinary Re. 1 shares. It also had in issue Rs. 40,000 15% Convertible Debentures which is convertible in two years' time at the rate of 4 ordinary shares for every Rs. 5 of debenture. The rate of tax is 30%. In 2007 gross profit of Rs. 200,000 and expenses of Rs. 50,000 were recorded, including interest payable of Rs. 6,000

Income Statement before conversion of debentures into the ordinary shares

	Rupees
Gross profit	200,000
Operating expenses	(44,000)
Profit from operations	156,000
Financial expenses	(6,000)
Profit before tax	150,000
Income tax 30%	(45,000)
Profit after tax (earnings)	**105,000**

Diluted earnings per share

a) Conversion of debentures into the ordinary number of shares
Rs. 40,000 x 4/5 = 32,000 number of ordinary shares

b) Adjustment of profits after the conversion of debentures into the ordinary shares

c)

	Rupees
Gross profit	200,000
Operating expenses	(44,000)
Profit from operations	156,000
Income tax 30%	(46,800)
Profit after tax (earnings)	**109,200**

d) Diluted EPS

$\frac{\text{Rs. } 109{,}200}{132{,}000}$ = Rs. 0.827 per share

e) Dilution:

The dilution in earnings would be Rs. 1.05 less 0.827 = Rs. 0.223/share.

Dilutive potential ordinary shares

Those convertible debentures or securities that will cause an increase in Basic EPS if these would have been converted in the current year are anti-dilutive potential ordinary shares.

According to IAS 33, potential ordinary shares should be treated as dilutive when, and only when, their conversion to ordinary shares would decrease net profit per share from continuing operations. This point is illustrated in the following example:

	Rupees
Profit from operations	156,000
Financial charges (interest @ 25%of Rs. 40,000 debentures)	(10,000)
Profit before tax	146,000
Income tax (@ 30%)	(43,800)
Profit after tax	**102,200**
Ordinary number of shares	100,000

Basic EPS

$$\frac{\text{Rs. } 123{,}300}{100{,}000 \text{ shares}} = \text{Rs. } 1.022 \text{ per shares}$$

Diluted EPS

Conversion rate is 3 ordinary shares will be issued against each Rs. 20 debentures in issue

Rs. 40,000 x 3/20 = 6,000 number of shares

Revised Income statement after conversion

	Rupees
Profit from operations	156,000
Financial charges	0
Profit before tax	156,000
Income Tax @ 30%	(46,800)
Profit after tax	**109,200**

Revised earnings per share after conversion

$$\frac{\text{Rs. } 109{,}200}{106{,}000\text{shares}} = \text{Rs. } 1.030 \text{ per share}$$

There is no dilution as the post conversion EPS is greater than the basic EPS.

This can also be understood by calculating individual EPS of the security/debenture. If the individual EPS of the security is lesser than the basic EPS then it is a dilutive potential shares, whereas, if the individual EPS of the security is greater than the basic EPS then it is a non dilutive potential shares.

Like is this case:	*Rupees*
Savings of financial charges	10,000
Income tax impact @ 30%	(3,000)
Impact on the earnings to the extent of the security	**7,000**

Individual EPS $\frac{\text{Rs. } 7{,}000}{6{,}000 \text{ shares}}$ = Rs. 1.667

This individual EPS is greater than the basic EPS i.e. 1.022 per share therefore this security is anti-dilutive potential share and should not be converted into the ordinary shares before calculating the diluted earnings per share.

Solved Questions

Ali Imran Co has 5,000,000 ordinary shares in issue, and also had in issue in 2004:

a) Rs. 1,000,000 of 14% convertible debentures, convertible in three years' time at the rate of 2 shares peer Rs. 10 of debentures
b) Rs. 2,000,000 of 10% convertible debentures, convertible in one year's time at the rate of 3 shares per Rs. 5 of debenture.

- The total earnings in 2004 were Rs. 1,750,000
- The rate of income tax is 35%

Requited: Calculate the basic EPS and the diluted EPS

Solution:

Basic EPS = $\frac{\text{Rs. } 1{,}750{,}000}{5{,}000{,}000}$ = 35 paisa

Diluted EPS:

Before calculating diluted EPS we must decide which of the potential ordinary shares (the convertible debentures) are dilutive.

a) Conversion into ordinary shares Rs. 1,000,000 x 2/10 = 200,000 ordinary shares

	Rupees
Savings of financial charges Rs. 1,000,000 x 14%	140,000
Income tax impact @ 35%	(49,000)
Impact on the earnings to the extent of the security	**91,000**

Individual EPS $\frac{\text{Rs. 91,000}}{20,000}$ = 45.5 paisa (greater than the basic EPS)

b) Conversion into ordinary shares Rs. 2,000,000 x 3/5 = 1,200,000 ordinary shares

	Rupees
Savings of financial charges Rs. 2,000,000 x 10%	200,000
Income tax impact @ 35%	(70,000)
Impact on the earnings to the extent of the security	**130,000**

Individual EPS $\frac{\text{Rs. 130,000}}{1,200,000}$ = 10.8 paisa (lesser than the basic EPS)

Therefore the diluted EPS will be calculated after converting the 10% debentures.

$$\frac{\text{Rs. 1,750,000 + Rs. 130,000}}{5,000,000 + 1,200,000} = \frac{\text{Rs. 1,880,000}}{6,200,000} = 30.30 \text{ paisa}$$

Dilution is equal to

Basic EPS	35.00
Diluted EPS	30.30
Dilution	**4.70**

LESSON # 36

GROUP ACCOUNTS

It is obvious from the name that group accounts will be demonstrating financial status of more than one entity. Group accounts are the financial statements of different entities operating in a group. Group of companies is established in order to obtain benefits of synergy, better management of resources, and to avoid competitive business environment.

Formation of a group of companies takes place when one company establishes its control over another company. This creates a relationship of parent and subsidiary. The company that enjoys control is named as parent company and the company that is controlled is known as subsidiary company. In a group there will be one parent company with its one ore more than one subsidiary companies. Therefore, *Group means a parent and all its subsidiaries.*

Control:

According to IFRS 3 and IAS 27, *Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities*.

Normally control is assumed to exist when the parent company acquires majority number of ordinary share capital. But according to the above referred accounting standards control exists when any of the following situation crops up.

When the parent company:

1. Has owned more than 50% of the voting rights of subsidiary company (Each ordinary share capital has one voting right)
2. Has power over more than 50% of the voting rights of subsidiary company by virtue of agreement with other shareholders of it.
3. Has power to govern the financial and operating policies of subsidiary company by statute or under an agreement.
4. Has power to appoint or remove a majority of the directors of subsidiary company.
5. Has power to cast the majority of votes at meetings of the board of directors of subsidiary company.

Consolidated Financial Statements:

A single set of financial statements that combine the assets, liabilities, incomes and expenses of a parent company and its subsidiaries. In our syllabus we shall learn how to prepare:

1. Consolidated Balance Sheet
2. Consolidated Income Statement

Example - [Case i] Simple Consolidation

Balance Sheet as on 31st December 2008

	P	**S**
	Rs	Rs
Fixed Assets	1,000	400
Investment in S.	500	
Current Assets	400	200
	1,900	**600**
Share Capital	1,200	300
Reserves	500	200
Current Liabilities	200	100
	1,900	**600**

The Parent Co. (P) acquired 100% shares of the Subsidiary Co. (S) on 31st December 2008.

Required:
Prepare the Consolidated Balance Sheet as on the same date.

Solution - [Case i]

Consolidated Balance Sheet
As at 31 December 2008

	Rs
Fixed Assets	1,400
Current Assets	600
	2,000
Share Capital	1,200
Reserves	500
Current Liabilities	300
	2,000

The above example covers simple consolidation of balance sheet that explains how the assets and liabilities of subsidiary company are consolidated with the assets and liabilities of the parent company. This also explains that the cost of investment appearing in the parent company gets cancelled with the amount of the owner equity of the subsidiary company. This cost of investments is asset of the parent company made up from its own sources therefore in the consolidated balance sheet we have to replace the cost of investment in subsidiary company with net assets of it. The only care is to be taken is to consolidate all assets and liabilities individually and remember do not confuse why we are not consolidating the owner equity of the subsidiary company in the parent company's owners' equity.

Example - [Case ii] Goodwill

Balance Sheet as on 31st December 2008

	P	S
	Rs	Rs
Fixed Assets	1,000	400
Investment in S.	500	
Current Assets	400	200
	1,900	**600**
Share Capital	1,200	300
Reserves	500	150
Current Liabilities	200	150
	1,900	**600**

The Parent Co. (P) acquired 100% shares of the Subsidiary Co. (S) on 31st December 2008.

Required:
Prepare the Consolidated Balance Sheet as on the same date.

Solution - [Case ii]

Working for Calculation of Good will:

Cost of investment	500
Net assets of S Co acquired	450
Good will	50

Consolidated Balance Sheet
As at 31 December 2008

	Rs
Fixed Assets	1,400
Goodwill	50
Current Assets	600
	2,050

Share Capital	1,200
Reserves	500
Current Liabilities	350
	2,050

Good Will:

Good will is the excess of the cost of investment made in the subsidiary company over the fair value of the net assets of the subsidiary company acquired.

LESSON # 37

GROUP ACCOUNTS (Cont.)

Example - [Case iii] Pre-acquisition Reserves, Goodwill

Balance Sheet as on 31st December 2008

	P	S
	Rs	Rs
Fixed Assets	1,000	400
Investment in S.	500	
Current Assets	400	200
	1,900	**600**
Share Capital	1,200	300
Reserves	550	150
Current Liabilities	150	150
	1,900	**600**

The Parent Co. (P) acquired 100% shares of the Subsidiary Co. (S) on 1st January 2008 when the reserves of the company were worth Rs100.

Required:

Prepare the Consolidated Balance Sheet as on 31/12/2008. (Ignore impairment of Goodwill).

Solution - [Case iii]

Analysis of Equity of Subsidiary Company

	Pre-acquisition Rs	**Post-acquisition** Rs
Share Capital of subsidiary company	300	
Reserves of subsidiary company	100	50
Total	**400**	
Calculation of Goodwill		
Cost of Investment	500	
Pre acquisition owners' equity of the subsidiary Co.	(400)	
Goodwill	**100**	
Calculation of Group Reserves		
All reserves of parent company		550
Post acquisition of the subsidiary company		50
Total		**600**

Consolidated Balance Sheet
As at 31 December 2008

	Rs
Fixed Assets	1,400
Goodwill	100
Current Assets	600
	2,100
Share Capital	1,200
Reserves	600
Current Liabilities	300
	2,100

Example - [Case IV] Goodwill Impairment, Pre-acquisition Reserves:

Balance Sheet as on 31st December 2008

	P	**S**
	Rs	Rs
Fixed Assets	1,000	400
Investment in S.	500	
Current Assets	400	200
	1,900	**600**
Share Capital	1,200	300
Reserves	550	150
Current Liabilities	150	150
	1,900	**600**

The Parent Co. (P) acquired 100% shares of the Subsidiary Co. (S) on 1st January 2008 when the reserves of the company were worth Rs100. Goodwill, has been impaired by Rs. 20

<u>Required:</u>

Prepare the Consolidated Balance Sheet as at 31/12/2008.

Solution - [Case IV]

Analysis of Equity of Subsidiary Company

	Pre-acquisition Rs	**Post-acquisition** Rs
Share Capital of subsidiary company	300	
Reserves of subsidiary company	100	50
Total	**400**	
Calculation of Goodwill		
Cost of Investment	500	
Pre acquisition owners' equity of the subsidiary Co.	(400)	
	100	
Impairment of goodwill	(20)	
Goodwill	**80**	
Calculation of Group Reserves		
All reserves of parent company		550
Post acquisition of the subsidiary company		50
Impairment loss of good		(20)
Total		**580**

Consolidated Balance Sheet
As at 31 December 2008

	Rs
Fixed Assets	1,400
Goodwill	80
Current Assets	600
	2,080
Share Capital	1,200
Reserves	580
Current Liabilities	300
	2,080

Example - [Case v] Impairment of Goodwill, Inter Co. Dividends & Loans

Balance Sheet as on 31st December 2008

	P	S
	Rs.	Rs.
Fixed Assets	1,000	600
Investment in S	500	
Dividend Receivable	100	
Other Current Assets	300	
Current Assets	400	200
Loan to S	200	
	2,100	800
Share Capital	1,200	300
Reserves	700	150
Loan from P		200
Dividend Payable		100
Other Current Liabilities		50
Current Liabilities	200	150
	2,100	800

The Parent Co. (P) acquired 100% shares of the Subsidiary Co. (S) on 1st January 2007 when the reserves of the company were worth Rs70. Goodwill has been impaired by Rs. 52

Required:
Prepare the Consolidated Balance Sheet as at 31/12/2008.

Solution - [Case v]

Analysis of Equity

	Pre	Post
	Rs.	Rs.
S		
Share Capital	300	
Reserves	70	80
	370	
P		
Investment	500	
Reserves		700
Goodwill	130	
Impairment of Goodwill	(52)	(52)
Group Goodwill	78	
Group Reserves		728

	P	S
	Rs.	Rs.
Fixed Assets	1,000	600
Investment in S	500	
Dividend Receivable	~~100~~	
Other Current Assets	300	
Current Assets	400	200
Loan to S	~~200~~	
	2,100	800
Share Capital	1,200	300
Reserves	700	150
Loan from P		~~200~~
Dividend Payable		~~100~~
Other Current Liabilities		50
Current Liabilities	200	150
	2,100	800

Consolidated Balance Sheet
As at 31 December 2008

	Rs.
Fixed Assets	1,600
Goodwill	78
Current Assets	500
	2,178
Share Capital	1,200
Reserves	728
Current Liabilities	250
	2,178

LESSON # 38

GROUP ACCOUNTS (Cont.)

Example - [Case vi] Minority Interest

Balance Sheet as on 31st December 2008

	P	S
	Rs.	Rs.
Fixed Assets	1,000	450
Investment in S.	550	
Current Assets	350	150
	1,900	**600**
Share Capital	1,200	300
Reserves	600	200
Current Liabilities	100	100
	1,900	**600**

The Parent Co. (P) acquired 80% shares of the Subsidiary Co. (S) on 31st December 2008

Required:
Prepare the Consolidated Balance Sheet as at 31/12/2008.

Solution - [Case vi]

Working

Calculation of Goodwill

	Rs.	Rs.
-		
Investment		550
Share Capital	300	
Reserves	200	
Owners equity	**500**	
Less: 500 x 80%		400
Good will		**150**

Simple calculation of Minority Interest is as under

Owners' equity of Subsidiary Company @ MI% =500 x 20% = 100

Alternatively we may split the Balance sheet of S Co. into the share of parent company and the share of minority interest. Net amount of the column of MI will be the amount of minority interest.

	H%	**MI%**
Fixed Assets	360	90
Current Assets	120	30
Current Liabilities	(80)	(20)
		100

Minority interest is the figure that represents the owners' equity of the minority share holders in the group. Therefore it is shown separately but within the owners' equity class.

Consolidated Balance Sheet
As at 31 December 2008

		Rs.
Fixed Assets		1,450
Goodwill		150
Current Assets		500
		2,100
Share Capital	1,200	
Reserves	600	
	1,800	
Minority Interest	100	1,900
Current Liabilities		200
		2,100

Example - [Case vii] Minority Interest, Pre-acquisition Reserves, Goodwill

Balance Sheet as on 31st December 2008

	P	**S**
	Rs.	Rs.
Fixed Assets	1,000	450
Investment in S.	500	
Current Assets	400	150
	1,900	**600**
Share Capital	1,200	300
Reserves	600	200
Current Liabilities	100	100
	1,900	**600**

The Parent Co. (P) acquired 80% shares of the Subsidiary Co. (S) on 1st January 2008 when its reserves were worth Rs.120. Goodwill impaired with Rs. 33 during the year.

Required:
Prepare the Consolidated Balance Sheet as at 31/12/2008.

Solution - [Case vii]

W-1

H%	80%	Determine the % of holding by dividing the number of equity shares acquired with the total number of shares of the subsidiary company
MI%	20%	%age representing the minority interest is very simple to calculate, just subtract H% from 100

W-2
Analysis of Equity of S Co.

	Pre-Acquisition	Post-acquisition
Share Capital	300	Nil
Reserves	120	80
	420	**80**

W-3
Calculation of goodwill

		Rupees
Cost of investment		500
Pre acquisition equity of S Co.	420 x 80%	(336)
		164
Impairment loss		(33)
Goodwill		131

W-4
Group Reserves

All reserves of P Co	600
Post acquisition reserves of S Co. (Rs.80 x 80%)	64
Impairment loss	(33)
	631

W-5
Minority Interest

Owners' equity of Subsidiary Company @ MI% =500 x 20%
= 100

<u>Detailed working</u>

Particulars	Total	Pre-acquisition	Post-acquisition
Owners' equity of S Co.	500	420	80
Holding - 80%	(400)	(336)	(64)
Minority Interest - 20%	100	84	16

Consolidated Balance Sheet
As at 31 December 2008

		Rs.
Fixed Assets		1,450
Goodwill		131
Current Assets		550
		2,131
Share Capital	1,200	
	631	
Reserves	1,831	
Minority Interest	100	1,931
Current Liabilities		200
		2,131

Example - [Case viii] Minority Interest, Inter-Company Dividends

Balance Sheet as on 31st December 2008

	P	**S**
	Rs.	Rs.
Fixed Assets	1,000	450
Investment in S.	500	
Dividend Receivable	40	
Other Current Assets	360	
Current Assets	400	150
	1,900	**600**
Share Capital	1,200	300
Reserves	600	200
Dividend Payable	70	50
Other Current Liabilities	30	50
Current Liabilities	100	100
	1,900	**600**

The Parent Co. (P) acquired 80% shares of the Subsidiary Co. (S) on 1st January 2008 when its reserves were worth Rs.120. Goodwill impaired with Rs. 33 during the year.

Required:
Prepare the Consolidated Balance Sheet as at 31/12/2008.

Solution - [Case vii]

W-1

H%	80%	Determine the % of holding by dividing the number of equity shares acquired with the total number of shares of the subsidiary company
MI%	20%	%age representing the minority interest is very simple to calculate, just subtract H% from 100

W-2
Analysis of Equity of S Co.

	Pre- Acquisition	Post-acquisition
Share Capital	300	Nil
Reserves	120	80
	420	**80**

W-3
Calculation of goodwill

		Rupees
Cost of investment		500
Pre acquisition equity of S Co.	420 x 80%	(336)
		164
Impairment loss		(33)
Goodwill		131

W-4
Group Reserves

All reserves of P Co	600
Post acquisition reserves of S Co. (Rs.80 x 80%)	64
Impairment loss	(33)
	631

W-5
Minority Interest

Owners' equity of Subsidiary Company @ MI% = 500 x 20%
= 100

<u>Detailed working</u>

Particulars	Total	Pre-acquisition	Post-acquisition
Owners' equity of S Co.	500	420	80
Holding - 80%	(400)	(336)	(64)
Minority Interest - 20%	100	84	16

W-6
Cancellation effects of Intra group Dividend

	P		S
	Rs.		Rs.
Fixed Assets	1,000		450
Investment in S.	500		
Dividend Receivable	~~40~~		
Other Current Assets	360		
Current Assets	400		150
	1,900		600
Share Capital	1,200		300
Reserves	600		200
Dividend Payable	70	~~40~~ 10 50	50
Other Current Liabilities	30		50
Current Liabilities	100		100
	1,900		600

Consolidated Balance Sheet
As at 31 December 2008

	Rs.	Rs.
Fixed Assets		1,450
Goodwill		131
Current Assets		510
		2,091
Share Capital		1,200
Reserves		631
Minority Interest		100
Other current liabilities		80
Dividend payable by P	70	
Dividends due to minority	10	80
Current Liabilities		160
		2,091

LESSON # 39

GROUP ACCOUNTS (Cont.)

Example - [Case ix] Inter Company Trading (P to S)

Balance Sheet as on 31st December 2008

	P	S
	Rs.	Rs.
Fixed Assets	1,000	550
Investment in S.	500	
Current Assets	400	350
	1,900	900
Share Capital	1,200	400
Reserves	500	300
Current Liabilities	200	200
	1,900	900

The Parent Co. (P) acquired 80% shares of the Subsidiary Co. (S) on 1st January 2003 when it's reserves were worth Rs.120. Total amount of Goodwill has been impaired. During the year 2008, P Co sold goods to S Co for Rs.500 that was costing Rs. 400. On the closing date, goods costing Rs.150 remained unsold in the inventories of S Co.

Required:
Prepare the Consolidated Balance Sheet as at 31/12/2008.

Solution: [Case ix]
W-1

H%	80%	Determine the % of holding by dividing the number of equity shares acquired with the total number of shares of the subsidiary company
MI%	20%	%age representing the minority interest is very simple to calculate, just subtract H% from 100

W-2

Analysis of Equity of S Co

	Pre-acquisition	Post-acquisition
Share Capital	400	Nil
Reserves	120	180
	520	180

W-3

Calculation of goodwill

		Rupees
Cost of investment		500
Pre acquisition equity of S Co.	520 x 80%	-416
		84
Impairment loss		-84
Goodwill		Nil

W-4

Group Reserves

All reserves of P Co		500
Post acquisition reserves of S Co to the extent of H%	180 x 80%	144
Impairment loss		-84
Reserves		560
Unrealized profit		-30
		530

Note:
The unrealized profit is given in this example that is Rs. 30.This amount of unrealized profit is to be subtracted form the Consolidated Stocks and also from the group reserves.

W-5
Minority Interest
Owners' equity of Subsidiary Company @ MI% = 700 x 20%
= 140

Consolidated Balance Sheet
As at 31 December 2008

		Rs.	Rs.
Fixed Assets	1000+550		1,550
Current Assets	400+350-30		720
			2,270
Owners' Equity			
Share Capital		1,200	
Group Reserves		530	
		1,730	
Minority Interest		140	1,870
Current Liabilities			400
			2,270

Example - [Case x] Inter Company Trading (S to P)

Balance Sheet as on 31st December 2008

	P	S
	Rs.	Rs.
Fixed Assets	1,000	550
Investment in S.	500	
Current Assets	400	350
	1,900	900
Share Capital	1,200	400
Reserves	500	300
Current Liabilities	200	200
	1,900	900

The Holding Co. (H) acquired 80% shares of the Subsidiary Co. (S) on 1st January 2003 when it's reserves were worth Rs.120. Total amount of Goodwill has been impaired. During the year 2008, S sold goods to P for Rs.500, the profit to S being 20% of selling price. On the closing date, goods costing Rs.150 remained unsold in the inventories of P. on which S made a profit of Rs. 30.

Required:
Prepare the Consolidated Balance Sheet as at 31/12/2008.

Solution: [Case x]

W-1

H%	80%	Determine the % of holding by dividing the number of equity shares acquired with the total number of shares of the subsidiary company

W-2

Analysis of Equity of S Co

	Pre-acquisition	Post-acquisition
Share Capital	400	Nil
Reserves	120	180
	520	180

W-3

Calculation of goodwill

		Rupees
Cost of investment		500
Pre acquisition equity of S Co.	520 x 80%	-416
		84
Impairment loss		-84
Goodwill		Nil

W-4

Group Reserves		Rs.
All reserves of P Co		500
Post acquisition reserves of S Co to the extent of H%	180 x 80%	144
Impairment loss		-84
		560
Unrealized profit to the extent of H% 30 x 80%		-24
		536

W-5

Minority Interest

Owners' equity of S Co to the extent of MI%	700 x 20%	140
Unrealized profit	30 x 20%	-6
		134

The unrealized profit given in this example is Rs. 30.This amount of unrealized profit given, is to be subtracted form the Consolidated Stocks and also from the group reserves.

Consolidated Balance Sheet
As at 31 December 2008

	Rs.
Fixed Assets	1,550
Current Assets	720
	2,270
Share Capital	1,200
Reserves	536
Minority Interest	134
Current Liabilities	400
	2,270

LESSON # 40

GROUP ACCOUNTS (Cont.)

Example - [Case xi] Fair Value Adjustments

Balance Sheet as on 31st December 2008

	P	S
	Rs.	Rs.
Fixed Assets	1,000	550
Investment in S.	750	
Current Assets	400	350
	2,150	**900**
Share Capital	1,200	400
Reserves	700	300
Current Liabilities	250	200
	2,150	**900**

The Parent Co. (P) acquired 80% shares of the Subsidiary Co. (S) on 1st January 2008 when its reserves were worth Rs.200 and the fair value of Net Assets of S was Rs. 300 more than the book value.

Required:
Prepare the Consolidated Balance Sheet as at 31/12/2008.

Solution - [Case xi]
W-1

H%	80%	Determine the % of holding by dividing the number of equity shares acquired with the total number of shares of the subsidiary company
MI%	20%	%age representing the minority interest is very simple to calculate, just subtract H% from 100

W-2
Analysis of Equity of S Co

	Pre-acquisition	Post-acquisition
Share Capital	400	Nil
Reserves	200	100
	600	
Fair Value adjustment	300	
	900	100

W-3

Calculation of goodwill

		Rupees
Cost of investment		750
Pre acquisition equity of S Co. to the extent of H%	900 x 80%	-720
Goodwill		30

W-4

Group Reserves

All reserves of P Co		700
Post acquisition reserves of S Co to the extent of H%	100 x 80%	80
		780

W-5

Minority Interest

Owners' equity of Subsidiary Company	700
Fair Value adjustment	300
	1,000
	x 20%
	200

Alternative working

Analysis of Equity of S Co

		Pre-acquisition	Post-acquisition
	Share Capital	400	Nil
	Reserves	200	100
		600	
	Fair Value adjustment	300	
		900	100
H%	*80%*	*720*	*80*
MI%	*20%*	*180*	*20*

Consolidated Balance Sheet
As at 31 December 2008

			Rs.
Fixed Assets	*(1,000+550=1,550+300)*		*1,850*
Goodwill			*30*
Current Assets			*750*
			2,630
Share Capital		*1,200*	
Reserves		*780*	
		1,980	
Minority Interest		*200*	*2,180*
Current Liabilities			*450*
			2,630

Example - [Case xii] Fair Value Adjustments (with depreciation adjustment)

Balance Sheet as on 31st December 2008

	P	**S**
	Rs.	Rs.
Fixed Assets	1,000	550
Investment in S.	750	
Current Assets	400	350
	2,150	900
Share Capital	1,200	400
Reserves	700	300
Current Liabilities	250	200
	2,150	900

The Parent Co. (P) acquired 80% shares of the Subsidiary Co. (S) on 1st January 2008 when its reserves were worth Rs.200 and the fair value of Net Assets of S was Rs.300 more than the book value. The revaluation of assets of S were subject to depreciation of Rs.45. Goodwill has been impaired by Rs. 6.

<u>Required:</u>

Prepare the Consolidated Balance Sheet as at 31/12/2008.

Solution - [Case xii]

W-1

H%	80%	Determine the % of holding by dividing the number of equity shares acquired with the total number of shares of the subsidiary company
MI%	20%	% age representing the minority interest is very simple to calculate, just subtract H% from 100

W-2

Analysis of Equity of S Co

	Pre-acquisition	Post-acquisition
Share Capital	400	Nil
Reserves	200	100
	600	
Fair Value adjustment	300	
	900	100

W-3

Calculation of goodwill

		Rupees
Cost of investment		750
Pre acquisition equity of S Co. to the extent of H%	900 x 80%	-720
Goodwill		30
Impairment loss		6
		24

W-4

Group Reserves

All reserves of P Co		700
Post acquisition reserves of S Co to the extent of H% (Rs. 100 x 80%)		80
		780
Impairment loss of goodwill		-6
Depreciation against fair value adjustment to the extent of H%	{45 x 80%}	-36
		738

W-5

Minority Interest

Owners' equity of Subsidiary Company		700
Fair Value adjustment		300
		1,000
		x 20%
		200
Depreciation against fair value adjustment to the extent of MI%	*{45 x 20%}*	*-9*
		191

Note:

All revaluation reserves against the fair value adjustment would be treated as pre-acquisition equity. Whereas, the depreciation charge on the fair value adjustment would be treated as post acquisition.

Alternative working

Analysis of Equity of S Co.

			Pre-acquisition	Post-acquisition
		Share Capital	400	Nil
		Reserves	200	100
			600	
		Fair value adjustment/depreciation	300	-45
			900	55
H%	80%		720	44
MI%	20%		180	11

*Minority interest = Rs. 180 + 11 = Rs. 191

Consolidated Balance Sheet
As at 31 December 2008

			Rs.
Fixed Assets	(1,000+550=1,550+300-45)		1,805
Goodwill			24
Current Assets			750
			2,579
Share Capital		1,200	
Reserves		738	
		1,938	
Minority Interest		191	2,129
Current Liabilities			450
			2,579

LESSON # 41

GROUP ACCOUNTS (Cont.)

Example - [Case xiii] Pre-acquisition Profits, Dividends

Balance Sheet as on 31st December 2008

	P	S
	Rs.	Rs.
Fixed Assets	3,500	1,450
Investment in S.	2,180	
Current Assets	2,700	1,250
	8,380	2,700
Share Capital (ordinary shares of Rs.1 each).	5,000	1,000
Reserves	3,380	1,700
	8,380	2,700

The Parent Co. (P) acquired 800 of the 1,000 Re.1 ordinary shares of the Subsidiary Co. (S) on 1st January 2008 for Rs. 2,500. S's balance sheet at 31 December 2007 showed a payable ordinary dividend of Rs.400 and reserves of Rs. 1,200. Goodwill has been impaired by Rs. 105.

Hint: Share of P Co in the dividend payable out of the pre-acquisition profit is Rs. 320 being 80%

Required:

Prepare the Consolidated Balance Sheet as at 31/12/2008.

Solution - [Case xiii]

W-1

H%	80%	Determine the % of holding by dividing the number of equity shares acquired with the total number of shares of the subsidiary company
MI%	20%	%age representing the minority interest is very simple to calculate, just subtract H% from 100

W-2

Analysis of Equity of S Co

	Pre-acquisition	Post-acquisition
Share Capital	1,000	Nil
Reserves	1,200	500
	2,200	500

W-3

Calculation of goodwill

		Rupees
Cost of investment	2,500	
Dividend out of pre-acquisition profits	-320	
		2,180
Pre acquisition equity of S Co. to the extent of H% (2,200x 80%)		-1,760
Goodwill		420
Impairment loss		105
		315

W-4

Group Reserves

All reserves of P Co	3,380
Post acquisition reserves of S Co to the extent of H% (500 x 80%)	400
	3,780
Impairment loss of goodwill	-105
	3,675

W-5

Minority Interest

Owners' equity of Subsidiary Company to the extent of MI% (2,700 x 20%)	540

Consolidated Balance Sheet
As at 31 December 2005

	Rs.
Fixed Assets	4,950
Goodwill	315
Current Assets	3,950
	9,215
Share Capital	5,000
Reserves	3,675
Minority Interest	540
	9,215

Example - [Case xiv] Acquisition during the year

Balance Sheet as on 31st December 2008

	P	S
	Rs.	Rs.
Fixed Assets	5,500	4,500
Investment in S.	4,000	
Current Assets	2,500	1,500
	12,000	6,000
Share Capital	8,000	3,000
Reserves	2,500	2,008
Current Liabilities	1,500	1,000
	12,000	6,008

The Parent Co. (P) acquired 80% shares of the Subsidiary Co. (S) on 1st October 2008. S's reserves on 31 December 2007 were worth Rs. 1,200. (Assume that profits of S accrue evenly throughout the year).

Required:

Prepare the Consolidated Balance Sheet as at 31/12/2008.

Solution - [Case xiv]

W-1

Reserves of S Co on 31-12-2008	2,000
Reserves of S Co on 1-1-2008	1,200
Profit for the year ending on 31-12-2008	800

W-2

Profit for the year 2008 representing the pre-acquisition period from 1-1-2008 to 30-09-2008 (9 months) 800 x 9/12	600
Profit for the year 2008 representing the post-acquisition period from 1-10-2008 to 31-12-2008 (3 months) 800 x 3/12	200
	800

W-3

Analysis of Equity of S Co

	Pre-acquisition		Post-acquisition
H%	3,840		160
Share Capital	3,000		Nil
Reserves			
as on 1-1-2008	1,200		
from 1-1-2008 to 30-9-2008		600	200
		4,800	200
MI%	960		40

Minority Interest Rs. 1,000

W-4

Calculation of goodwill

	Rupees
Cost of investment	4,000
Pre acquisition equity of S Co. to the extent of H%	-3,840
Goodwill	160

W-5

Group Reserves

All reserves of P Co		2,500
Post acquisition reserves of S Co to the extent of H%	200 x 80%	160
		2,660

W-6

Minority Interest

Owners' equity of Subsidiary Company to the extent of MI%
=Rs. 5,000 x 20%= RS.1,000

Consolidated Balance Sheet
As at 31 December 2008

		Rs.
Fixed Assets		10,000
Goodwill		160
Current Assets		4,000
		14,160
Share Capital	8,000	
Reserves	2,660	
	10,660	
Minority Interest	1,000	11,660
Current Liabilities		2,500
		14,160

Example - [Case xv] Negative Goodwill

Balance Sheet as on 31st December 2008

	P	**S**
	Rs.	Rs.
Fixed Assets	1,000	600
Investment in S.	400	
Current Assets	300	200
	1,700	800
Share Capital	1,200	500
Reserves	400	200
Current Liabilities	100	100
	1,700	800

The Parent Co. (P) acquired 80% shares of the Subsidiary Co. (S) on 1st January 2008 when its reserves were worth Rs.120.

Required:
Prepare the Consolidated Balance Sheet as at 31/12/2008.

Solution - [Case xv]
Analysis of Equity of S Co
W-1

		Pre-acquisition	Post-acquisition
	Share Capital	500	Nil
	Reserves	120	80
		620	80
H%	80%	496	64
MI%	20%	124	16

Minority Interest 140

W-2
Calculation of goodwill

	Rupees
Cost of investment	400
Pre acquisition equity of S Co. to the extent of H%	-496
Negative Goodwill	-96

W-3

Group Reserves

All reserves of P Co		400
Post acquisition reserves of S Co to the extent of H%	80 x 80%	64
		464
Add Negative Goodwill		96
		560

W-4

Minority Interest

Owners' equity of Subsidiary Company to the extent of MI%

= Rs. 700 x 20%= Rs. 140

Consolidated Balance Sheet
As at 31 December 2008

		Rs.
Fixed Assets		1,600
Goodwill		0
Current Assets		500
		2,100
Share Capital	1,200	
Reserves	560	
	1,760	
Minority Interest	140	1,900
Current Liabilities		200
		2,100

LESSON # 42

GROUP ACCOUNTS (Cont.)
Profit & Loss

Example - [Case i] Simple Consolidation

Income Statement for the year ended 31st December 2008

	P	S
	Rs.	Rs.
Sales	7,500	4,000
Cost of Goods Sold	(4,500)	(2,900)
Gross Profit	3,000	1,100
Operating Expenses	(1,800)	(600)
Operating Profit	1,200	500
Income Tax	(480)	(200)
Net Profit after Tax	720	300
Retained Profits b/f	1,000	450
Retained Profits c/f	1,720	750

The Parent Co. (P) acquired 100% equity of the Subsidiary Co. (S) on 1st January 2008 for Rs.1,700 when S's paid up share capital was Rs.1,250 & it's reserves were worth Rs.450. (Assume all reserves comprise only of Retained Profits).

Required: Prepare the Consolidated Income Statement for the year ended 31/12/2008.

Solution - [Case i]

Computation of Goodwill

	Rs.	Rs.
Cost of Acquisition		1,700
Ordinary Share Capital of S	1,250	
Pre-acquisition Retained Profits of S	450	0
Goodwill		1,700

Computation of opening balance of Group's Retained Profits

	Rs.	Rs.
Total amount of opening balance of retained profits of P Co		1,000
Post acquisition part in opening balance of retained profits of S Co		
opening balance of retained profits of S Co	450	
pre-acquisition retained profits	-450	0
Opening balance of Group's Retained Profits b/f		1,000

Consolidated Income Statement
For the year ended 31st December 2008

	Rs.
Sales	11,500
Cost of Goods Sold	(7,400)
Gross Profit	4,100
Operating Expenses	(2,400)
Operating Profit	1,700
Income Tax	(680)
Net Profit after Tax	1,020
Retained Profits b/f	1,000
Retained Profits c/f	2,020

Example - [Case ii] Post acquisition opening balance of retained profits

Income Statement for the year ended 31st December 2008

	P	**S**
	Rs.	Rs.
Sales	7,500	4,000
Cost of Goods Sold	(4,500)	(2,900)
Gross Profit	3,000	1,100
Operating Expenses	(1,800)	(600)
Operating Profit	1,200	500
Income Tax	(480)	(200)
Net Profit after Tax	720	300
Retained Profits b/f	1,000	450
Retained Profits c/f	1,720	750

The Parent Co. (P) acquired 100% equity of the Subsidiary Co. (S) on 1st January 2007 for Rs.1,700 when S's paid up share capital was Rs.1,250 & it's reserves were worth Rs.150. (Assume all reserves comprise only of Retained Profits).

Required:
Prepare the Consolidated Income Statement for the year ended 31/12/2008.

Solution - [Case ii]

Computation of Goodwill

	Rs.	Rs.
Cost of Acquisition		1,700
Ordinary Share Capital of S	1,250	
Pre-acquisition Retained Profits of S	150	(1,400)
		300

Computation of opening balance of Group's Retained Profits

		Rs.	Rs.
Total amount of opening balance of retained profits of P Co			1,000
Post acquisition part in opening balance of retained profits of S Co			
	opening balance of retained profits of S Co	450	
	pre-acquisition retained profits	-150	300
Opening balance of Group's Retained Profits b/f			1,300

Consolidated Income Statement
For the year ended 31st December 2008

	Rs.
Sales	11,500
Cost of Goods Sold	(7,400)
Gross Profit	4,100
Operating Expenses	(2,400)
Operating Profit	1,700
Income Tax	(680)
Net Profit after Tax	1,020
Retained Profits b/f	1,300
Retained Profits c/f	2,320

Example - [Case iii] Inter Co. Dividends

Income Statement for the year ended 31st December 2008

	P	**S**
	Rs.	Rs.
Sales	7,500	4,000
Cost of Goods Sold	(4,500)	(2,900)
Gross Profit	3,000	1,100
Operating Expenses	(1,800)	(600)
Operating Profit	1,200	500
Dividend Income	125	
Net Profit before Tax	1,325	500
Income Tax	(530)	(200)
Net Profit after Tax	795	300
Dividend Paid	(250)	(125)
	545	175
Retained Profits b/f	1,000	450
Retained Profits c/f	1,545	625

The Parent Co. (P) acquired 100% equity of the Subsidiary Co. (S) on 1st January 2006 for Rs.1,700 when S's paid up share capital was Rs.1,250 & it's reserves were worth Rs.50. (Assume all reserves comprise only of Retained Profits).

Required: Prepare the Consolidated Income Statement for the year ended 31/12/2008.

Solution - [Case iii]

Computation of Goodwill

	Rs.	Rs.
Cost of Acquisition		1,700
Ordinary Share Capital of S	1,250	
Pre-acquisition Retained Profits of S	50	(1,300)
		400

Computation of opening balance of Group's Retained Profits

	Rs.	Rs.
Total amount of opening balance of retained profits of P Co		1,000
Post acquisition part in opening balance of retained profits of S Co		
opening balance of retained profits of S Co	450	
pre- acquisition retained profits	-50	400
Opening balance of Group's Retained Profits b/f		1,400

Income Statement for the year ended 31st December 2008

	P	S
	Rs.	Rs.
Sales	7,500	4,000
Cost of Goods Sold	(4,500)	(2,900)
Gross Profit	3,000	1,100
Operating Expenses	(1,800)	(600)
Operating Profit	1,200	500
Dividend Income	~~125~~	
Net Profit before Tax	1,325	500
Income Tax	(530)	(200)
Net Profit after Tax	795	300
Dividend Paid	(250)	~~(125)~~
	545	175
Retained Profits b/f	1,000	450
Retained Profits c/f	1,545	625

Consolidated Income Statement
For the year ended 31st December 2008

	Rs.
Sales	11,500
Cost of Goods Sold	(7,400)
Gross Profit	4,100
Operating Expenses	(2,400)
Operating Profit	1,700
Income Tax	(730)
Net Profit after Tax	970
Dividend Paid	(250)
	720
Retained Profits b/f	1,400
Retained Profits c/f	2,120

Example - [Case iv] Minority Interest

Income Statement for the year ended 31st December 2008

	P	S
	Rs.	Rs.
Sales	7,500	4,000
Cost of Goods Sold	(4,500)	(2,900)
Gross Profit	3,000	1,100
Operating Expenses	(1,800)	(600)
Operating Profit	1,200	500
Income Tax	(480)	(200)
Net Profit after Tax	720	300
Dividend Paid	(200)	
	520	300
Retained Profits b/f	1,000	450
Retained Profits c/f	1,520	750

The Parent Co. (P) acquired 80% equity of the Subsidiary Co. (S) on 1st January 2006 for Rs.1,700 when S's paid up share capital was Rs.1,250 & it's reserves were worth Rs.50. (Assume all reserves comprise only of Retained Profits).

Required: Prepare the Consolidated Income Statement for the year ended 31/12/2008.

Solution - [Case iv]

Computation of Goodwill

		Rs.	Rs.
Cost of Acquisition			1,700
Ordinary Share Capital of S	80% of Rs.1,250	1,000	
Pre-acquisition Retained Profits of S	80% of Rs.50	40	(1,040)
	80% of Rs. 1300		660

Computation of opening balance of Group's Retained Profits

	Rs.	Rs.
Total amount of opening balance of retained profits of P Co		1,000
Post acquisition part in opening balance of retained profits of S Co		
opening balance of retained profits of S Co	450	
pre-acquisition retained profits	-50	
to the extent of H% i.e.80%	400	320
Opening balance of Group's Retained Profits b/f		1,320

Computation of Minority Interest

		Rs.
Profits after tax of S Co. to the extent of MI%	20% of Rs.300	60

Consolidated Income Statement
For the year ended 31st December 2008

	Rs.
Sales	11,500
Cost of Goods Sold	(7,400)
Gross Profit	4,100
Operating Expenses	-2,400
Operating Profit	1,700
Income Tax	(680)
Net Profit after Tax	1,020
Minority Interest	(60)
	960
Dividend Paid	(200)
	760
Retained Profits b/f	1,320
Retained Profits c/f	2,080

LESSON # 43

GROUP ACCOUNTS (Cont.)

Example - [Case v] Minority Interest, Inter Co. Dividends

Income Statement for the year ended 31st December 2008

	P	S
	Rs.	Rs.
Sales	7,500	4,000
Cost of Goods Sold	(4,500)	(2,900)
Gross Profit	3,000	1,100
Operating Expenses	(1,800)	(600)
Operating Profit	1,200	500
Dividend Income	100	
Net Profit before Tax	1,300	500
Income Tax	(520)	(200)
Net Profit after Tax	780	300
Dividend Paid	(250)	(125)
	530	175
Retained Profits b/f	1,000	450
Retained Profits c/f	1,530	625

The Parent Co. (P) acquired 80% equity of the Subsidiary Co. (S) on 1st January 2003 for Rs.1,700 when S's paid up share capital was Rs.1,250 & it's reserves were worth Rs.50. (Assume all reserves comprise only of Retained Profits). Total amount of goodwill has been impaired

Required: Prepare the Consolidated Income Statement for the year ended 31/12/2008.

Solution - [Case v]

Computation of Goodwill

		Rs.	Rs.
Cost of Acquisition			1,700
Ordinary Share Capital of S	80% of Rs.1,250	1,000	
Pre-acquisition Retained Profits of S	80% of Rs.50	40	(1,040)
			660
Goodwill totally impaired			(660)
			0

Computation of opening balance of Group's Retained Profits

	Rs.	Rs.
Total amount of opening balance of retained profits of P Co		1,000

Post acquisition part in opening balance of retained profits of S Co		
opening balance of retained profits of S Co	450	
pre-acquisition retained profits	-50	
to the extent of H% i.e.80%	400	320
Opening balance of Group's Retained Profits b/f		1,320
Goodwill impairment loss		(660)
		660

Computation of Minority Interest		
		Rs.
Profits after tax of S Co. to the extent of MI%	20% of Rs.300	60

Consolidated Income Statement
For the year ended 31st December 2008

	Rs.
Sales	11,500
Cost of Goods Sold	(7,400)
Gross Profit	4,100
Operating Expenses	(2,400)
Operating Profit	1,700
Income Tax	(720)
Net Profit after Tax	980
Minority Interest	(60)
	920
Dividend Paid	(250)
	670
Retained Profits b/f	660
Retained Profits c/f	1,330

Note:

In consolidated income statement the amount of dividend paid by the S Co. is completely eliminated, only the amount of dividend paid by the P Co is shown.

Example - [Case vi] Inter Co. Trading (when there is no URP)

Income Statement for the year ended 31st December 2008

	P	**S**
	Rs.	Rs.
Sales	7,500	4,000
Cost of Goods Sold	(4,500)	(2,900)
Gross Profit	3,000	1,100
Operating Expenses	(1,800)	(600)
Operating Profit	1,200	500

Dividend Income	100	
	1,300	500
Income Tax	(520)	(200)
Net Profit after Tax	780	300
Preference Dividend		
Ordinary Dividend	250	125
Dividend Paid	(250)	(125)
	530	175
Retained Profits b/f	1,000	450
Retained Profits c/f	1,530	625

The Parent Co. (P) acquired 80% equity of the Subsidiary Co. (S) on 1st January 2003 for Rs.1,700 when S's paid up share capital was Rs.1,250 & it's reserves were worth Rs.50. During the year S sold to P goods costing Rs.1,000 & selling price of Rs.1,250. (Assume all reserves comprise only of Retained Profits). Goodwill has been impaired so far.

Required: Prepare the Consolidated Income Statement for the year ended 31/12/2008.

Solution - [Case vi]

Computation of Goodwill

		Rs.	Rs.
Cost of Acquisition			1,700
Ordinary Share Capital of S	80% of Rs.1,250	1,000	
Pre-acquisition Retained Profits of S	80% of Rs.50	40	(1,040)
			660
Goodwill totally impaired			(660)
			0

Computation of opening balance of Group's Retained Profits

		Rs.	Rs.
Total amount of opening balance of retained profits of P Co			1,000
Post acquisition part in opening balance of retained profits of S Co			
	opening balance of retained profits of S Co	450	
	pre-acquisition retained profits	-50	
	to the extent of H% i.e.80%	400	320
Opening balance of Group's Retained Profits b/f			1,320
Goodwill impairment loss			(660)
			660

Computation of Minority Interest

		Rs.
Profits after tax of S Co. to the extent of MI%	20% of Rs.300	60

Consolidated Income Statement
For the year ended 31st December 2008

		Rs.
Sales	(7,500+4,000-1,250)	10,250
Cost of Goods Sold	(4,500+2,900-1250)	(6,150)
Gross Profit		4,100
Operating Expenses		(2,400)
Profit before tax		1,700
Income Tax		(720)
Net Profit after Tax		980
Minority Interest		(60)
		920
Dividend Paid		(250)
		670
Retained Profits b/f		660
Retained Profits c/f		1,330

Example - [Case viii] During the Year Acquisition of Wholly Owned Subsidiary

Income Statement for the year ended 31st December 2008

	P	S
	Rs.	Rs.
Sales	900	600
Cost of Goods Sold	(400)	(360)
Gross Profit	500	240
Operating Expenses	(200)	(48)
Selling & Distribution Expenses	(100)	(36)
Operating Profit	200	156
Income Tax	(90)	(72)
Net Profit after Tax	110	84

The Parent Co. (P) acquired 100% equity of the Subsidiary Co. (S) on 30th September 2008. (Assume profits and losses accrue evenly throughout the year).

Required: Prepare the Consolidated Income Statement for the year ended 31/12/2008.

Solution - [Case viii]

Income Statement for the year ended 31st December 2008

	12 months S	3 months S
	Rs.	Rs.
Sales	600	150
Cost of Goods Sold	(360)	(90)
Gross Profit	240	60
Operating Expenses	(48)	(12)
Selling & Distribution Expenses	(36)	(9)
Operating Profit	156	39
Income Tax	(72)	(18)
Net Profit after Tax	84	21

Consolidated Income Statement
For the year ended 31st December 2008

	Rs.
Sales	1,050
Cost of Goods Sold	(490)
Gross Profit	560
Operating Expenses	(212)
Selling & Distribution Expenses	(109)
Operating Profit	239
Income Tax	(108)
Net Profit after Tax	131

LESSON # 44

GROUP ACCOUNTS (Cont.)

Example - [Case vii] Inter Co. Trading (when there is unrealized profit)

Income Statement for the year ended 31st December 2008

	P	S
	Rs.	Rs.
Sales	7,500	4,000
Cost of Goods Sold	(4,500)	(2,900)
Gross Profit	3,000	1,100
Operating Expenses	(1,800)	(600)
Operating Profit	1,200	500
Dividend Income	100	
	1,300	500
Income Tax	(520)	(200)
Net Profit after Tax	780	300
Ordinary Dividend paid	(250)	(125)
	530	175
Retained Profits b/f	1,000	450
Retained Profits c/f	1,530	625

The Parent Co. (P) acquired 80% equity of the Subsidiary Co. (S) on 1st January 2003 for Rs. 1,700 when S's paid up share capital was Rs. 1,250 & it's reserves were worth Rs.50. During the year S sold to P goods costing Rs. 1,000 & selling price of Rs. 1,250 of which inventory of Rs. 200 cost to P Co. remained unsold. (Assume all reserves comprise only of Retained Profits). Goodwill has been impaired so far.

Required: Prepare the Consolidated Income Statement for the year ended 31/12/2008.

Solution - [Case vii]

Inventory of P Co represents purchases made from S Co worth Rs. 200, which from the standpoint of the group is above cost and hence reflects unrealized profit.

Profit made by the S Co in the intera group transaction

Selling price	1,250	100%
Cost to the S Co	(1,000)	
profit made by S Co	250	20%

Unrealized profit is the profit made by the S Co on the stock remained unsold by P Co stock at cost to the group is infect selling price of the S Co. therefore the %age of the profit is 20%. Applying this %age on the selling price of the unsold stock we get (200 x 20%) Rs. 40 of the URP

Computation of Goodwill			
		Rs.	Rs.
Cost of Acquisition			1,700
Ordinary Share Capital of S	80% of Rs.1,250	1,000	
Pre-acquisition Retained Profits of S	80% of Rs.50	40	(1,040)
			660
Goodwill totally impaired			(660)
			0

Computation of opening balance of Group's Retained Profits		
	Rs.	Rs.
Total amount of opening balance of retained profits of P Co		1,000
Post acquisition part in opening balance of retained profits of S Co		
opening balance of retained profits of S Co	450	
pre-acquisition retained profits	-50	
to the extent of H% i.e.80%	400	320
Opening balance of Group's Retained Profits b/f		1,320
Goodwill impairment loss		(660)
		660

Computation of Minority Interest		
	Rs.	Rs.
Profits after tax of S Co.	300	
Unrealized profit	-40	
to the extent of MI%	260	52

Consolidated Income Statement
For the year ended 31st December 2008

		Rs.
Sales	(7,500+4,000-1,250)	10,250
Cost of Goods Sold	(4,500+2,900-1250+40)	(6,190)
Gross Profit		4,060
Operating Expenses		(2,400)
Profit before tax		1,660
Income Tax		(720)
Net Profit after Tax		940
Minority Interest		(52)
		888
Dividend Paid		(250)
		638
Retained Profits b/f		660
Retained Profits c/f		1,298

Example - [Case viii] During the Year Acquisition of Wholly Owned Subsidiary

Income Statement for the year ended 31st December 2008

	P	S
	Rs.	Rs.
Sales	900	600
Cost of Goods Sold	(400)	(360)
Gross Profit	500	240
Operating Expenses	(200)	(48)
Selling & Distribution Expenses	(100)	(36)
Operating Profit	200	156
Income Tax	(90)	(72)
Net Profit after Tax	110	84

The Parent Co. (P) acquired 100% equity of the Subsidiary Co. (S) on 30th September 2008. (Assume profits and losses accrue evenly throughout the year).

Required: Prepare the Consolidated Income Statement for the year ended 31/12/2008.

Solution - [Case viii]

Income Statement for the year ended 31st December 2008

	12 months	3 months
	S	S
	Rs.	Rs.
Sales	600	150
Cost of Goods Sold	(360)	(90)
Gross Profit	240	60
Operating Expenses	(48)	(12)
Selling & Distribution Expenses	(36)	(9)
Operating Profit	156	39
Income Tax	(72)	(18)
Net Profit after Tax	84	21

Consolidated Income Statement
For the year ended 31st December 2008

		Rs.
Sales	(900+150)	1,050
Cost of Goods Sold	(400+90)	(490)
Gross Profit		560
Operating Expenses	(200+12)	(212)
Selling & Distribution Expenses	(100+9)	(109)
Operating Profit		239
Income Tax	(90+18)	(108)
Net Profit after Tax		131

LESSON # 45

GROUP ACCOUNTS (Cont.)
Comprehensive Workings in Group Accounts
Consolidated Balance Sheet

W-1

H% $\dfrac{\text{Number of ordinary shares of S Co acquired by P Co}}{\text{Total number of ordinary shares in S Co}} \times 100 = \%$

MI % 100 - H% = MI%

W-2

Analysis of equity of S Co for pre and post acquisition

	Pre-acquisition	Post-acquisition
Ordinary share capital	All	Nil
Reserves	on the date of acquisition	after the date of acquisition
Fair value adjustment	All	Nil
Total		
H% of total	Parent's share	Parent's share
MI% of total	Minority's share	Minority's share

W-3

Calculation of Goodwill

	Rs.
Cost of investment in S Co's ordinary shares	*****
less Dividend received out of the pre-acquisition profits	*****
	*****
Pre-acquisition fair value of net assets (owners' equity) of S Co x H%	*****
Goodwill	*****
less Impairment loss	(****)
Goodwill to be presented in consolidated balance sheet	*****

W-4

Calculation of Group Reserves

Reserves of Parent Co	All
add Post acquisition equity of S Co to the extent of H%	*****
less Un-realized profit (if intra group sale from P to S)	(All)
less Un-realized profit (if intra group sale from S to P) to the extent of H%	(****)
less depreciation effect on fair vale adjustment to the extent of H%	(****)
less impairment loss of goodwill	(****)
	*****

W-5

Calculation of Minority Interest

Owners' equity of S Co	All
add Fair value Adjustment	All
less URP (incase of intra group sale from S to P)	(All)
less Depreciation effect on fair value adjustment	(All)
Total value	Total

Minority Interest = Total x MI%

Calculations specific to the scenario

	Scenario	Action
1	Intra group loans	To be cancelled
2	Intra group current accounts	To be cancelled and balance if any to be shown as goods in transit or cash in transit, as the case may be.
3	Intra group dividend	To be cancelled to the extent of H%, the balance to be shown in the consolidated balance sheet as payable to Minority
4	Negative goodwill	To be added in the group reserve

5	During the year acquisition of S Co and calculation for pre acquisition reserves	Reserves as on the opening date of the year in which the S Co was acquired + profit for the year in which the S Co was acquired to the extend of the number of months remained in the group's acquisition

Consolidated Income Statement

W-1

Calculation of opening balance of group's retained profits

Opening balance of Retained profits of P Co	All
add Post acquisition opening balance of retained profits of S Co x H%	*****
less Goodwill impairment loss	(****)
	*****

W-2

Calculation of Minority Interest

Profit after tax of S Co.	*****
less Un-realized profit (if intra group sales from S to P)	(****)
Net/Total	*****

Net/Total amount x MI% = Minority Interest

Calculations specific to the scenario

1	Intra group dividend	To be cancelled. **TIP:** All amount of dividend paid by the S Co will be eliminated only the amount of dividend paid by the P Co will appear in the Consolidated Income Statement
2	Intra group trading	Deduct the same amount from the sales and also from the cost of goods sold in the consolidated income

		statement
3	Unrealized profits	Add in the consolidated cost of goods sold and subtract from the profit after tax of S Co before applying MI% to calculate Minority interest (only when the intra group trading is from S to P) If it is intra group trading from P to S then do nothing for Minority Interest calculation