MGT401 (Financial Accounting – II)

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Lecture 01

Types of Business Entities

- **Profit Oriented / Commercial Entities**

  Profit oriented or commercial entities are those entities where the main aim of carrying out business is to earn profit for the owners of the business. Profit oriented entities are of following types:

  - Sole Proprietorship
  - Partnership
  - Companies

  ✓ **Sole Proprietorship** – Is the type of business is owned by a single individual. There may a number of employees of the business but ownership and risks and returns rest with a single owner. All assets and liabilities of the business are the assets and liabilities of the owner.

  ✓ **Partnership** – Is the type of business that is owned by more than one person. These persons form a "Partnership Firm" through an agreement called "Partnership Agreement". Partnership firms and agreements are governed by the Partnership Act 1932.

  All partners of a firm are jointly and severally liable to liabilities of the firm. This means that in case of bankruptcy of the firm personal properties of the partners would also be utilized for payment of liabilities of the firm.

  ✓ **Companies** – are separate legal entities formed under the Companies Ordinance 1984. The main difference between companies or limited companies as they are commonly called is that companies are separate legal entities and the liability of the owners is also limited whereas characteristics are not there in case of sole proprietorship and partnership.

- **Non Profit Oriented Entities**

  Non-profit oriented entities are those business entities / concerns where the main purpose of doing business is not to earn profits for the owners / sponsors but to provide benefit to general public or to carryout a social cause. Profits of a non-profit oriented entity can only be utilized for the purpose for which the entity is established

  - NGO's
  - Trusts
  - Societies

- **Separate Entity Concept**

  This concept forms the basis of the accounting principles. It means that for the purpose of accounting 'The Business' is treated independently from The Owners".

  This means that although anything owned by the business belongs to the owners of the business and anything owed by the business is payable by the owners but for accounting purposes we assume that the business is independent of its owners.

  If the business purchases a machine or piece of equipment it will own and obtain benefit from that equipment. Likewise if the business borrows money from 'someone' it will have to repay the money. This someone includes even the owner of the business.

  This treatment of the business independently from its owners is called the 'Separate Entity Concept'.

- **Separate Legal Entity (Corporate Entity) / Limited Liability**

  Limited company is a legal entity separate from its owners (called shareholders). The basic difference between a partnership and a limited company is the concept of limited liability. In case a sole proprietor or partnership business runs into losses and is unable to pay its liabilities, its proprietor / partners will have to pay the liabilities from their own wealth.

Whereas in case of limited company the shareholders don't lose anything more than the amount of capital they have contributed in the company i.e. their personal wealth is not at stake and their liability is limited to the amount of share capital they have contributed.

Limited company is an artificial legal person. It has a legal entity separate from its owners (shareholders). It can enter into agreements under its own name, can sue and can be sued.

- **Companies Limited By Shares**

"Company Limited by Shares" is a company in which the liability of the members (shareholder) of the company is limited to the amount of share capital that they have contributed. This means that the owners will only suffer a loss to the extent of the amount contributed as capital, in case the company is closed and its assets are insufficient to repay its liabilities.

Section 2 (8) of the Companies Ordinance 1984 sates:

"company limited by shares" means a company having the liability of its members limited by the memorandum to the amount, if any, unpaid on the shares respectively held by them.

- **Types of Companies Limited by Shares**

✓ Private Limited Companies
✓ Single Member Companies
✓ Public Limited Companies
  ➢ Public Listed Companies
  ➢ Public Unlisted Companies

✓ **Private Limited Companies** – are those companies that restrict the right of shareholders to transfer their shares to a person other than the existing shareholders.

If a member wishes to sell his shares he will first have to offer the shares to the existing members. In case, none of the existing members accepts the shares and at the same time does not object to the selling of the shares to an outsider only then the shares can be sold to an outsider. Private Limited companies use the words "Private Limited" or "(Pvt) Ltd" at the end of their name.

The maximum numbers of shareholders allowed in a private limited company is 50.
Private Limited Company is defined in Companies Ordinance 1984 in Section 2 (28) as:

"Private company" means a company which, by its articles,—

(i) restricts the right to transfer its shares, if any;
(ii) limits the number of its members to fifty not including persons who are in the employment of the company; and
(iii) prohibits any invitation to the public to subscribe for the shares, if any, or debentures of the company:

Provided that, where two or more persons hold one or more shares in a company jointly, they shall, for the purposes of this definition, be treated as a single member;

✓ **Single Member Companies** – are also private limited companies but there is only one shareholder in the company. Before 2002 there was a limit of two for the minimum number of shareholders in a private limited company. However the limit was relaxed and companies with only one member were also allowed.

In case of a single member company two persons are required to be nominated to takeover the company in case of the death of the member.

- ✓ **Public Limited Companies** – are those companies in which there is no restriction of transfer of shares. There is also no limit as to the maximum number of shareholders. However, the minimum number cannot be less than three. Public Limited Companies uses the words "Limited" or "Ltd" at the end of their name.

  Public Limited Company is defined in Companies Ordinance 1984 in Section 2 (30) as:

  "Public company" means a company which is not a private company

- ✓ **Public Listed Companies** – are those public companies whose shares are traded on stock exchanges. These are also called "quoted companies".

- ✓ **Public Unlisted Companies** – are those public limited companies whose shares are not traded on any stock exchange. These are also called "public unquoted companies".

- **Limited Companies not Formed for Profit [Section 42]**

  Companies Ordinance also permits formation of non-profit oriented companies which means that the company will not distribute its profits among its share holders. These companies have to take special permission from SECP and are also allowed to dispense with the phrases "Private Limited" or "Limited"

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Lecture 02

Formation of Companies and Meetings

- **Types of Companies**

There are three major types of companies:

- ✓ Companies Limited by Shares
- ✓ Companies Limited by Guarantee
- ✓ Unlimited Companies

Section 15 of the Companies Ordinance 1984 sates:

(1) *Any three or more persons associated for any lawful purpose may, by subscribing their names to a memorandum of association and complying with the requirements of this Ordinance in respect of registration, form a public company and any one, or more persons so associated may in like manner from a private company.*

(2) *A company formed under sub-section (1) may be a company with or without limited liability, that is to say,—*

   a) *a company limited by shares; or*
   b) *a company limited by guarantee; or*
   c) *an unlimited company*

- **Companies Limited By Shares**

"Company Limited by Shares" is a company in which the liability of the members (shareholder) of the company is limited to the amount of share capital that they have contributed which means that the owners will only suffer a loss to the extent of the amount contributed as capital in case the company is closed and its assets are insufficient to repay its liabilities.

Section 2 (8) of the Companies Ordinance 1984 sates:

"company limited by shares" means a company having the liability of its members limited by the memorandum to the amount, if any, unpaid on the shares respectively held by them.

- **Companies Limited By Guarantee**

In companies limited by guarantee the shareholders guarantee to contribute a specific amount to repay the liabilities of the company in case of winding up o the company.

Section 2 (9) of the Companies Ordinance 1984 sates:

"company limited" by guarantee means a company having the liability of its members limited by the memorandum to such amount as the members may respectively thereby undertake to contribute to the assets of the company in the event of its winding up.

A company limited by guarantee may or may not have a paid up capital.

- **Unlimited Companies**

In case of unlimited companies the liability of the members is unlimited. As far as liability of members is concerned an unlimited company is just like a partnership the only difference is that it has a separate legal entity.

- **Formation of Companies**

Following procedure is followed for formation of companies:

- ✓ In the first step the availability of name is checked from SECP. SECP ensures that two companies with same name do not get registered.

- ✓ In the second step Memorandum and Articles of Association are prepared and signed by the sponsors (first shareholders) of the company.

- ✓ In the third step memorandum and articles along with certain other forms are filed with SECP for registration.

- ✓ SECP after checking the documents and ensuring that all formalities for formation of company have been fulfilled issues a Certificate of Incorporation to the company. The date mentioned on certificate of incorporation is the "date of birth" of the company.

- ✓ Private limited companies can start business immediately after receiving the certificate of incorporation.

- ✓ Public limited companies, however, have to fulfill certain conditions after which a certificate of commencement of business is issued to them by SECP. These requirements have been listed in detail in Section 146 of the Companies Ordinance 1984.

- ✓ Public companies can start their business after receiving certificate of commencement of business.

- **Memorandum of Association**

Memorandum of association is an agreement between the persons forming a company (promoters / first shareholders). It is the basic document and the business of the company is carried out within the limits defined by this document. Shareholders can, however, make changes in the memorandum of association by following a set procedure.

Contents of memorandum of association have been listed in Sections 16, 17 and 18 of the Companies Ordinance 1984.

✓ ***Section 16 – Memorandum of company limited by shares.-*** *In the case of a company limited by shares,—*

(a) the memorandum shall state—

(i) the name of the company with the word "limited" as the last word of the name in the case of a public limited company, and the parenthesis and words "(Private) Limited" as the last words of the name in the case of a private limited company;

(ii) the Province or the part of Pakistan not forming part of a Province, as the case may be, in which the registered office of the company is to be situate:

(iii) the objects of the company and, except in the case of a trading corporation the territories to which they extend;

(iv) that the liability of the members is limited; and

(v) the amount of share capital with which the company proposes to be registered, and the division thereof into shares of a fixed amount;

(b) no subscriber of the memorandum shall take less than one share; and

(c) each subscriber of the memorandum shall write opposite to his name the number of shares he takes.

✓ ***Section 17 – Memorandum of company limited by guarantee -*** *In the case of a company limited by guarantee,—*

(a) whether or not the company has a share capital, the memorandum shall state—

(i) the name of the company with the parenthesis and words "(Guarantee) Limited" as the last words of its name;

(ii) *the province or the part of Pakistan not forming part of a Province, as the case may be in which the registered office of the company is to be situate;*

(iii) *the objects of the company and except in the case of a trading corporation, the territories to which they extend;*

(iv) *that the liability of the members is limited; and*

(v) *that each member undertakes to contribute to the assets of the company in the event of its being wound up while he is a member or within one year afterwards, for payment of the debts and liabilities of the company contracted before he ceases to be a member, and of the costs, charges and expenses of winding up, and for adjustment of the rights of the contributories among themselves such amount as may be required, not exceeding a specified amount; and*

(b) *if the company has a share capital,—*

(i) *the memorandum shall also state the amount of share capital with which the company proposes to be registered and the division thereof into shares of a fixed amount;*

(ii) *no subscriber of the memorandum shall take less than one share; and*

(iii) *each subscriber shall write opposite to his name the number of shares he takes.*

✓ Section ***18 – Memorandum of unlimited company.-*** *In the case of an unlimited company,—*

(a) *whether or not the company has a share capital, the memorandum shall state—*

(i) *the name of the company;*

(ii) *the Province or the part of Pakistan not forming part of a Province, as the case may be, in which the registered office of the company is to be situate; and*

(iii) *the objects of the company, and, except in the case of a trading corporation, the territories to which they extend; and*

(b) *if the company has a share capital,—*

(i) *no subscriber of the memorandum shall take less than one share; and*

(ii) *each subscriber shall write opposite to his name the number of shares he takes.*

- **Articles of Association**

Articles of association lay down the general rules of business of the company. Standard forms of memorandum and articles of association are available in the First Schedule of the Companies Ordinance 1984. The promoters may if they wish use the standard formats or draft their own Articles of Association.

- **Standard Forms of Article and Memorandum of Association**

Standard forms of Article and Memorandum of Association are given in the following tables:

✓ Table A Regulation for Management of a Company Limited by Shares
✓ Table B Memorandum of association of company limited by shares
✓ Table C Memorandum and articles of association of a company limited by guarantee and not having a share capital
✓ Table D Memorandum and articles of association of a company limited by guarantee and having a share capital
✓ Table E Memorandum and articles of association of an unlimited company having a share capital

- **Meetings of Companies**

  - ✓ **Statutory Meeting** – Only public limited companies are require to hold statutory meetings. Requirements for statutory meeting are listed in Section 157 of the Companies Ordinance 1984. It is required to be held with in 3 to 6 months of the incorporation of the company. Directors produce a report of the performance of the company to the in the form of a report called "Statutory Report". A 21 days notice is given to members for holding the meeting.

  - ✓ **Annual General Meeting** – First Annual General Meeting (AGM) is required to be held within 18 months of incorporation. Thereafter once in every calendar year within 4 months of closing of financial year. Gap between two AGMs should not be more than 15 months. A 21 days notice is required to be sent to members. Requirements for annual general meeting are listed in Section 158 of the Companies Ordinance 1984.

  - ✓ **Extraordinary General Meeting** – All meetings of members other than AGM, are called Extraordinary General Meetings. Directors or shareholders having 10% voting power can summon EOGM. 21 days notice is required to be sent to members. Requirements for extra ordinary general meeting are listed in Section 158 of the Companies Ordinance 1984.

- **Resolution in General Meetings**

  - ✓ **Ordinary Resolution –** is that which is passed by simple majority of the votes at any general meeting of the shareholders. The ordinary routine business of the company is decided just by an ordinary resolution.

  - ✓ **Special resolution –** is being passed by majority of not less than ¾ if such members title to vote. A notice of 21 days is required for the meeting in which such a resolution is passed. The following matters are taken through the passage of special resolution.
    - Chang in the name and objects of the company
    - Alternatives of the articles
    - Reduction of share capital of the company
    - Creation of reserve capital
    - Making the liability of directors unlimited
    - Voluntary winding up of company

Lecture 03

Relationships between Companies

Two or more companies may be interconnected or interrelated in one of the following manners:

- They can have a business relationship of such a nature that they can be termed as Related Parties.
- They can be Associated to each other.
- One company can be a subsidiary of the other.

Related Parties

- ✓ Related parties in relation to a company have been defined in the Fourth Schedule of Companies Ordinance 1984 as follows:

  Related party, in relation to a company, means an entity which has the ability to control the company or exercise significant influence over the company in making financial and operating decisions or vice versa.

- ✓ This means that there is such a business relationship among the companies / individuals / entities that they can influence the decision making process of each other or at least one of them can influence the other.

- ✓ Related parties as per Companies Ordinance 1984 include the following:

  (a) Entities that directly or indirectly through one or more intermediaries control, or are controlled by, or are under common control with, the reporting company including holding companies, subsidiaries and fellow subsidiaries;

  (b) Associates, as defined in the International Accounting Standard 28, Accounting for Investments in Associates;

  (c) Individuals owning, directly or indirectly, an interest in the voting power of the reporting company that gives them significant influence over the company, and close members of the family of any such individual;

  (d) key management personnel, that is, persons having authority and responsibility for planning, directing and controlling the activities of the reporting company including directors and officers of such company and close members of the families of such individuals;

  (e) entities in which a substantial interest in the voting power is owned, directly or indirectly, by any person described in clause (c) or (d) or over which such person is able to exercise significant influence including entities owned by directors or major shareholders of the reporting company and entities that have a key management personnel in common with the reporting company;

  (f) entities in which one or more of the directors or members of the governing board are appointed by the reporting company or vice versa;

  (g) where one or more of the directors or members of the governing board of the entity as well as the reporting company are appointed by the same person or persons;

  (h) entities whose process of manufacture or business is wholly dependent on the use of know-how, patents, copyrights, trademarks, licenses, franchises or any other business or commercial rights of similar nature, or any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process, of which the reporting company is the owner or in respect of which the company has exclusive rights or vice versa;

  (i) where more than half of the raw materials and consumables required in the process of manufacture of an entity are supplied by the reporting company, or by persons specified by the company, or vice versa, and the prices and other conditions relating to the supply are influenced by the entity or the company; and

(j) where goods or articles manufactured or processed by an entity are sold or transferred to the reporting company or to persons specified by the company, or vice versa, and the prices and other conditions relating thereto are influenced by the entity or the company.

- ✓ According to the International Accounting Standards (IAS) 24 a party is related to an entity if:

(a) Directly or indirectly through one or more intermediaries, it:
- – Controls, is controlled by, or is under common control with, the entity (this includes parents, subsidiaries and fellow subsidiaries);
- – Has an interest in the entity that gives it significant influence over the entity; or
- – Has joint control over the entity;

(b) It is an associate;

(c) It is a Joint Venture in which the entity is a ventured;

(d) It is the member of the key management personnel of the entity or its parents;

(e) It is a close member of the family of an individual referred to in (a) or (d);

(f) It is an entity that is controlled, jointly controlled or significantly influenced by; or for which significant voting power in such entity resides with, directly or indirectly, any individual referred to in (d) or (e); or

(g) It is a post employment benefit plan for the benefit of employees of the entity, or of any entity that is a related party of the entity.

- ✓ In case of transactions with related parties certain information has to be disclosed in financial statements. The information needed to be disclosed includes the accounting policy used in recording the related party transactions and that all transactions have been recorded at an arm's length price.

Associated Undertakings / Companies

- ✓ Associated undertakings / companies have been defined in the Companies Ordinance 1984 as follows:

"associated companies" and "associated undertakings" mean any two or more companies or undertakings, or a company and an undertaking, interconnected with each other in the following manner, namely: —

(i) if a person who is the owner or a partner or director of a company or undertaking, or who, directly or indirectly, holds or controls shares carrying not less than twenty per cent of the voting power in such company or undertaking, is also the owner or partner or director of another company or undertaking, or directly or indirectly, holds or controls shares carrying not less than twenty per cent of the voting power in that company or undertaking; or

(ii) if the companies or undertakings are under common management or control or one is the subsidiary of another; or

(iii) if the undertaking is a modaraba managed by the company; and a person who is the owner of or a partner or director in a company or undertaking or, who so holds or controls shares carrying not less than ten per cent of the voting power in a company or undertaking, shall be deemed to be an "associated person" of every such other person and of the person who is the owner of or a partner or director in such other company or undertaking, or who so holds or controls such shares in such company or undertaking:

- ✓ There are two different conditions; in clause (i) if one person holds more than twenty percent shares in two different companies then both the companies would be associated; and in clause (iii) all persons holding more than ten percent shares of a single entity would be associated with each other.

- ✓ International Accounting Standard 28 defines an associated with the identification of influence. As per the IAS 28 associate is an enterprise in which the investor has significant influence and which is neither a subsidiary nor a joint venture of the investor.

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Significant Influence

- ✓ It is important to understand significant influence in order to understand the definition of associate given by IAS 28.

- ✓ Significant influence is the ability to participate but not to control the financial and management affairs of the enterprise.

- ✓ If the investor holds directly or indirectly 20% or more of the voting power of the investee, it is presumed that the investor does have significant influence, unless it can be clearly demonstrated that this is not the case.

- ✓ Conversely, if the investor holds, directly or indirectly, less than 20% of the voting power of the investee, it is presumed that the investor does not have significant influence, unless such influence can be clearly demonstrated.

- ✓ A substantial or majority ownership by another investor does not necessarily preclude an investor from having significant influence.

Subsidiary Companies

- ✓ As per the Companies Ordinance 1984, a company should be termed as a subsidiary of another company if the other company holds more than 50% of its shares or has the power to appoint more than 50% of its directors.

- ✓ Subsidiary is defined in International Accounting Standard 27 as, an enterprise would be the subsidiary of another enterprise if that investor enterprise can control the subsidiary.

Control

- ✓ According to the IAS 27 control is defined as:

  "The power to govern the financial and operating policies of an enterprise so as to obtain benefits from its activities." and

  "A firm the management of which is controlled by a company or where the company is entitled to more than fifty per cent of its profits or is liable to bear more than fifty percent of its losses."

Types of Subsidiaries

- ✓ Direct and Indirect Subsidiaries

  The relation of direct and indirect subsidiaries can be explained with the following example:

  Company B holds more than 50% shares of company A and therefore A is a subsidiary of B, and
  Company C holds more than 50% shares of company B and therefore B is a subsidiary of C.

  C ------------→ B -----------→ A

  In this example there are two direct relations, A to B and B to C.

  A is a direct subsidiary of B
  B is a direct subsidiary of C

  Whereas there is one indirect relationship exist between C and A. Although C does not hold any shares in A, but still A would be its Indirect Subsidiary as A is a subsidiary of B which in turn is a subsidiary of C.

- ✓ Wholly Owned and Partially Owned Subsidiaries

  If the holding company owns more than 50% but less than 100% shares of the subsidiary then the subsidiary is termed as Partially Owned Subsidiary.

  Whereas if the holding company owns 100% shares of the subsidiary company then the subsidiary is called a Wholly Owned Subsidiary.

  A subsidiary can be a Virtually Wholly Owned subsidiary if the holding company owns marginally less than 100% shares. This is usually done to fulfill the requirement of minimum number of shareholders. We have studied that minimum number of shareholders in a Private Limited Company other than a Single Member Company is 2 and 3 in case of a Public Limited Company. Therefore a small number of shares (can be one share) is allotted to other individual and the holding company is left with less than 100% shares.

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Lecture 04

Preparation and Presentation of Financial Statements

- Preparation and presentation of financial statements is governed by:

  - ✓ Companies Ordinance 1984 (4th and 5th Schedule)
  - ✓ International Accounting Standards (IAS)
    OR
  - ✓ International Financial Reporting Standards (IFRS)

Companies Ordinance 1984

- The Companies Ordinance 1984 is an Ordinance issued by Government of Pakistan and It regulates establishment and management of Limited Companies.

4th and 5th Schedule

- 4th Schedule of The Companies Ordinance 1984 provides disclosure requirement for the Listed Companies.

- 5th Schedule of The Companies Ordinance 1984 provides disclosure requirement for the Non-Listed Companies.

- 4th and 5th Schedules of The Companies Ordinance 1984 consist of three parts:

  - ✓ Part I – Definitions and general requirements for preparation and presentation of financial statements.
  - ✓ Part II – Requirements for Balance Sheet.
  - ✓ Part III – Requirements for Profit and Loss Account.

International Accounting Standards

- International Accounting Standards are issued by International Auditing and Assurance Standards Board (IAASB).

- The main objectives of IAS are

  To prescribe the basis for presentation of general purpose financial statements, in order to ensure comparability both with the entity's own financial statements of previous periods and with the financial statements of other entities.

- IAS – 1 applies to all general-purpose financial statements prepared in accordance with IASs, i.e. those intended to meet the needs of users who are not in a position to demand reports tailored to their specific needs.

- Only those IAS are applicable in Pakistan that are recommended by The Institute of Chartered Accountants of Pakistan and adopted and notified by Securities and Exchange Commission of Pakistan (SECP).

Book of Accounts to be Kept by Companies

- Every company shall keep at its registered office proper books of account with respect to:

  - ✓ All sums of money received and expended by the company and the smatters in respect of which the receipt and expenditure takes place;
  - ✓ All sales and purchases of goods by the company;
  - ✓ All assets of the company:
  - ✓ All liabilities of the companies: and
  - ✓ In the case of a company engaged in production, processing, manufacturing or mining activities, such particulars relating to utilisation of material or labour or to other inputs or items of cost as may be

prescribed, if such class of companies is required by the Authority by a general or special order to include such particulars in the books of accounts:

Preparation of Accounts

- It is the responsibility of the directors of every company to prepare annual accounts of the company.
- Directors of every company should lay before the Annual General Meeting, Balance Sheet, Profit and Loss or Income and Expenditure Account as the case may be.
- First annual accounts of the company will be prepared within eighteen (18) months of the incorporation of the company.
- Subsequently annual accounts will be prepared every year.
- In addition listed companies are required to prepare Quarterly and Half Yearly accounts.

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Presentation of Balance Sheet

Following is a sample balance sheet:

ABC Food Processing and Packing Co Ltd.

Balance Sheet As At June 30, 2004

	Note	2004 Rs'000	2003 Rs'000
ASSETS			
Non-Current Assets			
Fixed Assets	5	588,704	672,466
Capital Work in Progress	6	627,126	231,340
Long Term Loans	7	2,898	2,639
Deferred Cost	8	346	2,419
		1,219,074	908,864
Current Assets			
Stores and Spares	9	95,281	117,811
Stock in Trade	10	1,005,315	1,013,483
Trade Debts	11	136,229	168,346
Advances, Deposits, Prepayments and Other Receivables	12	23,698	32,185
Cash and Bank Balances	13	24,620	21,725
		1,285,143	1,353,550
		2,504,217	**2,262,414**
Financed By			
Share Capital and Reserves			
Share Capital		92,364	92,364
Accumulated Profit / (Loss)		1,639,309	1,376,739
Shareholders Equity		1,731,673	1,469,103
Long Term Liabilities			
Deferred Taxation	13	30,796	45,205
Obligation Under Lease Finance	14	-	-
		30,796	45,205
Current Liabilities			
Short Term Finances	15	-	144,331
Current Maturity of Obligation Under Lease Finance	16	-	1,316
Creditors, Accrued and Other Liabilities	17	415,362	322,746
Provision for Taxation		181,667	166,164
Other Provisions	18	5,020	4,110
Divided Payable	19	139,699	109,439
		741,748	748,106
		2,504,217	**2,262,414**

General Requirements for Presentation of Financial Statements

- Following information needs to be disclosed in the financial statements of a company:
  - ✓ Name of the entity.
  - ✓ Date on which the balance sheet is being drawn.
  - ✓ Currency in which balance sheet is presented.
  - ✓ Reporting period if it is less or more than one year.

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- ✓ Clause 6 of Part I of Fourth Schedule requires that, except for the first financial statements laid before the company, financial statements shall also give the corresponding figures for the immediately preceding financial year.
- ✓ According to International Accounting Standards 1, comparative information is to be disclosed for the previous period for all numerical information, unless another IAS permits/requires otherwise. Comparatives should also be given in narrative information where helpful.

Non-Current Assets

- Following different headings are prescribed by the IAS and the Companies Ordinance 1984

Companies Ordinance	International Accounting Standards (IAS)
Fixed Assets (Includes both tangible and intangible)	Property Plant and Equipment Intangible Assets
Long term Investments	Investments in Associates
Long Term Loans and Advances	Other Financial Assets
Long Term Deposits, Prepayments & Deferred Costs	

Fixed Assets

- Fixed assets are distinguished between tangible and intangible and are classified under appropriate sub-heads, duly itemized such as-

  - ✓ Tangible;
    - Land
    - Buildings
    - Plant and Machinery
    - Furniture and Fittings
    - Vehicles
    - Capital Work in Progress
    - Others (to be specified);
  - ✓ Intangible:
    - Goodwill;
    - Patents, Copyright, Trade Marks and Designs; and
    - Others (to be specified).

Disclosure Requirements for Fixed Assets

- The standard has a long list of disclosure requirements, for each class of property, plant or equipment.

  - ✓ Depreciation method used
  - ✓ Useful lives or depreciation rates used
  - ✓ Gross carrying amount and accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the period
  - ✓ Measurement basis for determining the gross carrying amount (if more than one, the gross carrying amount for that basis in each category)
  - ✓ Reconciliation of the carrying amount at the beginning and end of the period showing:
    - Additions
    - Disposals
    - Acquisitions through business combinations
    - Increase/ decrease during the period from revaluations and impairment losses.
    - Impairment losses recognized in the income statement
    - Impairment losses reversed in the income statement
    - Depreciation
    - Net exchange differences (from translation of statements of foreign entity)
    - Any other movements.

- The financial statements should also disclose the following.

  - ✓ Any recoverable amounts of property, plant and equipment
  - ✓ Existence and amounts of restrictions on title, and items pledged as security for liabilities
  - ✓ Accounting policy for the estimated costs of restoring the site
  - ✓ Amount of expenditures on account of items in the course of construction
  - ✓ Amount of commitments to acquisitions

- Revalued assets require further disclosures.

  - ✓ Basis used to revalue the assets
  - ✓ Effective date of the revaluation
  - ✓ Whether an independent valuer was involved
  - ✓ Nature of any indices used to determine replacement cost
  - ✓ Carrying amount of each class of property, plant and equipment that would have been included in the financial statements had the assets been carried at cost less accumulated depreciation and accumulated impairment losses.
  - ✓ Revaluation surplus, indicating the movement for the period and any restrictions on the distribution of the balance to shareholders.

- The standard also encourages disclosure of additional information, which the users of financial statements may find useful.

  - ✓ The carrying amount of temporarily idle property, plant and equipment
  - ✓ The gross carrying amount of any fully depreciated property, plant and equipment that is still in use
  - ✓ The carrying amount of property, plant and equipment retired from active use and held for disposal.
  - ✓ The fair value of property, plant and equipment when this is materially different from the carrying amount

- These all disclosures are disclosed in financial statements through a schedule, which is called Fixed Asset schedule.

- The fixed asset schedule has nine columns in which quantity of columns may be increased or decreased according to the need of the organization.
  - ✓ First column – shows the category of assets and if the company has leased assets then assets subject to freehold and assets subject to leasehold are separately distinguished.
  - ✓ Second column – shows the cost of assets brought forward (cost at the start of the financial year).
  - ✓ Third and fourth columns – show the addition and disposals of assets during the year respectively.
  - ✓ Fifth column – shows the accumulated cost of assets (opening cost brought forward plus addition less disposal during the year.
  - ✓ Columns second to five are related to the cost of the assets.
  - ✓ Sixth column – shows the rate of depreciation applied to assets categories.
  - ✓ Just like columns second to five depreciation on assets is shown in columns seventh to column tenth.
  - ✓ Seventh column – shows the accumulated depreciation on the assets brought forward (opening balance of accumulated deprecation).
  - ✓ Eight column – shows the adjustment of depreciation which was caused due to movement in assets (Disposals / Transfers).
  - ✓ Ninth column – shows the depreciation for the year, which is calculated by deducting the accumulated depreciation and its adjustments from accumulated cost after additions and disposals and multiplying this with the depreciation rate.
  - ✓ Tenth column – shows the accumulated depreciation at the end of the year (inclusive of current year depreciation).
  - ✓ Eleventh column – shows the Written down value of assets which is calculated after deducting the year end accumulated depreciation from year end accumulated cost. This is the amount which is shown in Balance Sheet.
  - ✓ At the bottom of schedule allocation of depreciation should be made between cost of sales, selling and marketing and general and admin.

5. Fixed Assets Sample

Rs' 000

Particulars	Cost				RATE	Accumulated Depreciation				WDV
	As On Jul 01 2003	**Addition**	**Disposal**	**As On Jun 30 2004**		**As On Jul 01 2003**	**On Disposal**	**For The Year**	**As On Jun 30 2004**	**As On Jun 30 2004**
Owned Assets										
Freehold Land	108,978	-	-	108,978	-	-	-	-	-	108,978
Factory Building on Free hold Land	231,849	545	-	232,394	10	130,667	-	16,988	147,655	84,739
Employees Quarters	526	-	526	-	10	526	526	-	-	-
Plant, Machinery and Equipment	1,015,671	11,507	308	1,026,870	10	588,108	308	74,178	661,978	364,892
Other Machinery and Equipment	24,274	443	-	24,717	10-12	17,971	-	1,507	19,478	5,239
Furniture, Fixture and Office equip.	34,167	873	8	35,032	20-25	23,882	8	3,510	27,384	7,648
Vehicles	33,383	9,795	3,435	39,743	20	17,459	1,376	6,452	22,535	17,208
	1,448,848	**23,163**	**4,277**	**1,467,734**		**778,613**	**2,218**	**102,635**	**879,030**	**588,704**
							1707*			
Assets subject to finance lease										
Vehicles	3,938	-	3,938*	-	20	1,707	1,707*	-	-	-
	3,938	**-**	**3,938**	**-**		**1,707**	**1,707**	**-**	**-**	**-**
Total 2004	**1,452,786**	**23,163**	**8,215**	**1,467,734**		**780,320**	**3,925**	**102,635**	**879,030**	**588,704**
Total 2003	**x**	**x**	**x**	**x**		**x**	**x**	**x**	**x**	**x**

*** These leased assets have been transferred to owned assets during the period.**

5.1 Depreciation charge for the year has been allocated as follows:

	2004	**2003**
	Rs'000	Rs'000
Cost of sales	95,579	**x**
Selling and Marketing Expenses	1,975	**x**
General and Administrative exp.	5,081	**x**
	102,635	**x**

Lecture 05

Property, Plant and Equipment

Recording, Classification and Reporting of Property Plant and Equipment / Fixed Assets is governed by IAS 16 – Property Plant and Equipment

IAS 16, Property Plant and Equipment

This standard covers all aspects of accounting for property, plant and equipment. This represents the bulk of items which are **"tangible" non-current assets**.

Scope:

- ✓ IAS 16 should be followed when accounting for property, plant and equipment unless another International Accounting Standard requires a different treatment.
- ✓ IAS 16 does not apply to the following:
  - Biological assets related to agricultural activity.
  - Mineral rights and mineral reserves, such as oil, gas and other non-regenerative resources.
- ✓ However, the standard applies to property, plant and equipment used to develop these assets.

Definitions:

- ✓ **Property, plant and equipment** are tangible assets that:
  - Are held for use in the production or supply of goods or services, for rental to others, or for administrative purpose; and
  - Are expected to be used during more than one period.

1. **Cost** is the amount of cash or cash equivalent paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction.

2. **Residual value** is the net amount which the entity expects to obtain for an asset at the end of its useful life after deducting the expected costs of disposal.

3. **Fair value** is the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction.

4. **Carrying amount** is the amount at which an asset is recognized in the balance sheet after deducting any accumulated depreciation and accumulated impairment losses.

5. **Impairment loss** is the amount by which the carrying amount of an asset exceeds its recoverable amount.

Recording of Property, Plant and Equipment

Recording of property plant and equipment can be categorized into following activities.

- ✓ Initial recognition
- ✓ Measurement of cost
- ✓ Subsequent expenditure
- ✓ Measurement subsequent to initial recognition
- ✓ Impairment

Initial Recognition

- ✓ Recognition simply means incorporation of the items in the business's accounts, in this case as a non-current asset. The recognition of property, plant and equipment depends on two criteria.

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- The enterprise expects to obtain future economic benefit from the asset.
- The value of the asset can be measured reliably.

✓ These recognition criteria apply to subsequent expenditure as well as costs incurred initially. Property, Plant and equipment can amount to substantial amounts in financial statements, affecting the presentation of the company's financial position (in the balance sheet) and the profitability of the entity, through depreciation and also if an asset is wrongly classified as an expense and taken to the income statement.

✓ **First Criterion: Future Economic Benefits**

The degree of certainty attached to the flow of future economic benefits must be assessed. This should be based on the evidence available at the date of initial recognition (usually the date of purchase). The entity should thus be assured that it will receive the rewards attached to the asset and it will incur the associated risks, which will only generally be the case when the rewards and risks have actually passed to the entity. Until then, the asset should not be recognized.

✓ **Second Criterion: Cost Measured Reliably**

It is generally easy to measure the cost of an asset at the transfer amount on purchase, i.e. what was paid for it. Self constructed assets can also be measured easily by adding together the purchase price of all the constituent parts (labour, material, etc) paid to external parties. In other words, In case of a purchased asset the consideration paid for the acquisition of the asset identifies its cost.

✓ Otherwise the expenditure should be treated as revenue expenditure and charged to current period.

✓ Most of the times assets will be identified individually, but this will not be the case for **smaller items**, such as tools, dies and moulds, which are sometimes classified as inventory and written off as an expense.

✓ Major components or spare parts, however, should be recognized as property, plant and equipment.

✓ For very large and specialized items, an apparently single asset should be broken down in to its composite parts. This occurs where the different parts have different useful lives and different depreciation rates are applied to each part, e.g. an aircraft, where the body and engines are separated as they have different useful lives.

Initial Measurement of property plant and equipment

An item of property plant and equipment that qualifies for recognition should be measured at its cost.

Components of Cost

✓ The cost of an item of property plant and equipment includes all costs incurred in bringing the asset to working condition for its intended use.
✓ The standard lists the components of the cost of an item of property, plant and equipment.

✓ The components of cost include:

- Purchase price, less trade discount or rebate
- Import duties,
- Other non-refundable taxes,
- Cost of site preparation
- Initial delivery and handling costs
- Installation costs
- Testing
- Professional fees (architects, engineers)

- Administration and other costs (incurred on the construction / development of the assets)
- Borrowing costs

✓ The following costs **will not be part of the cost** of property, plant and equipment unless they can be attributed directly to the asset's acquisition, or bringing it into its working condition.

- Administration and other general overhead costs
- Start-up and similar pre-production costs
- Initial operating losses before the asset reaches planned performance

✓ All of these will be recognized as an expense rather than an asset.

✓ In the case of self constructed assets, the same principles are applied as for acquired assets. If the entity makes similar assets during the normal course of business for sale externally, then the cost of the asset will be the cost of its production under IAS 2 inventories. This also means that abnormal costs (wasted material, labour or other resources) are excluded from the cost of the asset. An example of a self-constructed asset is when a building company builds its own head office.

Exchange of Assets (Dissimilar Assets)

✓ In case an item of property plant and equipment is exchanged or part exchanged for a dissimilar asset of the enterprise, the cost of the new asset is measured at the fair value of the asset received.

✓ The cost of such an item is equivalent to:

- Fair value of the asset given up, plus
- Value of any cash or cash equivalent transferred.

Exchange of Assets (Similar Assets)

✓ In case an item of property plant and equipment is exchanged for similar asset of the enterprise, the cost of the new asset is measured at the carrying value of the old asset.

✓ The fair value of the asset received may provide evidence of an appreciation or impairment in the asset given up.

Subsequent Expenditure

✓ A subsequent expenditure on an asset already recognized should only be added to the carrying cost of the asset if:

"It is probable that future economic benefits, in excess of the originally assessed standards of performance of the asset, will flow to the enterprise"

✓ All other subsequent expenditures should be recognized as an expense in the period in which they are incurred.

✓ Subsequent expenditure on property plant and equipment is only recognized as an asset when the expenditure improves the condition of the asset beyond its originally assessed standard of performance.

✓ Examples of subsequent expenditure that can be capitalized:

- Modification of an item of plant to extend its useful life or capacity
- Up gradation in plant to achieve a substantive improvement quality of output.
- Adoption of new production processes enabling a substantial reduction in previously assessed operating costs.

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- ✓ Expenditure on repairs or maintenance of property, plant and equipment is made to restore or maintain the future economic benefits that an enterprise can expect from the originally assessed standard of performance of the asset. As such it is usually recognized as an expense when incurred.

- ✓ Examples of subsequent expenditure that should not be capitalized:

    Expenditure on repairs and maintenance of property plant and equipment that is made to restore or maintain the economic benefit from it

- ✓ Major components of some items of property, Plant and equipment may require replacement at regular intervals. For example, a furnace may require relining after a specified number of hours of usage or aircraft interiors such as seats and galleys may require replacement several times during the life of the airframe. The components are accounted for as separate assets because they have useful lives different from those of the items of property, plant and equipment to which they relate. Therefore, the expenditure incurred in replacing or renewing the component is accounted for as the acquisition of a separate asset and the replaced asset is written off.

Measurement Subsequent to Initial Recognition

- ✓ The standard offers two possible treatments here, essentially a choice between keeping an asset recorded at cost OR revaluing it to fair value.

- ✓ Subsequent to initial measurement an asset is carried at:

  Cost less accumulated depreciation and any accumulated impairment loss.

- ✓ **OR Alternatively**

- ✓ Subsequent to initial measurement an asset is carried:
  At a revalued amount, being its fair value at the date of revaluation less any subsequent accumulated depreciation and any subsequent accumulated impairment losses.

Depreciation

- ✓ Depreciation is a systematic allocation of depreciable amount of an asset over its estimated useful life.

- ✓ Depreciation is usually treated as an expense, but not where it is absorbed by the entity in the process of producing other assets. For example, depreciation of plant and machinery is incurred in the production of goods for sale (inventory items). In such circumstances, the depreciation is included in the cost of the new assets produced.

- ✓ Land and buildings are dealt with separately even when they are acquired together because land normally has an unlimited life and is therefore not depreciated. In contrast buildings do have a limited life and must be depreciated. Any increase in the value of land on which a building is standing will have no impact on the determination of the building's useful life.

Depreciable Amount

- ✓ Depreciable amount of an asset is its cost or other amount substituted for cost (revalued) amount less its expected disposal value.

Useful Life

- ✓ The number of years over which an enterprise expects to use an asset.

OR

- ✓ The number of production or similar units expected to be obtained from an asset.

Lecture 06

Revaluation of Assets

- ✓ The market value of land and buildings usually represents fair value, assuming existing use and line of business. Such valuations are usually carried out by professionally qualified valuers.

- ✓ Most importantly, when an item of property, plant and equipment is revalued, the whole class of assets to which it belongs should be revalued.

- ✓ In the case of plant and equipment, fair value can also be taken as market value. Where a market value is not available, however, depreciated replacement cost should be used. There may be no market value where types of plant and equipment are sold only rarely or because of their specialized nature (i.e. they would normally only be sold as part of an ongoing business).

- ✓ The frequency of valuation depends on the volatility of the fair values of individual items of property, plant and equipment. The more volatile the fair value, the more frequently revaluations should be carried out. Where the current fair value is very different from the carrying value then a revaluation should be carried out.

- ✓ All the items within a class should be revalued at the same time, to prevent selective revaluation of certain assets and to avoid disclosing a mixture of costs and values from different dates in the financial statements. A rolling basis of revaluation is allowed if the revaluations are kept up to date and the revaluation of the whole class is completed in a short period of time.

Recognition of Fixed Assets – Benchmark Treatment

The benchmark treatment of IAS 16 is to carry property plant and equipment at Cost less Accumulated Depreciation and any Accumulated Impairment Losses.

Impairment Losses:

A fall in the value of an asset, so that its recoverable amount is now less than its carrying value in the balance sheet.

Carrying value:

Is the net value at which the asset is included in the balance sheet (i.e. after deducting accumulated depreciation and any impairment losses?)

Difference between Depreciation and Impairment

Depreciation is the result of systematic allocation of the depreciable amount of an asset over its estimated useful life. Depreciation for the accounting period is charged to net profit or loss for the period either directly or indirectly.

However the impairment in the value of any asset is a fall in the value of an asset due to many reasons beyond the control of the company, so that its recoverable amount is now less than its carrying value in the balance sheet.

Recognition of Fixed Assets – Allowed Alternative Treatment

- The standard allows as an alternative treatment to record property plant and equipment at its Revalued Amount less Accumulated Depreciation and any Accumulated Impairment Losses

Revalued Amount:

The revalued amount of any asset is the fair value of that asset. The market value of any asset represents its fair value.

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Revaluation Policy

- All assets of same class are revalued at the same time.
- Only recognized surveyor can carryout the revaluation.

When an item of property, plant and equipment is revalued, the entire class of property, plant and equipment to which that asset belongs should be revalued.

A class of property, plant and property is a grouping of assets of a similar nature and use in an enterprise's operations. The following are examples of separate classes:

(a) Land;
(b) Land and building;
(c) Machinery;
(d) Ships
(e) Aircrafts;
(f) Motor vehicles;
(g) Furniture and fixtures; and
(h) Office equipment.

Frequency of Revaluation

- ✓ A review of the useful life of property, plant and equipment should be carried out at least each financial year end and the depreciation charge for the current and future periods should be adjusted if expectations have changed significantly from previous estimates. Changes are changes in accounting estimates and are accounted for prospectively as adjustments to future depreciation.
- ✓ If the allowed alternative, that is stating the assets at revalued amount is adopted then the revaluation has to be carried out at regular intervals.

- ✓ These intervals may vary from every year to three to five years depending upon the volatility in the market value of assets in use.

Who Can Conduct Revaluation?

International Accounting Standard IAS 16 requires that revaluation should be carried out by professionally qualified valuers.

Companies Ordinance in 4th Schedule requires that valuation should be carried out by an independent valuer (expert) competent to do so.

The Companies Ordinance 1984 defines the expert as:

"Expert" includes an engineer, a valuer, an accountant and every other person whose profession gives authority to a statement made by him.

Effect of Revaluation

The value of an item of property, plant and equipment may be increased or decreased as a result of revaluation.

How should any increase in value be treated when a revaluation takes place? The debit will be the increase in value in the balance sheet, but what about the credit? IAS 16 requires the increase to be credited to a revaluation surplus (i.e. part of owners' equity), unless the increase is reversing a previous decrease which was recognized as an expense. To the extent that this offset is made, the increase is recognized as income; any excess is then taken to the revaluation reserve.

Treatment of Revaluation Loss

A revaluation loss is charged to profit and loss account in the period in which the revaluation is carried out.

However a revaluation decrease should be charged directly against any related revaluation surplus to the extent that the decrease does not exceed the amount held in surplus in respect of the same asset.

In other words decrease should be recognised as an expense, except where it offsets a previous increase taken as a revaluation surplus in owners' equity. Any decrease greater than the previous upwards increase in value must be taken as an expense in the income statement.

Example:

A company has an asset which originally cost Rs. 150,000, revalued upwards to Rs. 200,000 two years ago. The value has now fallen to Rs. 130,000.

Solution:

The double entry is:

DEBIT	Revaluation Surplus	Rs. 50,000	
DEBIT	Income and Expense Account		Rs. 20,000
CREDIT	Asset Value (Balance Sheet)		Rs. 70,000

Treatment of Revaluation Surplus

A revaluation surplus is credited directly to equity under the heading of Revaluation Surplus.

However a revaluation increase should be treated as income to the extent that it reverses the revaluation decrease of the same asset previously recognized as expense.

The revaluation surplus included in equity may be transferred directly to retained earnings when the surplus is realized. The whole surplus may be realized on the retirement or disposal of the asset. However, some of the surplus mat be realized as the asset is used by the enterprise; in such a case, the amount of the surplus realized is the difference between depreciation based on the revalued carrying amount of the asset and depreciation based on the asset's original cost. The transfer from revaluation surplus to retained earnings is not made through the income statement

Example:

A company has an item of land carried in its books at Rs. 130,000. Two years ago slump in land values led the company to reduce the carting value from Rs. 150,000. This was taken as an expense in the income statement. There has been a surge in land prices in the current year, however, and the land is now worth Rs. 200,000.

Required: Account for the revaluation in the current year.

Solution:

The double entry is:

DEBIT	Asset Value (Balance Sheet)	Rs. 70,000	
CREDIT	Income Statement		Rs. 20,000
CREDIT	Revaluation Surplus		Rs. 50,000

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Revaluation [Section 235]

Where a company revalues its fixed assets, the increase in, or sums added by writing up of, the value of such assets as appearing in the books of accounts of the company shall be transferred to an account to be called "Surplus on Revaluation of Fixed Assets Accounts" and shown in the balance-sheet of the company after Capital and Reserves.

Except and to the extent actually realized on disposal of the assets which are revalued, the surplus on revaluation of fixed assets shall not be applied to set-off or reduce any deficit or loss, whether past, current or future, or in any manner applies, adjusted or treated so as to add to the income, profit or surplus of the company, or utilized directly or indirectly by way of dividend or bonus.

Provided that the surplus on revaluation of fixed assets may be applied by the company in setting-off or in diminution of any deficit arising from the revaluation of any other fixed assets of the company

After revaluation as aforesaid, depreciation on the assets so revalued shall be provided with reference to the value assigned to such assets before revaluation and surplus on revaluation may be amortized according to life of the assets.

If default is made in complying with any requirements of this section, the directors of the company who are knowingly and willfully in default shall be punishable with fine not exceeding twenty thousand rupees and shall also be jointly and severally liable to the company for any loss sustained by the company on account of such default.

Restating the Carrying Amount

IAS 16 has provided two methods of restating (revaluing) the carrying amount of any asset.

The first Method is:

Gross carrying value of the asset should be restated along with the accumulated depreciation so that the carrying value equals the revalued amount.

Example

- Cost and Accumulated Depreciation of the asset before revaluation:

Cost of Asset/Gross carrying Amount	Rs. 500,000
Accumulated Depreciation	Rs. 200,000
Carrying amount	Rs. 300,000

- Suppose the asset is revalued at Rs. 450,000

Solution

- Now the cost and accumulated depreciation of the asset would be restated as follows;

Gross carrying Amount	
(500,000 x 450,000 / 300,000)	Rs. 750,000
Accumulated Depreciation	
(200,000 x 450,000 / 300,000)	Rs. 300,000
Carrying amount	Rs. 450,000

Restating the Carrying Amount

The second method is.

Accumulated depreciation is eliminated against the gross carrying value of the asset and the carrying amount is restated to the revalued amount.

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Example

- Accumulated depreciation of the asset would be written off against the gross carrying amount of the asset, bringing it down to 300,000 (its carrying value). This carrying value would then be restated to Rs. 450,000;

Gross carrying Amount	Rs. 450,000
Accumulated Depreciation	0
Carrying amount	Rs. 450,000

Realization of Revaluation Surplus

- The revaluation surplus is transferred to retained earnings when the surplus is realized. The surplus is realized when:
  - ✓ The asset is disposed off.
  - ✓ With the use of the asset.

There is a further complication when a revalued asset is being depreciated. An upward revaluation means that the depreciation charge will increase. Normally, a revaluation surplus is only realized when the asset is sold, but when it is being depreciated, part of that surplus is being realized as the asset is used. The amount of the surplus realized is the difference between depreciation charged on the revalued amount and the (lower) depreciation which would have been charged on the asset's original cost. This amount can be transferred to retained (i.e. realized) earnings but not through the income statement.

Example - 01

- Cost and Accumulated Depreciation of the asset before revaluation:

Cost of Asset/Gross carrying Amount	Rs. 500,000
Accumulated Depreciation	Rs. 200,000
Carrying amount	Rs. 300,000

- The asset is revalued at Rs. 450,000
- Suppose depreciation is charged at 20 % on written down value.

Solution:

- The depreciation charge on old carrying amount would have been Rs. 60,000/-
- On the revalued amount depreciation would be Rs. 90,000/-.
- The difference of Rs. 30,000/- would be transferred from revaluation surplus to retained earnings.

Example - 02

A company bought an asset for Rs. 10,000 at the beginning of 20X6. It had a useful life of five years. On 1 January 20X8 the asset was revalued to Rs. 12,000. The expected useful life has remained unchanged (i.e. three years remain).

Solution:

On 1 January 20X8 the carrying value of the asset is:

Rs. 10,000 – (2 x Rs. 10,000 / 5) = Rs. 6,000.

For the revaluation:

DEBIT	Asset Value (Balance Sheet)	Rs. 6,000	
CREDIT	Revaluation Reserve		Rs. 6,000

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The depreciation for the next three years will be Rs. 12,000 / 3 = Rs. 4,000, compared to depreciation on cost of Rs. 10,000 / 5 = Rs. 2,000. So each year, the extra Rs. 2,000 can be treated as part of the surplus which has become realized:

DEBIT	Revaluation Surplus	Rs. 2,000	
CREDIT	Retained Earnings		Rs. 2,000

This is a movement on owners' equity only, not an item in the income statement.

Lecture 07

Property, Plant & Equipment and Borrowing Cost

Disclosure Requirements for Property Plant & Equipment

The financial statements should disclose, for each class of property, plant and equipment:

Disclosure Requirements

- The measurement basis used for determining the gross carrying amount.
- When more than one basis has been used, the carrying amount for that basis in each category should be disclosed.

Sample

Tangible fixed assets are stated at cost less accumulated depreciation except land and capital work in progress, which are stated at cost.

- The depreciation method used.
  - ✓ Straight Line Method.
  - ✓ Written Down Value / Diminishing Balance Method

- The useful lives or the depreciation rates used.

Sample

- ✓ Depreciation on operating fixed assets is provided on a **straight-line**-basis. **Rates of depreciation**, which are disclosed in note 5, are designed to write off the cost over the estimated useful lives of the assets.

- ✓ One month's depreciation is charged in month of addition and no depreciation is charged in the month of deletion.

- ✓ Maintenance and normal repairs are charges to income as and when incurred. Major renewals and improvements are capitalized. Gains and losses on disposals are determined by comparing the sale proceeds with the carrying value and are included in the profit and loss account for the year.

- A reconciliation of the carrying amount at the beginning and end of the period showing;
  a) Additions
  b) Disposals
  c) Acquisitions through business combinations
  d) Increase or decrease during the period resulting from revaluations and from impairment losses recognized or reversed directly in equity under IAS 36, Impairment of assets.
  e) Impairment losses recognized in income statement during the period.
  f) Impairment losses reversed in the income statement during the period.
  g) Depreciation
  h) The net exchange differences arising on the translation of the financial statements of a foreign entity: and
  i) Other movements.

- Comparative figures are not required for reconciliation.

- This reconciliation is given in the form of a schedule or table which is called "Fixed Assets Schedule". A detailed explanation of this schedule has already been given in the previous lectures. The last point i.e. "Comparative figures are not required for reconciliation", means that comparative figures of additions and disposals in individual class of assets is not required. Comparatives of only total figure are given.

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5. Fixed Assets(Sample)

Rs' 000

Particulars	Cost: As On Jul 01 2003	Cost: Addition	Cost: Disposal	Cost: As On Jun 30 2004	RATE	Accumulated Depreciation: As On Jul 01 2003	Accumulated Depreciation: On Disposal	Accumulated Depreciation: For The Year	Accumulated Depreciation: As On Jun 30 2004	WDV As On Jun 30 2004
Owned Assets										
Freehold Land	108,978	-	-	108,978	-	-	-	-	-	108,978
Factory Building on Free hold Land	231,849	545	-	232,394	10	130,667	-	16,988	147,655	84,739
Employees Quarters	526	-	526	-	10	526	526	-	-	-
Plant, Machinery and Equipment	1,015,671	11,507	308	1,026,870	10	588,108	308	74,178	661,978	364,892
Other Machinery and Equipment	24,274	443	-	24,717	10-12	17,971	-	1,507	19,478	5,239
Furniture, Fixture and Office equip.	34,167	873	8	35,032	20-25	23,882	8	3,510	27,384	7,648
Vehicles	33,383	9,795	3,435	39,743	20	17,459	1,376	6,452	22,535	17,208
	1,448,848	**23,163**	**4,277**	**1,467,734**		**778,613**	**2,218**	**102,635**	**879,030**	**588,704**
							1707*			
Assets subject to finance lease										
Vehicles	3,938	-	3,938*	-	20	1,707	1,707*	-	-	-
	3,938	**-**	**3,938**	**-**		**1,707**	**1,707**	**-**	**-**	**-**
Total 2004	**1,452,786**	**23,163**	**8,215**	**1,467,734**		**780,320**	**3,925**	**102,635**	**879,030**	**588,704**
Total 2003	**x**	**x**	**x**	**x**		**x**	**x**	**x**	**x**	**x**

*** These leased assets have been transferred to owned assets during the period.**

5.1 Depreciation charge for the year has been allocated as follows:

	2004	**2003**
	Rs'000	Rs'000
Cost of sales	95,579	**x**
Selling and Marketing Expenses	1,975	**x**
General and Administrative exp.	5,081	**x**
	102,635	**x**

Disclosure Requirements (Continued)

- The financial statements should also disclose.
  - ✓ The existence and amount of restrictions on title, and property plant and equipment pledged as security.
  - ✓ The accounting policy for estimated costs of restoring site of items of property plant and equipment
  - ✓ The amount of expenditures on account of property, plant and equipment in the course of construction.
  - ✓ The amount of commitments for the acquisition of property, plant and equipment.

- The selection of the depreciation method and the estimation of the useful life of assets are matters of judgment. Therefore, disclosure of the methods adopted and the estimated useful lives or depreciation rated provides users of financial statements with information which allows them to review the policies selected by management and enables comparisons to be made with other enterprises. For similar reasons, it is necessary to disclose the depreciation allocated in a period and the accumulated depreciation at the end of that period.

- An enterprise discloses the nature and effect of a change in an accounting estimate that has a material effect in the current period or which is expected to have a material effect in subsequent periods in accordance with IAS 8, Net Profit or Loss for the period, Fundamental Errors and Changes in accounting policy. Such disclosure may arise from changes in estimates with respect to:

  a) Residual Values;
  b) The estimated costs of dismantling and removing items of property, plant or equipment and restoring the site;
  c) Useful lives; and
  d) Depreciation method.

- Where the items of property plant and equipment are stated at revalued amount the following should be disclosed:
  - ✓ The basis used for revaluation.
  - ✓ The effective date of revaluation.
  - ✓ Whether an independent valuer was involved.
  - ✓ The nature of any indices used to determine replacement cost.

- ✓ The carrying amount of each class of property plant and equipment if they had not been revalued.
- ✓ The revaluation surplus indicating the movement for the period and any restrictions of distributions of the balance to the shareholders.

- An enterprise discloses information on impaired property, plant and equipment under IAS 36, Impairment of Assets.

- Financial Statement users also find the following information relevant to their needs:

  a) The carrying amount of temporarily idle property, Plant and equipment;
  b) The gross carrying amount of any fully depreciated property, plant and equipment that is still in use;
  c) The carrying amount of property, Plant and equipment retired from active use and held for disposal; and
  d) When the benchmark treatment is used, the fair value of property, plant and equipment when this is materially different from the carrying amount.

Retirement and Disposal:

- An item of property, plant and equipment should be eliminated from the balance sheet on disposal or when the asset is permanently withdrawn from use and no future economic benefits are expected from its disposal.

- Gains or losses arising from the retirement or disposal of an item of property, plant and equipment should be determined as the difference between the estimated net disposal proceeds and the carrying amount of the asset and should be recognised as income or expense in the income statement.

- When an item of property, plant and equipment is exchanged for a similar asset, the cost of the acquired asset is equal to the carrying amount of the asset disposed of and no gain or loss results.

- Property, plant and equipment that is retired from active use and held for disposal is carried at its carrying amount at the date when the asset is retired from active use. At least at each financial yearend, an enterprise tests the asset for impairment under IAS 36, Impairment of Assets, and recognises any impairment loss accordingly.

Borrowing Costs IAS 23

This standard looks at the treatment of borrowing costs, particularly where the related borrowings are applied to the construction of certain assets. These are what are usually called 'self-constructed assets', where an enterprise builds its own inventory or non-current assets over a substantial period of time.

Definitions:

Borrowing Costs: Interest and other costs incurred by an enterprise in connection with the borrowing of funds

The standard gives examples of borrowing costs:

- Borrowing costs may include:
  - ✓ Markup on running finances, short and long term finance,
  - ✓ Other costs incurred in connection with borrowings,
  - ✓ Markup on in respect of finance leases,
  - ✓ Exchange differences arising from foreign currency borrowings to the extent that they are regarded as adjustment to interest cost.

- IAS 23 generally requires that the borrowing costs should be charged as an expense.

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- However it allows capitalization of these costs as an alternate treatment, if certain conditions are met. Borrowing costs are interest and other costs incurred in connection of borrowing of funds.

Qualifying asset: An asset that necessarily takes a substantial period of time to get ready for its intended use or sale

The standard gives examples of qualifying assets:

- Inventories that require a substantial period of time to bring them to a saleable condition.
- Manufacturing plants
- Power generation facilities.
- Investment properties.

Inventories produced in bulk over short periods and on a regular basis are **not qualifying assets**, nor are assets ready for sale or their intended use when purchased.

Recognition of Borrowing Costs (Benchmark Treatment)

- The benchmark treatment of borrowing costs is the most straightforward and prudent. The accounting policy adopted for borrowing costs should be disclosed Under the benchmark treatment of IAS 23 borrowing cost should be treated as expense in the period they are incurred regardless of the of how the loan is used.

Disclosure Requirements

- If benchmark treatment is used the enterprise is only required to disclose the policy adopted for borrowing costs.

Capitalization of Borrowing Costs (Allowed alternative Treatment)

- IAS 23 allows capitalization of borrowing cost as an allowed alternative to the benchmark. The IAS states:

  "Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalized as cost of the asset".

- Under the allowed alternative treatment, certain borrowing costs may be capitalized. Any other borrowing costs remaining must still be recognized as an expense as under the benchmark treatment.

- The standard also lays out the criteria for determining which borrowing costs are eligible for capitalization.

Qualifying Asset – IAS 23

- Qualifying asset is an asset

  "That necessarily takes a substantial period of time to get ready for its intended use".

Borrowing Costs Eligible for Capitalization

- ✓ Those borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset must be identified Only those borrowing costs are eligible for capitalization that would have been avoided if the expenditure on the qualifying asset had not been made.
- ✓ It may be easy to identify these costs if the funds are specifically borrowed for the asset. In other words it is straight forward where funds have been borrowed for the financing of one particular asset.
- ✓ If the funds are used from the funds generally borrowed for the enterprise the amount to be capitalized should be calculated by applying a weighted average borrowing rate to the expenditure on asset.

- Difficulties arise, however, where the enterprise uses a range of debt instruments to finance a wide range of assets, so that there is no direct relationship between particular borrowings and a specific asset. For example, all borrowings may be made centrally and then lent to different parts of the group or enterprise. Judgment is there required, particularly where further complications can arise (e.g. foreign currency loan).

- Once the relevant borrowings are identified, which relate to a specific asset, then the amount of borrowing costs available for capitalization will be the actual borrowing costs incurred on those borrowings during the period, less any investment income on the temporary investment of those borrowings. It would not be unusual for some or all of the funds to be invested before they are actually used on the qualifying asset.

- In a situation where borrowings are obtained generally, but are applied in part to obtaining a qualifying asset, then the amount of borrowing costs eligible for capitalization is found by applying the 'capitalization rate' to the expenditure on the asset.

- The capitalization rate is the weighted average of the borrowing costs applicable to the enterprise's borrowings that are outstanding during the period, excluding borrowings made specifically to obtain a qualifying asset. However, there is a cap on the amount of borrowing costs calculated in this way: it must not exceed actual borrowing costs incurred.

Commencement and Cessation Capitalization

- Capitalization of borrowing costs should begin when three events or transactions took place:

  ✓ Expenditure on assets are being incurred
  ✓ Borrowing cost are being incurred
  ✓ Activities that are necessary to prepare the asset to its intended use are in progress.

- Expenditure must result in the payment of cash, transfer of other assets or assumption of interest-bearing liabilities. Deductions from expenditure will be made for any progress payments or grants received in connection with the asset. IAS 23 allows the average carrying amount of the asset during a period (including borrowing costs previously capitalized) to be used as a reasonable approximation of the expenditure to which the capitalization rate is applied in the period. Presumably more exact calculations can be used.

- Activities necessary to prepare the asset for its intended sale or use extend further than physical construction work. They encompass technical and administrative work prior to construction, e.g. obtaining permits. They do not include holding an asset when no production or development that changes the asset's condition is taking place, e.g. where land is held without any associated development activity.

Capitalization of borrowing costs should be suspended if:

  - Active development of the asset is suspended for an extended period.

  - Suspension of capitalization of borrowing costs is not necessary for temporary delays or for periods when sustainable technical or administrative work is taking place.

Capitalization of borrowing costs should cease when:

  ✓ Substantially all activates necessary to prepare an asset for its intended use or sale is complete.

The asset may be completed in parts or stages, where each part can be used while construction is still taking place on the other parts. Capitalization of borrowing costs should cease for each part as it is completed. The example given by the standard is a business park consisting of several buildings.

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Disclosure Requirements

- The accounting policy adopted for borrowing costs.
- The amount of borrowing costs capitalized during the period.
- The capitalization rate used to determine the amount borrowing costs eligible for capitalization.

Lecture 08

Intangible Assets – Companies Ordinance 1984

Classification Fourth Schedule

- Classification of intangible assets:

  - ✓ Goodwill
  - ✓ Patent, Copyrights, Trademarks and Designs
  - ✓ Others (to be specified)

Disclosure Requirements Fourth Schedule

- Original cost or the amount of valuation
- Additions thereto and deductions there from since the previous balance sheet date
- Aggregate amount written off, or provided or retained, up to the date of the balance sheet, by way of provision for depreciation or amortization or diminution in value.

Intangible Assets International Accounting Standard 38

Definition of an Intangible asset:

- An intangible asset is an identifiable Non-Monetary Asset without physical substance held for use in production or supply of goods or services, for rentals to others, or for administrative purposes. The asset must be:

  a. Controlled by the enterprise as a result of events in the past
  b. Something from which the enterprise expects future economic benefits to flow

- The objective of the standard is:

  a. To establish the criteria for when an intangible assets may or should be **recognized**
  b. To specify how intangible assets should be **measured.**
  c. To specify the **disclosure requirements** for intangible assets.

Intangible Resources

- Scientific or technical knowledge (computer software)
- Design and implementation of new processes
- Licenses (Fishing licenses, Import / Export quotas)
- Intellectual property (patents, copyrights, motion picture films)
- Market knowledge (customer lists, customer or supplier relationships, market share)
- Trademarks

An item should not be recognized as an intangible asset, unless it fully meets the definition in the proposed standard.

- If an intangible resource does not meet the definition of intangible asset, then any expenditure incurred to acquire or internally generate it will be recorded as current period expense.

Recognition of Intangible asset

- An intangible asset should be recognized if and only if,
  - ✓ Future economic benefits that are attributable to the asset will flow to the enterprise
  - ✓ The cost of the asset can be measured reliably

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Management has to exercise its judgment in assessing the degree of certainty attached to the flow of economic benefits to the enterprise. External evidence is best.

a) If an intangible asset is acquired separately, its cost can usually be measured reliably as its purchase price (including incidental costs of purchase such as legal fees, and any costs incurred in getting the asset ready for use).
b) When an intangible asset is acquired as part of a business combination (i.e. an acquisition or takeover), the cost of the intangible asset is its fair value at the date of the acquisition.

Deciding whether the cost of the intangible item can be reliably measured will call for judgment. There may be a readily-available market price for similar items. If there is no available market price, it may be possible to decide, on the basis of the best information available, what the enterprise would have had to pay for the asset in an arm's length transaction, perhaps by discounting the future expected benefits to a present value. In many cases, however, a reliable measurement of fair value will not be possible, and in such circumstances, the 'value' of the acquired intangible item should be included within the overall cost of purchased goodwill.

(Note: an enterprise may recognize an intangible asset when acquiring another business, provided the fair value of the asset can be measured, even if the business that has been acquired did not recognize the intangible asset in its own accounts).

Unless there is an active market for an intangible asset acquired in an acquisition, an intangible asset should not be recognized if its recognition would create or increase any negative goodwill arising at the date of acquisition.

In accordance with IAS 20, intangible assets acquired by way of government grant and the grant itself may be recorded initially either at cost (which may be zero) or fair value.

Criteria for Recognition

- Identifiable:

  An intangible asset must be identifiable in order to distinguish it from goodwill. With non physical items, there may be a problem with **'identifiably'**

  a) If an intangible asset is acquired separately through purchase, there may be a transfer of a legal right that would help to make an asset identifiable.
  b) An intangible asset may be identifiable if it is separable, i.e. if it could be rented or sold separately. However, 'separability' is not an essential feature of an intangible asset.

- Control over a resource:

  Another element of the definition of an intangible asset is that it must be under the control of the enterprise as a result of a past event. The enterprise must therefore be able to enjoy the future economic benefits from the asset, and prevent the access of others to those benefits. A **legally enforceable right** is evidence of such control, but is not always a necessary condition.

  a. Control over **technical knowledge or know-how** only exists if it is protected by a **legal right.**
  b. The skill of employees, arising out of the benefits of training costs, are most unlikely to be recognizable as an intangible asset, because an enterprise does not control the future actions of its staff.
  c. Similarly, market share and customer loyalty cannot normally be intangible assets, since an enterprise cannot control the actions of its customers.

- Existence of future economic benefits:

An item can only be recognized as an intangible asset if economic benefits are expected to flow in the future from ownership of the asset. Economic benefits may come from the sale of products or services, or from a reduction in expenditures (cost savings).

Initial Measurement

- An intangible asset should be measured initially at cost.

Separate Acquisition

- The cost of the intangible asset comprises its purchase price, including any duties and non-refundable taxes and any directly attributable expenditure on preparing the asset for its intended use.

Acquisition as Part of a Business Combination

- If an intangible asset is acquired in a business combination, the cost of the asset is based on its fair value on the date of acquisition.

Acquisition by Way of a Govt Grant

- In some cases an intangible asset may be created free of charge, or at a nominal value as a result of a government grant.

- Examples include:
  - ✓ Airport landing rights
  - ✓ Licenses to operate radio / TV channels
  - ✓ Import licenses or quotas
  - ✓ Access to other restricted territories

An enterprise may choose to recognize both the intangible asset and the government grant at fair value initially,

- If the enterprise chooses not to recognize the asset at its fair value they may recognize the asset at the nominal amount paid plus any expenditure incurred for preparing the asset for its intended use.

Exchange of Assets (Dissimilar Assets)

- In case of exchange with a Dissimilar Asset, the value of the item acquired is the fair market value of the item surrendered adjusted for any cash of cash equivalent transferred

Exchange of Assets (Similar Assets)

- In case of exchange with a Similar Asset, the value of the item acquired is the carrying amount of the item surrendered adjusted for any cash or cash equivalent transferred

Internally Generated Goodwill

- Internally generated goodwill should not be recognized as an asset.

The standard deliberately precludes recognition of internally generated goodwill because it requires that, for initial recognition, the cost of the asset rather than its fair value should be capable of being measured reliably and that it should be identifiable and controlled. Thus you do not recognize an asset which is subjective and cannot be measured reliably.

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Internally Generated Intangible Assets

The costs allocated to an internally generated intangible asset should be only costs that can be directly attributed or allocated on a reasonable and consistent basis to creating, producing or preparing the asset for its intended use. The principles underlying the costs which may or may not be included are similar to those for inventory.

The cost of an internally generated intangible asset is the sum of the expenditure incurred from the date when the intangible asset first meets the recognition criteria. If, as often happens, considerable costs have already been recognized as expense before management could demonstrate that the criteria have been met, this earlier expenditure should not be retrospectively recognized at a later date as part of the cost of an intangible asset.

Recognition of an Expense

- All expenditure related to an intangible which does not meet the criteria for recognition either as an identifiable asset or as goodwill arising on an acquisition should be expensed as incurred. The IAS gives examples of such expenditure.

  a) Start up Costs
  b) Training Costs
  c) Advertising Costs
  d) Business Relocation Costs

Prepaid costs for services, for example advertising or marketing costs for campaigns that have been prepared but not launched, can still be recognized as a prepayment.

If tangible asset costs have been expensed in previous financial statements, they may not be recognized as part of the cost of the asset.

- To assess whether an internally generated asset meets the criteria for recognition, an enterprise classifies the generation of asset into following phases:
  - ✓ Research phase
  - ✓ Development phase

Research Phase

- Research activities by definition do not meet the criteria for recognition under IAS 38. This is because, at the research stage of a project, it cannot be certain that future economic benefits will probably floe to the enterprise for the project. There is too much uncertainty about the likely success or otherwise of the project. Research costs should therefore be written off as an expense as they are incurred. In short:

- No intangible asset arising from research (or from research phase of an internal project) should be recognized.
- Expenditure on research (or from research phase of an internal project) should be recognized as an expense when incurred.

Examples of Research costs include:

a) Activities aimed at obtaining new knowledge.
b) The search for, evaluation and final selection of, applications of research findings or other knowledge.
c) The search for alternatives for materials, devices, products, processes, systems or services.
d) The formulation, design evaluation and final selection of possible alternatives for new or improved materials, devices, products, systems or services.

Development Phase

- An intangible asset arising from development (or from development phase of an internal project) should be recognized, if and only if, an enterprise can demonstrate all of the following:

  - ✓ The technical feasibility of completing the intangible asset so that it will be available for use or sale,
  - ✓ Its intention to complete the asset and use or sell it,
  - ✓ Its ability to use or sell the asset.
  - ✓ How the intangible asset will generate probable future benefits, among other things, the enterprise should demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of intangible asset.
  - ✓The availability of technical, financial and other resources to complete the asset.
  - ✓ Ability to measure the expenditure attributable to the intangible asset during development reliably.

- In contrast with research costs development costs are incurred at a later stage in a project, and the probability of success should be more apparent. Examples of development costs include:

  a) The design, construction and testing of pre-production or pre-use prototypes and models.
  b) The design of tools, jigs, moulds, and dies involving new technology.
  c) The design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production.
  d) The design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services.

Other Internally Generated Intangible Assets:

- The standard **prohibits** the recognition of internally generated brands, mastheads, publishing titles and customer lists and similar items an intangible asset. These all fail to meet one or more (in some cases all) the definition and recognition criteria and in some cases probably indistinguishable from internally generated goodwill.

Subsequent Expenditure

- Subsequent expenditure on an intangible asset after its purchase or its completion should be recognized as an expense when it is incurred, unless:

  - ✓ It is probable that this expenditure will enable the asset to generate future economic benefits in excess of its originally assessed standards.
  - ✓ This expenditure can be measured and attributed to the asset reliably.

Amortisation Period

- The depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life.
- This is a 'rebuttable' assumption that the useful life of an intangible asset cannot exceed 20 years (in other words maximum useful life allowed is 20 years. But an enterprise may put forward a case for an intangible asset having a life in excess of 20 years.) The view taken by the standard is that the future beyond 20 years will usually be uncertain and unpredictable.

  - ✓ The method of amortization that is used should reflect the pattern in which the economic benefits from the asset are consumed. If such a pattern cannot be predicted reliably, the straight line method of amortization should be used.
  - ✓ The residual value of an intangible asset should be presumed to be zero, unless a third party is committed to buying the intangible asset at the end of its useful life or unless there is an active market for that type of asset

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(so that its expected residual value can be measured) and it is probable that there will be a market for the asset at the end of its useful life.

- ✓ The amortization method used and the useful life of intangible asset should be reviewed at each financial year end.

Measurement Subsequent to Initial Recognition

The proposed standard allows two methods of valuation for intangible assets after they have been first recognized.

- Benchmark Treatment:

    - ✓ Cost less accumulated amortization and any accumulated impairment loss.

OR Alternatively

- Allowed Alternative Treatment

    - ✓ At a revalued amount, being its fair value at the date of revaluation less any subsequent accumulated amortization and any subsequent impairment loss.

        a) The fair value must be able to be measured reliably with reference to an active market in that type of asset.
        b) The entire class of intangible assets of that type must be revalued at the same time (to prevent selective revaluations).
        c) If an intangible asset in a class of revalued intangible assets cannot be revalued because there is no active market for this asset, the asset should be carried at its **cost less any accumulated amortization and impairment losses**
        d) Revaluations should be made with such regularities that the carrying amount does not differ from that which would be determined using fair value at the balance sheet date.

The guidelines state that there will not usually be an active market in an intangible asset; therefore the alternative accounting treatment will usually not be applicable. For example, although copyrights, publishing rights and film rights can be sold, each has a unique sale value. In such cases, revaluation to fair value would be inappropriate. A fair value might be obtainable however for assets such as fishing rights or quotas or taxi cab licenses.

Where an intangible asset is revalued upwards to fair value, the amount of the revaluation should be credited directly to equity under the heading of a revaluation **surplus.**

However, if a revaluation surplus is a reversal of a revaluation decrease that was previously charged against income, the increase can be recognized as income.

Where the carrying amount of an intangible asset is revalued downwards, the amount of the downward revaluation should be charged as an expense against income, unless the asset has previously been revalued upwards. A revaluation decrease should be first charged against any previous revaluation surplus in respect of that asset.

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Lecture 09

Intangible Assets IAS 38 & Investment in Associates

Disclosure Requirements

- The financial statements should disclose the following for each class of intangible assets, distinguishing between internally generated assets and other intangible assets:

  - ✓ The useful lives or the amortization rates used.
  - ✓ The amortization method used.
  - ✓ The gross carrying amount and the accumulated amortization at the beginning and at the end of the period.
  - ✓ The line items of the income statement in which the amortization of intangible assets is included.
  - ✓ The reconciliation of carrying amount at the beginning and at the end of the period. The reconciliation should show the following:

    a) Additions, indicating separately those from internal development and through business combinations:
    b) Retirements and disposals:
    c) Increases or decreases under the period resulting from revaluations and from impairment losses recognized or reversed directly in equity under IAS 36, Impairment of Assets,
    d) Impairment losses recognized in the income statement during the period under IAS 36
    e) Impairment losses reversed in the income statement during the period under IAS 36
    f) Amortization recognized during the period.
    g) Net exchange differences arising on the translation of the financial statements of a foreign entity: and
    h) Other changes in the carrying amount during the period.

    However comparative information is not required in case of reconciliation of carrying amount.

- A class of intangible assets is a grouping of assets of a similar nature and use in an enterprise's operations. Examples of separate classes may include:

    a) Brand names;
    b) Mastheads and publishing titles;
    c) Computer software;
    d) Licenses and franchises;
    e) Copyrights, patents and other industrial property rights, services and operating rights;
    f) Recipes, formulae, models, designs and prototypes; and
    g) Intangible assets under development.

- The classes mentioned above are disaggregated (aggregated) in to smaller (larger) classes if this results in more relevant information for the users of the financial statements.

- An enterprise discloses the nature and effect of a change in an accounting estimate that has a material effect in the current period or that is expected to have a material effect in subsequent periods, under IAS 8, Net profit or Loss for the period, fundamental Errors and Changes in Accounting Policy. Such disclosure may arise from changes in:

    a) The amortization period;
    b) The amortization method; or
    c) Residual values

- The financial statements should also disclose:

  - ✓ If an intangible asset is amortized over a period of more than 20 years the reason why the presumption of useful life was rebutted. In giving these reasons, the enterprise should describe the factor(s) that played a significant role in determining the useful life of the asset;

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- ✓ Description, carrying amount and remaining amortization period of any individual asset that is material to financial statements.

- For intangible assets acquired by way of Government grants:

  - ✓ The fair value initially recognized
  - ✓ The carrying amount
  - ✓ Whether they are carried at benchmark or the allowed alternative treatment for subsequent measurement;
  - ✓ The existence of intangible assets whose title is restricted and the carrying amount intangible assets pledged as security for liabilities.
  - ✓ The amount of commitments for acquisition of intangible assets.

Intangible Assets Carried Under the Allowed Alternative Treatment

- If intangible assets are carried at revalued amount the financial statements should disclose:

  - ✓ By class of intangible assets:

    a) The effective date of revaluation
    b) The carrying amount of revalued assets
    c) The carrying amount of the intangible assets that would have been included in financial statement had the assets been carried under benchmark treatment.
    d) The amount of revaluation surplus at the beginning and at the end of period indicating the changes during the period, indicating the changes during the period and any restrictions on the distribution of the balance to shareholders

- It may be necessary to aggregate the classes of revalued assets in to larger classes for disclosure purposes. However, classes are not aggregated if this would result in the combination of a class of intangible assets that includes amounts measured under both benchmark and allowed alternative treatments for subsequent measurement.

Research and Development Expenditure

- The financial statements should also disclose the aggregate amount of research and development expenditure recognized as expense during the period.

- Research and Development expenditure comprises all expenditure that is directly attributable to research or development activities or that can be allocated on a reasonable and consistent basis to such activities.

Other Information:

- An enterprise is encouraged, but not required, to give the following information:

    a) A description of any fully amortized asset that is still in use; and
    b) A brief description of significant intangible assets controlled by the enterprise but not recognized as asset because they did not meet the recognition criteria in this Standard or because they were acquired or generated before this Standard was effective.

Associated Companies – Companies Ordinance 1984

- According to Companies Ordinance 1984 a single person:

  - ✓ Is Owner / Partner / Director in both the enterprises
  - ✓ Holds Twenty Percent holding in both the enterprises.

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- If both companies and enterprises are under common management or control or if one is a subsidiary of the other.

- If the undertaking is a modaraba managed by a company.

- Two persons / companies / enterprises would be associated if:

  - ✓ They are partners of a single enterprise.
  - ✓ They hold Ten Percent holding in a single company.

Associated Companies – IAS 28

- IAS 28 defines An Associate through identification of influence,

Definitions:

Associate:

- An enterprise in which an investor has significant influence and which is neither a subsidiary nor a joint venture of the investor.

Significant Influence:

- Significant influence is the ability to participate but not to control the financial and management affairs of an enterprise.

As per the IAS 28 an investor is presumed to have a significant influence over the investee if the investor controls Twenty Percent voting power in the investee.

This type of investment is something less than a subsidiary, but more than a simple investment (nor is it a joint venture). You can see from the definition given above that the key criterion here is significant influence. This is defined as the 'power to participate', but not to 'control' (which could make the investment a subsidiary)

As with control, significant influence can be determined by the holding of voting rights (usually attached to shares) in the enterprise. IAS 28 states that if an investor holds 20% or more of the voting power of the investee, it can be presumed that the investor has significant influence over the investee, unless it can be clearly shown that this is not the case.

Again as with control, significant influence can be presumed not to exist if the investor holds less than 20% of the voting power of the investee. Significant influence can still be demonstrated in such a case, however, and even a substantial or majority ownership by another investor does not necessarily preclude an investor from having significant influence.

- Significant influence is usually evidenced in following ways:

  - ✓ Representation on the board of directors.
  - ✓ Participation in policy making process
  - ✓ Material transactions between investor and investee
  - ✓ Interchange of managerial personnel
  - ✓ Provision of technical information

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Recognition of Investment in Associated Companies

- There are two methods for recognition of investment in associated companies:

    - ✓ Cost method
    - ✓ Equity method

Cost Method

- A method of accounting for investments whereby the investment is recorded at cost. The income statement reflects income from the investment only to the extent that the investor receives distributions from accumulated net profits of the investee arising subsequent to the date of acquisition.

Important treatments are;

- ✓ Under the cost method the investment in Investee Company is recorded at cost of acquisition.
- Any distribution of profits by the investee company is recorded as income.

Equity Method

- Under the equity method the investment is initially recorded at cost.

- The carrying amount of the investment is increased or decreased to recognize the investor's share of profits or losses of the investee after the date of acquisition.

Selection of Method

- Investments made for a long term are recorded using equity method and shown separately in the balance sheet as long-term assets
- Investment made for a short period of time should be recognized at cost and classified in short term investments.

- IAS 28 requires all investments in associates to be accounted for under the equity method in consolidated accounts, unless the investment was acquired and is held exclusively with a view to disposal in the near future, in which case it should be accounted for under the cost method.

- The cost method is also applied when the associate operates under severe long-term restrictions that significantly impair its ability to transfer funds to the investor.

- The use of the equity method should be discontinued from the date that:

    a) The investor ceases to have significant influence, although it still holds the investment; or
    b) The associate comes under severe long-term restrictions, so the equity method is not appropriate, and the cost method should be used.

From that date, the carrying amount of the investment should be regarded as cost.

Impairment Losses:

- If there is an indication of impairment of an investment in an associate, the loss is recognized in accordance with IAS 36 Impairment of Assets, generally for cash associate individually.

Associates Losses:

- When the equity method is being used and the investor's share of losses of the associate equals or exceeds the carrying amount of the investment, the investor will usually discontinue including its share of further losses and the investment id reported at nil value. Additional losses should be provided for to the extent that the investor has incurred obligations or made payments on behalf of the associate in relation to guarantees or commitments made for the associate's obligations.

Disclosures:

- An appropriate listing and description of **significant associates** including proportion of ownership interest and if different, the proportion of voting power held.
- The method used to account for such investments.
- When the equity method is used the following must be disclosed separately on the face of the financial statements.

  ✓ Investments in associates (Balance Sheet)
  ✓ Share of Profits/Losses (Income Statement)
  ✓ Share of extraordinary/ prior period items (income statement/reserves)

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Lecture 10

Other Non-Current Assets

- The Fourth Schedule to the Companies Ordinance 1984 has prescribed following additional heads in case of non-current / long term assets.

  - ✓ Long Term Loans and Advances
  - ✓ Long Term Deposits, Prepayments and Deferred Costs.

Long Term Loans and Advances

Following information must be disclosed in the financial statements in case of long-term loans and advances (it shall also be classified as secured and unsecured.)

  - ✓ Amounts considered good, doubtful and bad distinguishing between:
  - ✓ Loans and advances to subsidiary companies, controlled firms, managed modarbas and other associated companies.
  - ✓ Loans and advances to chief executive, directors and executives of the company.
  - ✓ Other loans and advances.

- In case of Loans and advances to subsidiary companies following information must be disclosed:

  - ✓ The name of each borrower together with the amount of loans and advances, the terms of loan and advance and the particulars of collateral security held, if any.

The maximum aggregate amount of loans and advances outstanding at any time, since the date of incorporation or since the date of the previous balance sheet, whichever is later, such maximum amounts to be calculated by reference to month-end balance.

- In case of Loans and advances to chief executive, directors, managing agents and executives of the company following information will be disclosed:

  - ✓ Separately the aggregate amount of loans and advances to the directors, chief executive and executives together with the purposes for which loans and advances were made and the general terms of repayment.

- In case of Other loans and advances following information will be disclosed:

  - ✓ in respect of loans and advances other than those to the suppliers of goods or services, the name of the borrower and term of repayment if the loan or advance is material together with the particulars of collateral security, if any.

- Other information to be disclosed:

  - ✓ Provisions, if any, made for bad or doubtful loans and advances shall be shown as a deduction under each sub-head

- Loans and advances due for payment after a period of twelve months from the date of balance-sheet shall be shown under this head indicating separately.

    a) Outstanding for periods exceeding three years; and
    b) Others.

- This information should be stated in respect of each loan:

    a) The rate of interest;

b) Installments or period in which the loan has to be repaid
c) Where any of the long-term loans are secured otherwise than by the operation of law on any assets of the company the fact that the loans are so secured, together a statement of the assets upon which they are secured and where more than one class of liabilities is so secured, their relative priorities with respect to payment of interest or profit and redemption;
d) Any other material terms.

Long Term Deposits Prepayments and Deferred Cost

- Following has to be disclosed separately.

  - ✓ Long Term Deposits
  - ✓ Long Term Prepayments
  - ✓ Deferred Costs

- In respect of each material item of prepayments and deferred cost, the basis on which each item is being amortized or written off shall be stated.

- In respect of each item of deferred costs the reasons for carrying forward such costs shall be stated.

- Following Subheads are required to be shown separately in Deferred Costs:

  - ✓ Preliminary expenses,
  - ✓ Discount allowed on the issue of shares, if any, and
  - ✓ Expenses incurred on the issue of shares including any sums paid by way of commission or brokerage on the issue of shares,

Inventory / Stock in Trade

In most businesses the value put on inventory is an important factor in the determination of profit. Inventory valuation is, however, a highly subjective exercise and consequently there is a wide variety of different methods used in practice.

IAS-2 lays out the required accounting treatment for inventories (sometimes called stocks) under the historical cost system. The major area of contention is the cost value of inventory to be recorded. This is recognized as an asset of the enterprise until the related revenues are recognized (i.e. the item is sold) at which point the inventory is recognized as an expense (i.e. cost of sales). Part or all of the cost of inventories may also be expensed if a write-down to **net realizable value** is necessary.

In other words, the fundamental accounting assumption of accruals requires costs to be matched with associated revenues. In order to achieve this, costs incurred for goods, which remain unsold at the year end, must be carried forward in the balance sheet and matched against future revenues.

Scope:

The following items are excluded from the scope of the standard.

a) Work in progress under construction contracts (covered by IAS 11)
b) Financial Instruments
c) Livestock, agriculture and forest products, and mineral ores.

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Definition:

Inventories:

- IAS 2 – Inventories are assets:

  - ✓ Held for sale in the ordinary course of business;
  - ✓ In the process of production for such sale; or
  - ✓ In the form of materials or supplies to be consumed in the production process or in the rendering of services

Net Realizable Value:

- It is the estimated selling price in the ordinary course of business less the estimated costs of completion and estimated costs necessary to make the sale.

- Types of Stock in Trade / Stores:

  - ✓ Raw Material (Materials and supplies awaiting use in the production process)
  - ✓ Finished Goods
  - ✓ Semi Finished Goods
  - ✓ Work in Process
  - ✓ Machinery Spares, Tools
  - ✓ Other Consumable Stock
  - ✓ Goods Purchased and Held for Resale.

Measurement of Inventories – IAS 2

- Inventories should be measured at lower of cost and net realizable value.

- Net realizable value is the estimated selling price in the ordinary course of business less the estimated cost of completion and the estimated cost necessary to make the sale.

Cost of Inventories:

- The cost of inventories will consists of all costs of:

  a) Purchase
  b) Costs of Conversion
  c) Other costs incurred in bringing the inventories to their location and condition.

Costs of Purchase:

- The standard lists the following as comprising the costs of purchase of Inventories:

  a) Purchase price plus
  b) Import duties and other taxes plus
  c) Transport, handling and any other cost directly attributable to the acquisition of finished goods, services and materials less
  d) Trade discounts, rebates and other similar amounts.

Other Costs:

- Any other costs should only be recognized if they are incurred in bringing the inventories to their **present location and condition.**

- The standard lists types of cost which would not be included in cost of inventories. Instead, they should be recognized as an expense in the period they are incurred

    a) Abnormal amounts of wasted materials, labour or other production costs.
    b) Storage costs (except costs which are necessary in the production process before a further production stage)
    c) Administrative overheads not incurred to bring inventories to their present location and conditions.
    d) Selling Costs.

Cost Formulas:

- Cost of inventories should be recognized by specific identification of their individual costs for:
    a) Items that are not ordinarily interchangeable
    b) Goods or services produced or segregated for specific projects

- Specific costs should be attributed to individual items of inventory when they are segregated for a specific project, but not where inventory consists of a large number of interchangeable (i.e. identical or very similar) items. In the latter circumstances, one of two approaches may be taken

Methods of Calculation of Cost

- Cost of the inventory is calculated as follows:

    ✓ First in First Out (FIFO)
    ✓ Last in First Out (LIFO)
    ✓ Specific identification of cost
    ✓ Weighted Average

Selection of Method – IAS 2

- The cost of inventories of items that are not normally interchangeable and goods produced and segregated for specific projects should be assigned by using specific identification of their individual costs.

    ✓ **Benchmark Treatment** – IAS 2 recommends that the cost of inventories should be assigned using FIFO or Weighted Average Method.

    ✓ **Allowed Alternative** – As an allowed alternative the cost of inventories may be measured using LIFO method.

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Lecture11

Inventories

Inventories:

- IAS 2 – Inventories are assets:

  - ✓ Held for sale in the ordinary course of business;
  - ✓ In the process of production for such sale; or

- In the form of materials or supplies to be consumed in the production process or in the rendering of services

IAS-2 lays out the required accounting treatment for inventories (sometimes called stocks) under the historical cost system. The major area of contention is the cost value of inventory to be recorded. This is recognized as an asset of the enterprise until the related revenues are recognized (i.e. the item is sold) at which point the inventory is recognized as an expense (i.e. cost of sales). Part or all of the cost of inventories may also be expensed if a write-down to **net realizable value** is necessary.

In other words, the fundamental accounting assumption of accruals requires costs to be matched with associated revenues. In order to achieve this, costs incurred for goods, which remain unsold at the year end, must be carried forward in the balance sheet and matched against future revenues.

Methods of Stock Valuation

Normally following methods are used for valuation of stock within the organization:

- First in First out (FIFO)
- Last in First out (LIFO)
- Specific identification of cost
- Weighted Average

Selection of Method – IAS 2

Commonly following two treatments are used for selection of valuation methods:

- Benchmark Treatment – Cost of inventories should be assigned using FIFO or Weighted Average Method.
- Allowed Alternative – The cost of inventories may be measured using LIFO method.

Cost and Net Realizable Value

- The cost of inventories may not be recoverable if those inventories are damaged, if they have become wholly or partially obsolete, or if their selling price has declined.

- The cost of inventories may also not be recoverable if the estimated cost to complete and sell them has increased.

- In such case the inventories are written down to net realizable value.

- The estimation of NRV of inventories is made in each accounting period.

- When the circumstances which previously caused the inventories to be written down to net realizable value no longer exist the amount of write down is reversed so that the new carrying amount is the lower of cost and net realizable value.

Materials and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost. However, when a decline in the price of materials indicates that the cost of the finished products will exceed net realizable value, the materials are written down to net realizable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realizable value.

Recognition of Expense – IAS 02

- When the inventories are sold the carrying amount of those inventories should be recognized as an expense in the period in which the related revenue is recognized.

- The amount of any write down of inventories to NRV and all losses of inventories should be recognized as an expense in the period the write down or the loss occurs.

- The amount of any reversal of write down of inventories arising from an increase in the NRV should be recognized as a reduction in the amount of inventories recognized as expense in the period in which the reversal occurs.

- The process of recognizing as an expense the carrying amount of inventories sold results in the matching of costs and revenues.

- Some inventories may be allocated to other asset accounts, for example, inventory used as a component of self-constructed property, plant or equipment. Inventories allocated to another asset in this way are recognized as an expense during the useful life of that asset.

Techniques for the measurement of cost

Two techniques are mentioned by the standard, both of which produce results which approximate to cost, and so both of which may be used for convenience.

a) **Standard Costs:** are set up to take account of normal production values: amount of raw materials used, labour time etc. they are reviewed and revised on a regular basis.

b) **Retail Method**: this is often used in the retail industry where there is a large turnover of inventory items, which nevertheless have similar profit margins. The only practical method of inventory valuation may be to take the total selling price of inventories and deduct an overall average profit margin, thus reducing the value to an approximation of cost. The percentage will take account of reduced price lines. Sometimes different percentages are applied on a department basis.

<u>Other Costs:</u>

Other costs are included in the cost on inventories only to the extent that they are incurred in bringing the inventories to their present location and condition. For example, it may be appropriate to include non-production overheads or the costs of designing products for specific customers in the cost of inventories.

Examples of costs excluded from the cost of inventories and recognized as expenses in the period in which they are incurred are:

a) Abnormal amounts of wasted materials, labour, or other production costs;
b) Storage costs, unless those costs are necessary in the production process prior to a further production stage;
c) Administrative overheads that do not contribute to bringing inventories to their present location and condition; and
d) Selling costs.

In limited circumstances, borrowing costs are included in the cost of inventories. These circumstances are identified in the allowed alternative treatment in IAS 23, Borrowing Costs.

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Disclosure Requirements – IAS 02

- The accounting policy adopted
- The total carrying amount and the carrying amount in classification appropriate to the enterprise.
- The carrying amount of the inventories carried at NRV.
- The amount of any reversal of any write down that is recognized as the income.
- The circumstances and events that led to the reversal of write down
- The carrying amount of any stocks pledged for security.
- If the inventories are recorded using allowed alternative treatment then the difference of inventories under benchmark treatment and allowed alternative treatment is also required to be disclosed.
- The financial statements should also disclose the cost of inventories recognized as expense during the period.

Information about the carrying amounts held in different classifications of inventories and the extent of the changes in these assets is useful to financial statement users. Common classifications of inventories are merchandise, production supplies, materials, work in progress and finished goods. The inventories of a service provider may simply be described as work in progress.

The cost of inventories recognized as an expense during the period consists of those costs previously included in the measurement of the items of inventory sold and unallocated production overheads and abnormal amounts of production costs of inventories. The circumstances of the enterprise may also warrant the inclusion of other costs, such as distribution costs.

Some enterprises adopt a different format for the income statement which results in different amounts being disclosed instead of the cost of inventories recognized as an expense during the period. Under this different format, an enterprise discloses the amounts of operating costs, applicable to revenues for the period, classified by their nature. In this case, the enterprise discloses the costs recognized as an expense for raw materials and consumables, labor costs and other operating costs together with the amount of the net change in inventories for the period.

Types of Stock in Trade

Different types of business have different types of Inventories e.g.

- Trading concerns
  - ✓ Stock in Trade (Finished inventory only)

- Manufacturing Concerns
  - ✓ Raw Material
  - ✓ Work in Process
  - ✓ Finished Goods

Perpetual Inventory System:

In perpetual Inventory systems inventory is recorded as:

- Receipt of inventory is Debited to Stock Account.
- Issues are Credited to Stock Account and Debited to Material Consumption Account.
- Value is assigned to every issue according to selected valuation policy.
- Material Consumption Account becomes part of Trading OR Work in Process Account.

Periodic Inventory System

In periodic Inventory systems inventory is recorded as:

- Receipt of inventory is Debited to purchases account.
- No recording is made for individual issue in the General Ledger.
- Available balance of stock in trade at the end of the period is valued according to selected policy and closing stock is recorded by Debiting the Stock Account and Crediting Trading Account OR Work in Process Account.

The accounting treatment of both Inventory systems periodic and perpetual can be understood through following references.

Accounting treatment of Inventories:

- **Trading Concerns (Periodic Inventory)**

Stock In Trade Account
Receipt / Purchase are Debited (At Cost)
Sales / Issues are Credited (At Cost)
Balance of Stock is shown in Balance Sheet

Trading Account
Cost of Items Sold is Debited (From Stock Account)
Selling Price of Items Sold is Credited (At Selling Price)
Balance is Gross Profit

- **Trading Concerns (Perpetual Inventory)**

Purchases Account
Receipt / Purchase are Debited (At Cost)
Balance is transferred to Trading Account by Crediting Purchases A/c

Opening Stock
O / B (Debit) comes from last year books
This balance is transferred to Trading Account by Crediting Stock A/c

Closing Stock
Value of Closing Stock is Debited in the Stock Account

Trading Account
Opening Stock is Debited to Trading Account
Purchases are Debited to Trading Account
Closing Stock is Credited to Trading Account
Balance is Gross Profit

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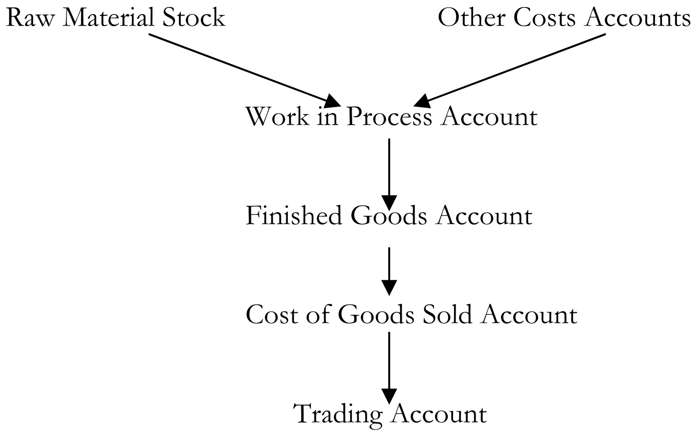
- **Movement of Stock in Trade in Accounts**



Raw material consumed and other costs incurred in the production process are charged to the work in process account. In this account further indirect or direct costs are incurred on these items which are charged to this account. After the units are completed they are transferred to finished goods account. The cost of these items are transferred to the cost of goods sold account and then subsequently to trading account.

Cost of Inventories of a Service Provider:

- The cost of inventories of a service provider consists primarily of the labour and other costs of personnel directly engaged in providing the service, including supervisory personnel, and attributable overheads. Labour and other costs relating to sales and general administrative personnel are not included but are recognized as expenses in the period in which they are incurred.

Schedule of cost of goods sold statement :(next page)

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In all production concerns a statement produced, called cost of goods sold statement. In this statement purchases and costs incurred on these purchases are added to the opening raw material account balance and after deducting closing material account from it the total cost of material consumed was obtained, and then conversion costs are added to that amount which forms total factory cost. (Conversion costs include labour and factory overheads). Opening work in process was added and closing work in process was deducted from total factory cost and the amount of cost of goods manufactured was obtained. In this figure finished goods opening stock was added and closing stock of finished goods was deducted and finally cost of goods sold figure was obtained.

- Cost Incurred to Purchase Raw Material – While considering the cost of RM all costs are included that are incurred to bring the material to the premises of the buyer e.g. freight charges paid to bring the RM to the warehouse, duties and other charges etc. paid.

- Advance Taxes (Sales Tax) – Only those taxes are included in the cost of inventory that are not refundable / adjustable. e.g., Sales tax paid at the time of purchase if adjustable will not be included in the cost of inventory.

- Discounts Received – Generally there are two types of discounts; Trade Discounts; and Cash Discounts:
  - ✓ Trade discounts are usually received on bulk purchase and are agreed at the time of negotiation of cost. The cost of inventory is recorded net of these discounts.
  - ✓ Cash discounts are received on early payment of the outstanding amount. These discounts are conditional and are not reduced from the value of the inventory.

Lecture 12

Valuation of Inventories

Methods of Stock Valuation

- First in First Out (FIFO)
- Last in First Out (LIFO)
- Weighted Average
- Specific Identification Method

The requirement of using these methods is that the units to which the assumption is applied should be homogeneous in nature-that is, nearly identical to each other. If each unit is unique, the specific identification methods is needed in order to achieve a proper matching of sales revenue with the cost of goods sold.

- These three valuation methods are explained with the help of following data

Example:

- Receipts:
  - ✓ 07 Jan 20--, 15 units @ Rs. 130 per unit
  - ✓ 08 Jan 20--, 25 units @ Rs. 140 per unit
  - ✓ 27 Jan 20--, 30 units @ Rs. 150 per unit
- Issues:
  - ✓ 25 Jan 20--, 10 units
  - ✓ 26 Jan 20--, 15 units
  - ✓ 28 Jan 20--, 20 units

Solution:

First In First Out (FIFO)

Date	**Receipts / Issues**		**Value of Stock**	
07-01-20--	15 @ Rs. 130 = 1,950	1,950	15 x 130 = 1,950	1,950
08-01-20--	25 @ Rs. 140 = 3,500	3,500	15 x 130 = 1,950 25 x 140 = 3,500	5,450
25-01-20--	10 @ 130 = 1,300	1,300	5 x 130 = 650 25 x 140 = 3,500	4,150
26-01-20--	5 @ 130 = 650 10 @ 140 = 1,400	2,050	0 x 130 = 0 15 x 140 = 2,100	2,100
27-01-20--	30 @ Rs. 150 = 4,500	4,500	15 x 140 = 2,100 30 x 150 = 4,500	6,600
28-01-20--	15 @ 140 = 2,100 5 @ 150 = 750	2,850	0 x 140 = 0 25 x 150 = 3,750	3,750

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WEIGHTED AVERAGE

Date	Receipts / Issues	Value of Stock	Average Cost
07-01-20--	15x130 1,950.00	 1,950.00	1,950 / 15 130
08-01-20--	25x140 3,500.00	1,950 + 3,500 5,450.00	5,450 / 40 136.25
25-01-20--	10x136.25 1,362.50	5,450 – 1,362.5 4,087.50	4,087.5 / 30 136.25
26-01-20--	15x136.25 2,043.75	4,087.5 – 2,043.75 2,043.75	2,043.75 / 15 136.25
27-01-20--	30x150 4,500.00	2,043.75 + 4,500 6,543.75	6,543.75 / 45 145.42
28-01-20--	20x145.42 2,908.4	6,543.75 – 2,908.4 3,635.35	3,635.35 / 25 145.41

Last In First Out (LIFO)

Date	Receipts / Issues		Value of Stock	
07-01-20--	15 @ Rs. 130 =	1,950	15 x 130 = 1,950	1,950
08-01-20--	25 @ Rs. 140 =	3,500	15 x 130 = 1,950 25 x 140 = 3,500	 5,450
25-01-20--	10 @ 140 =	1,400	15 x 130 = 1,950 15 x 140 = 2,100	 4,050
26-01-20--	15 @ 140 =	2,100	15 x 130 = 1,950 0 x 140 = 0	 1,950
27-01-20--	30 @ Rs. 150 =	4,500	15 x 130 = 1,950 30 x 150 = 4,500	 6,450
28-01-20--	20 @ 150 =	3,000	15 x 130 = 1,950 10 x 150 = 1,500	 3,450

Effect of Valuation on Profit

- Assume selling price to be 250.
  The revenue would be
  45 x 250 = 11,250

- In case of FIFO, Cost of Sale is:

  1,300 + 2,050 + 2,850 = 6,200
  Therefore Gross Profit is
  11,250 – 6,200 = 5,050

- In case of Weighted Average, Cost of Sales is:

  1,362.5 + 2,043.75 + 2,908.4 = 6,314.65
  Therefore Gross Profit is
  11,250 – 6,314.65 = 4,935.35

- In case of LIFO Cost of Sales is:

  1,400 + 2,100 + 3,000 = 6,500
  Therefore Gross Profit is
  11,250 – 6,500 = 4,750

Comparison of Cost and NRV

Example:

- Suppose a company has a:
  - ✓ Partially completed inventory item at the year end.
  - ✓ Expected selling price of the item when completed is Rs. 2500.
  - ✓ A further cost of Rs. 500 is required to complete the item
  - Expected selling cost of the item is Rs. 100

Required:

- What will be the carrying value of the inventory item if the cost incurred to date is:
  - ✓ Rs. 1000
  - ✓ Rs. 1900
  - ✓ Rs. 2100

Solution:

Net Realizable Value of the stock item:

Selling price – Selling Exp – Completion costs
2500 – 100 – 500 = 1900

Comparison of Cost and NRV

- Compare this NRV with costs:
  - ✓ 1900 vs. 1000 – Cost is less than NRV therefore inventory will be shown at cost and no adjustment will be required.
  - ✓ 1900 vs. 1900 – Cost is equal to NRV therefore inventory will be shown at cost and no adjustment will be required.
  - ✓ 1900 vs. 2100 – Cost is greater than NRV therefore inventory will be shown at NRV.

Comparison of Cost and NRV (Adjustment)

- Following adjustment will be required to bring stock to its NRV.

Debit	Profit and Loss Account	Rs. 200	
Credit	Stock in Trade		Rs. 200

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Evaluation of the methods:

First in First out (FIFO):

The distinguishing character of the FIFO method is that the oldest purchase costs are transferred to the cost of goods sold, while the most recent costs remain in inventory.

Over the last 50 years, we have lived in an inflationary economy, which means that most prices tend to rise over time. When purchase costs are rising, the FIFO method assigns lower (older) costs to the cost of goods sold and the higher (more recent) costs to the goods remaining in inventory.

By assigning lower costs to the cost of goods sold, FIFO usually causes a business to report somewhat higher profits then would be reported under the other inventory valuation methods. Some companies favor the FIFO method for financial reporting purposes, because their goal is to report the highest net income possible. For income tax purposes, however, reporting more income than necessary results in paying more income taxes than necessary.

Some accountants and decision makers believe that FIFO tends to overstate a company's profitability. Revenue is based on current market conditions. By offsetting this revenue with a cost of goods sold based upon older (and lower) prices, gross profits may be overstated consistently.

A conceptual advantage of the FIFO method is that inventory is valued at recent purchase cost. Therefore, this asset appears in the balance sheet at an amount closely approximating its current replacement cost.

Last in First Out (LIFO):

The LIFO method is one of the most interesting and controversial flow assumptions. The basic assumption in the LIFO method is that the most recently purchased units are sold first and that the older units remain in inventory. This assumption is not in accord with the physical flow of merchandise in most businesses. Yet, there are strong logical arguments in support of the LIFO method, in addition to income tax considerations.

For the purpose of measuring income, most accountants consider the flow of costs more important than the physical flow of merchandise. Supporters of the LIFO method contended that the measurement of income should be based upon current market conditions. Therefore, current sales revenue should be offset by the current cost of the merchandise sold.

Under the LIFO method, the costs assigned to the cost of goods sold are relatively current, because they stem for the most recent purchases. Under the FIFO method, on the other hand, the cost of goods sold is based upon "older" costs.

Income tax considerations, however, provide the principal reason for the popularity of the LIFO method. Remember that the LIFO method assigns the most recent inventory purchase costs to the cost of goods sold. In the common situation of rising prices, these 'most recent' costs are also the highest costs. By reporting a higher cost of goods sold than results from the other inventory valuation methods, the LIFO method usually results in lower taxable income. In short, if inventory costs are rising, a company can reduce the amount of its income tax obligation by using the LIFO method in its income tax returns.

There is one significant short coming to the LIFO method. The valuation of the asset inventory is based upon the company's "oldest" inventory acquisition costs. After the company has been in business for many years, these "oldest" costs may greatly understate the current replacement cost of the inventory. Thus, when an inventory is valued by the LIFO method, the company also should disclose the current replacement cost of the inventory in a note to the financial statements.

Therefore, LIFO is regarded as the most conservative of the inventory pricing methods. FIFO, on the other hand, is the least conservative method.

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Weighted Average:

Identical items will have the same accounting values only under the average cost method.

Assume for example that a hardware store sells a special size nail for one rupee. The hardware store buys the nails in 1,000 rupee quantities at different times at prices ranging from fifty to sixty paisa per rupee. Several hundred rupees of nails are always on hand, stored in a large bin. The average cost method properly recognizes that when a customer buys a nails it is not necessary to know exactly which nails the customer selected from the bin in order to measure the cost of goods sold.

Therefore, the average cost method avoids the shortcomings of the specific identification method. It is not necessary to keep track of the specific items sold and of those still in inventory. Also it is not possible to manipulate income merely by selecting the specific items to be delivered to customers.

A shortcoming in the average cost method is that changes in current replacement costs of inventory are concealed because these costs are averaged with older costs. Thus, neither the valuation of ending inventory nor the cost of goods sold will quickly reflect changes in the current replacement cost of merchandise.

Specific Identification Method:

Besides the three inventories valuation methods mentioned above this valuation method can also be used. The specific identification method is best suited to inventories of high-priced, low-volume items. This is the only method which exactly parallels the physical flow of the merchandise. If each item in the inventory is unique, as in the case of valuable paintings, custom jewelry and most real estate, specific identification is clearly the logical choice.

The specific identification method has an intuitive appeal, because it assigns actual purchase costs to the specific units of merchandise sold or in inventory. However, when the units in inventory are identical (or nearly identical), the specific identification method may produce misleading results by implying differences in value which-under current market conditions-do not exist.

As an example, assume that a coal dealer has purchased 100 tons of coal at a cost of Rs. 5,000/- per ton. A short time later, the company purchases another 100 tons of the same grade of coal, but this time, the cost is Rs. 8,000/- per ton. The two purchases are in separate piles; thus, it would be possible for the company to use the specific identification method in accounting for sale.
Assume now that the company has an opportunity to sell 10 tons of coal at a retail price of Rs. 12,000/- per ton. Does it really matter from which pile this coal is removed? The answer is no; the coal is a homogeneous product. Under current market conditions, the coal in each pile is equally valuable. To imply that it is more profitable to sell coal from one pile rather than the other is an argument of questionable logic.

Let us try to understand this point in more easy way: would you be willing to shovel the more recently purchased coal out of the way so that the customer can get its truck back to the lower cost coal pile.

Do Inventory Methods Really Affect Performance?

Except for their effects upon income taxes, the answer to this question is no.

During the period of rising prices, a company might report higher profits by using FIFO instead of LIFO. But the company would not really be any more profitable. An inventory valuation method affects only the allocation of costs between the inventory account and the Cost of goods sold account. It has no effect upon the total costs actually incurred in purchasing or manufacturing inventory. Except for income taxes, differences in the profitability reported under different inventory methods exist "only on paper."

The inventory method in use does affect the amount of income taxes owed. To the extent that an inventory method reduces these taxes, it does increase profitability.

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Lecture 13

Current Assets, Fourth Schedule – Companies Ordinance 1984

Current Assets

According to the Fourth Schedule of Companies Ordinance 1984 the current assets categories are:
- Stocks / Inventory
- Raw Material
- Finished Goods
- Work in Process
- General Stores / Spares
- Tools
- Marketable Securities
- Loans and Advances
- Cash and Bank Balances

Current assets shall be classified under sub-heads appropriate to the company's affairs, including, where applicable, the following:

- General Stores and spare parts distinguishing, where practicable, each from the other.
- Loose tools Moulds / Dies.

- Stock-in-trade, distinguishing where practicable, between:

  - ✓ stock of raw materials and components
  - ✓ work in progress
  - ✓ stock of finished products and
  - ✓ other stocks

In the case of above three sub-heads, the respective basis of valuation shall be stated.

These methods of valuation are:

Methods of Stock Valuation

- First in First Out (FIFO)
- Last in First Out (LIFO)
- Specific identification of cost
- Weighted Average

If the basis such as "**cost**", "**net realizable value**" or cost or net realizable value whichever is lower" is given, there shall also be given to the extent practicable a general indication of the method of determining the "cost" or "net realizable value" e.g., "average cost", "first-in, first out" or "last in, first out".

Where the basis is of valuation involves departure from the recognized accounting principles, the reasons there for along with financial impact should be shown in Financial Statements.

Trade debts which shall include amounts due in respect of goods sold or services rendered or in respect of other contractual obligations but shall not include the amounts which are in the nature of loans or advances

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Classification of Debt:

- Debts considered good and debts considered doubtful or bad shall be separately stated.
- Debts considered good shall be distinguished between those which are secured and those for which the company holds no security other than the debtor's personal security.
- Loans and advances due for repayment within a period of twelve months from the date of the balance-sheet.
- Showing separately those considered well and those considered doubtful or bad debts.
- Trade deposits and short term prepayments and current account balances with statutory authorities.
- Bills receivable.
- Marketable securities, other than long-term investments.
- Interest accrued or interest outstanding.
- Other receivables specifying separately the material items.
- Tax refunds due from Governments, showing separately excise duties, customs duties, sales tax, income tax etc.
- Cash and bank balances, Distinguishing between:

  ✓ Cash in hand,
  ✓ Cash in transit and
  ✓ Balance with banks indicating the nature thereof, e.g., on current or deposit account.

- Amounts required to be kept in special or separate accounts under any law shall be shown separately.
- In case of trade debts, loans and advances and other receivables following information shall also be disclosed.

  ✓ The aggregate amount due by directors, chief executive, and executives of the company and any of them severally or jointly with any other person.

  ✓ Aggregate amount due by associated undertakings, controlled firms and managed modarbas, names to be specified in each case.

The maximum amount of debts, under each of the preceding items, at any time, since the date of incorporation or since the date of the previous balance-sheet, whichever is the later, and such maximum amounts to be calculated by reference to month-end balances.

Provision, if any, made for diminution in the value of or loss in respect of any current asset shall be shown as deduction from the gross amount of the respective assets.

If in the opinion of the directors any of the current assets have, on realization in the ordinary course of the company's business, a value less than the amount at which they are stated in the financial statements, a disclosure of the fact that the directors are of that opinion together with their estimates of the realizable value and the reasons for assigning higher values in the balance-sheet shall be required.

Current Assets – Disclosures (Samples)

- Stores and Spares – Policy Note:

  ✓ Stores and spares are valued at lower of cost or net realizable value. Cost is calculated using weighted average method. Stores in transit are valued at invoice value.

- **Notes to the accounts (Stores and Spares)**

	Notes	**20-2**	**20-1**
• Stores and Spares			
Stores		xxx	xxx
Spares		xxx	xxx
Stores in Transit		xxx	xxx

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- **Notes to the accounts (Trade Debtors)**

	Notes	20-2	20-1
• Trade Debtors			
Secured		xxx	xxx
Unsecured – Considered Good			
Associated Undertakings		xxx	xxx
Others		xxx	xxx
		xxx	xxx
– Considered Doubtful		xxx	xxx
Less Provision for Doubtful Debts		(xxx)	(xxx)
		xxx	xxx
		xxx	xxx

Current Assets – Disclosures (Samples)

The maximum aggregate amount at the end of any month during the year from associated undertaking was Rs. xxxx.

Current Assets – Disclosures (Samples)

- **Notes to the accounts (Advances, Receivables, Prepayments and other Receivables)**

	Notes	20-2	20-1
• Advances, Receivables, Prepayments and other Receivables:			
Advances – Considered Good			
Executives'		xxx	xxx
Other Employees		xxx	xxx
		xxx	xxx
Suppliers of goods – Considered Good			
Security Deposits		xxx	xxx
Prepayments		xxx	xxx
		xxx	xxx
Due from Associated Undertaking		xxx	xxx
Other Receivables			
Considered Good		xxx	xxx
Considered Doubtful		xxx	xxx
Less Provision for Doubtful Balances		(xxx)	(xxx)
		xxx	xxx
Total Advances, Receivables and prepayments		xxx	xxx

- No advances were given to the directors of the company.

- The maximum aggregate amount at the end of any month during the year from associated undertaking was Rs. xxxx.

Current Assets – Disclosures (Samples)

- **Notes to the accounts (Cash and Bank Balances)**

	Notes	20-2	20-1
• Cash and Bank Balances			
Cash at Bank			
Current accounts		xxx	xxx
Saving accounts		xxx	xxx
		xxx	xxx
Cash in Hand		xxx	xxx
		xxx	xxx

Current Assets – Disclosures (Samples)

- **Notes to the accounts (Stores and Spares)**

	Notes	20-2	20-1
• Stores and Spares			
General Stores and Spares		xxx	xxx
		xxx	xxx

Most of the items of stores and spares are of inter-changeable nature and can be used as machine spares or consumed as stores. Accordingly, it is not practical to distinguish stores from spares until their actual usage. Stores and spares include items which may result in fixed capital expenditure but are not distinguishable.

Current Assets – Disclosures (Samples)

- **Notes to the accounts (Stock in Trade)**

	Notes	20-2	20-1
• Stock in Trade			
Raw materials and components		xxx	xxx
Goods in Transit		xxx	xxx
Work in Process		xxx	xxx
Finished Goods			
Manufacturing		xxx	xxx
Trading		xxx	xxx
Others		xxx	xxx
		xxx	xxx
Less: Provision for slow moving and obsolete items		(xxx)	(xxx)
		xxx	xxx

Included in stocks are goods held with third parties amounting to Rs. xxx

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Current Assets – Disclosures (Samples)

- **Notes to the accounts (Investments)**

	Notes	20-2	20-1
• Investments:			
Available for sale			
ABC Power Generation Limited			
1,000,000 ordinary shares of Rs. 10 each		xxx	xxx
		xxx	xxx

Market value of the above mentioned securities as at 20-2 was Rs. xxx.

Lecture 14

Presentation and Disclosure of Assets in Balance Sheet

We have studied the presentation and disclosure requirements of the asset side of the balance sheet according to Companies Ordinance 1984 and International Accounting Standards. Following IAS affect the recognition, presentation and disclosure of fixed assets in financial statements

- IAS 01 – Presentation of Financial Statements
- IAS 16 – Property Plant and Equipment
- IAS 23 – Borrowing Costs
- IAS 36 – Impairment of Assets (not included in syllabus)
- IAS 38 – Intangible Assets

Fixed Assets (Example)
Following information about the fixed assets of a company is available.

Balances of Fixed Assets as On July 01	**Rupees**
Description	**000**
Freehold Assets – Cost	
Freehold Land	22,088
Building on Freehold Land	75,328
Plant and Machinery	588,050
Tools and Equipment	6,287
Furniture and Fixture	5,449
Office Equipment	15,850
Vehicles	28,062
Leasehold Assets – Cost	
Plant and Machinery	40,569
Vehicles	-
Freehold Assets - Accumulated Depreciation	
Freehold Land	-
Building on Freehold Land	52,495
Plant and Machinery	344,933
Tools and Equipment	5,613
Furniture and Fixture	4,680
Office Equipment	12,740
Vehicles	22,790
Leasehold Assets - Accumulated depreciation	
Plant and Machinery	3,948
Vehicles	-

Capital work in progress on July 01 amounting to Rs. 500,000, included an under construction building. A further cost of Rs. 200,000 was incurred during the year after which the building was capitalized.
Other Assets purchased during the year included:

- Plant and Machinery Rs. 1,070,000
- Office Equipment Rs. 55,000
- Leased Vehicles Rs. 580,000

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Assets disposed off during the year included a company owned vehicle costing Rs. 1,000,000 and having accumulated depreciation of Rs. 488,000.

The car was sold to an employee of the company under terms of employment at book value.

The company got its land and building revalued in the last year that resulted in a revaluation surplus of:

- Land Rs. 1,500,000
- Building Rs. 1,000,000

This surplus is included in the balance of cost as on July 01.
Balance of revaluation surplus on July 01 was Land Rs. 1,500,000, Building Rs. 950,000
The revaluation resulted in an increased charged of depreciation charge of Rs. 47,500.

During the year lease term of a machine costing Rs. 6 million and having accumulated depreciation of Rs. 2,928,000 on July 01 was completed and the machine was transferred to the company owned assets.

The company charges depreciation on written down value of the assets at following rates:

- Building on Freehold Land 05%
- Plant and Machinery 10%
- Tools and Equipment 20%
- Furniture and Fixture 20%
- Office Equipment 20%
- Vehicles 20%

The company charges full year's depreciation in the year of purchase and no depreciation in the year, in which the asset is disposed off.
Land, Building, Machinery and Tools are all utilized in production. Half of Furniture Fixture, Office Equipment and Vehicles are used for Administration and balance for marketing and sales.

Fixed Assets (Solution)

Now let's see how the disclosure of this information will be given in the financial statements. Three different headings (line items) in the balance sheet will be shown, i.e.

- Property Plant and Equipment
- Capital work in Progress
- Surplus on Revaluation

Details of the above three items will be given in the notes to the accounts.
In addition a policy note, giving the details of policies adopted will also be given

Property Plant and Equipment:

- Fixed capital expenditure and depreciation

Operating fixed assets except freehold land are stated at cost less accumulated depreciation. Freehold land has been revalued by an independent valuer and is stated at revalued amount. Cost in relation to certain operating assets comprises historical cost, exchange differences and cost of borrowing during construction period in respect of loans taken for specific projects.

Depreciation on all operating fixed assets is charged to profit and loss account on the diminishing balance method so as to write off the written down value of an assets over its estimated useful life. Full year's depreciation is charged on additions during the year and no depreciation is charged for assets disposed off during the year.

Maintenance and repairs are charged to income as when incurred. Major renewals and improvements are capitalized and the assets so replaced, if any, are retired. Gains and losses on disposal of fixed assets are taken to the profit and loss account.

- Capital work-in-progress
  Capital work-in-progress is stated at cost.

Assets acquired under a finance lease are depreciated over the useful life of the asset on diminishing balance method. Depreciation of leased assets is charged to profit and loss account.

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Fixed Assets Schedule

S.#	Particulars	Cost			Dep %	Acc Dep				Written Down Value
		As On 01-Jul	Addition / (Deletion)	As On 30-Jun		As On 01-Jul	Addition / (Deletion)	During the Year	As On 30-Jun	
		(Rupees in thousands)								
	Assets Subject to Free Hold									
1	Freehold Land	20,588		20,588	-	-	-	-	-	20,588
2	Building on Free Hold Land	74,328	700	75,028	5	52,495	-	1,127	53,525	21,503
3	Plant and Machinery	588,050	1,070 6,000	595,120	10	344,933	2,928	24,726	369,659	225,461
4	Tools and Equipment	6,287		6,287	20	5,613	-	135	5,748	539
5	Furniture and Fixture	5,449		5,449	20	4,680	-	154	4,834	615
6	Office Equipment	15,850	55	15,905	20	12,740	-	633	13,373	2,532
7	Vehicles	28,062	(1,000)	27,062	20	22,790	(488)	757	23,059	4,003
		738,614	6,825	745,439		443,251	2,440	27,532	470,198	275,241
	Assets Subject to Lease Hold									
1	Plant and Machinery	40,569	(6,000)	34,569	10	3,948	(2,928)	2,769	6,717	27,852
2	Vehicles	-	580	580	20	-		116	116	464
		40,569	(5,420)	35,149		3,948	(2,928)	2,885	6,833	28,316
		779,183	**1,405**	**780,588**		**447,199**	**(488)**	**30,417**	**477,031**	**303,557**

Depreciation charged for the year has been allocated as follows:

Cost of Sales	28,757
Administrative and General Expenses	830
Selling and Marketing Expenses	830
	30,417

Fixed Asset schedule (Explanation)

- The fixed asset schedule has ten columns in which quantity of columns may be increased or decreased according to the need of the organization.

  - ✓ First column – shows the category of assets and if the company has leased assets then assets subject to freehold and assets subject to leasehold are separately distinguished.
  - ✓ Second column – shows the cost of assets brought forward (cost at the start of the financial year).
  - ✓ Third column – shows the addition and disposals of assets during the year respectively.
  - ✓ Fourth column – shows the accumulated cost of assets (opening cost brought forward plus addition less disposal during the year and also added by the amount of assets transferred from the heading "assets subject to lease hold" to "free hold assets"
  - ✓ Columns second to four are related to the cost of the assets.
  - ✓ Fifth column – shows the rate of depreciation applied to assets categories.
  - ✓ Just like columns second to column four, depreciation on assets is shown in columns sixth to column ninth.
  - ✓ Sixth column – shows the accumulated depreciation on the assets brought forward (opening balance of accumulated deprecation).
  - ✓ Seventh column – shows the adjustment of depreciation which was caused due to movement in assets (Disposals / Transfers).
  - ✓ Eighth column – shows the depreciation for the year, which is calculated by deducting the accumulated depreciation and its adjustments from accumulated cost after additions and disposals and multiplying this with the depreciation rate.
  - ✓ Ninth column – shows the accumulated depreciation at the end of the year (inclusive of current year depreciation).
  - ✓ Tenth column – shows the Written down value of assets which is calculated after deducting the year end accumulated depreciation from year end accumulated cost. This is the amount which is shown in Balance Sheet.
  - ✓ At the bottom of schedule allocation of depreciation should be made between cost of sales, administrative and general and selling and marketing.

Revaluation of Assets:

Revaluation of Land and Building was carried out in the year ----, resulting in a surplus of Rs. 1,500,000 and Rs. 1,000,000 respectively. The revaluation was carried out by independent valuers on the basis of market value in case of land and discounted current replacement cost in case of building.

Had there been no revaluation the carrying value of land and building would have been Rs. 21,588,000 and Rs. 21,503,000 respectively.

Disposal of Operating Fixed Assets

Particulars	**Cost**	**Accumulated Depreciation**	**Written Down Value**	**Sale Proceeds**	**Profit / (Loss)**	**Mode of Disposal**	**Particulars of Buyer**
	(Rupees in thousands)						
Vehicles Honda Civic LXS-834	1,000	488	512	512	-	Employee Car Scheme	Mr. M. A. Asif
	1,000	488	512	512	-		

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Disposal of Operating fixed asset schedule has eight columns

- ✓ First column – Shows the particulars of the asset disposed off during the year.
- ✓ Second Column – Shows the cost of the asset at which we purchase that particular asset.
- ✓ Third Column – Shows the accumulated depreciation of the particular asset which was charged during the useful life of that asset.
- ✓ Fourth Column – Shows the written down value of the asset.
- ✓ Fifth Column – Shows the amount of sale proceeds.
- ✓ Sixth Column – Shows the Profit or (Loss), after deducting the sale proceeds from the written down value of the asset.
- ✓ Seventh Column – Shows the mode of disposal, either the asset was sold outside the organization or given to an employee in any company policy.
- ✓ Eights Column – Shows the name and particulars of buyer.

Surplus on Revaluation	**Rupees 000**	**Rupees 000**
Surplus on Revaluation of Land	1,500	xxx
Surplus on Revaluation of Building	950	xxx
Less Transferred to Retained Earnings	(47)	xxx
	903	xxx
Closing Balance	2,403	xxx

- In Surplus on revaluation of Fixed Assets calculation, the surplus on the revaluation of land was shown separately and additional depreciation due to revaluation increase in the value of the building was charged to revaluation on building account.

- The reason why we don't less any amount from the revaluation surplus on land is that, we don't charge depreciation on land.

Capital Work In Progress :

	(Rupees in thousands)	
Building on Free hold land	-	500
	-	500

During the year an addition of Rs 200,000 (Last year 500,000) was incurred in capital work-in-progress and total amount of Rs 700,000 (Last year Nil) was transferred to Building on Free Hold Land.

Lecture 15

Long Term Investments, Presentation and Disclosure

Long Term Investments

- Long Term investments are classified under following categories:

  - ✓ Investment in Associated Undertaking
  - ✓ Other Investments.

- Investment in associated undertaking can be an investment in:

  - ✓ Subsidiary Companies
  - ✓ Associated Companies
  - ✓ Interest in Joint Ventures

- Measurement, Presentation and Disclosure of Long Term Investments is governed by following standards:

  - ✓ IAS 27, Consolidated and Separate Financial Statements
  - ✓ IAS 28, Investments in Associates
  - ✓ IAS 31, Interests in Joint Ventures
  - ✓ IAS 32, Financial Instruments Disclosure and Presentation
  - ✓ IAS 39, Financial Instruments Recognition and Measurement

Investment in Subsidiaries IAS 27

- In the parent's / investor's individual financial statements, investments in subsidiaries, associates, and jointly controlled entities should be accounted for either:

  - ✓ at cost; or
  - ✓ in accordance with IAS 39; or
  - ✓ using equity method in accordance IAS 28

- Disclosures required in Consolidated Financial Statements:

  - ✓ The nature of the relationship between the parent and a subsidiary when the parent does not own, directly or indirectly through subsidiaries, more than half of the voting power;

The reasons why the ownership, directly or indirectly through subsidiaries, of more than half of the voting or potential voting power of an investee does not constitute control;

Direct or Indirect Subsidiary

The relation of direct and indirect subsidiaries can be explained with the following example:

Company B holds more than 50% shares of company A and therefore A is a subsidiary of B, and Company C holds more than 50% shares of company B and therefore B is a subsidiary of C.

C ------------→ B -----------→ A

In this example there are two direct relations, A to B and B to C.

A is a direct subsidiary of B
B is a direct subsidiary of C

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Whereas, there is one indirect relationship exist between C and A. Although C does not hold any shares in A, but still A would be its Indirect Subsidiary as A is a subsidiary of B which in turn is a subsidiary of C.

- The reporting date of the financial statements of a subsidiary when such financial statements are used to prepare consolidated financial statements and are as of a reporting date or for a period that is different from that of the parent, and the reason for using a different reporting date or period; and

- The nature and extent of any significant restrictions on the ability of subsidiaries to transfer funds to the parent in the form of cash dividends or to repay loans or advances.

Wholly Owned and Partially Owned Subsidiaries:

- If the holding company owns more than 50% but less than 100% shares of the subsidiary then the subsidiary is termed as Partially Owned Subsidiary.

- Whereas if the holding company owns 100% shares of the subsidiary company then the subsidiary is called a Wholly Owned Subsidiary.

- A subsidiary can be a Virtually Wholly Owned subsidiary if the holding company owns marginally less than 100% shares. This is usually done to fulfill the requirement of minimum number of shareholders. We have studied that minimum number of shareholders in a Private Limited Company other than a Single Member Company is 2 and 3 in case of a Public Limited Company. Therefore a small number of shares (can be one share) is allotted to other individual and the holding company is left with less than 100% shares.

Investment in Associate IAS 28:

- IAS 28 defines An Associate through identification of influence,

Associate:

- An enterprise in which an investor has significant influence and which is neither a subsidiary nor a joint venture of the investor.

Significant Influence:

- Significant influence is the ability to participate but not to control the financial and management affairs of an enterprise.

- Significant influence is usually evidenced in following ways:

  ✓ Representation on the board of directors.
  ✓ Participation in policy making process
  ✓ Material transactions between investor and investee
  ✓ Interchange of managerial personnel
  ✓ Provision of technical information

Recognition of Investment in Associated Companies

- There are two methods for recognition of investment in associated companies:

  ✓ Cost method
  ✓ Equity method

- Investments made for a long term are recorded using equity method and shown separately in the balance sheet as long-term assets
- Investment made for a short period of time should be recognized at cost and classified in short term investments.
- IAS 28 requires all investments in associates to be accounted for under the equity method in consolidated accounts, unless the investment was acquired and is held exclusively with a view to disposal in the near future, in which case it should be accounted for under the cost method.
- The cost method is also applied when the associate operates under severe long-term restrictions that significantly impair its ability to transfer funds to the investor.
- The use of the equity method should be discontinued from the date that:

    c) The investor ceases to have significant influence, although it still holds the investment; or

    d) The associate comes under severe long-term restrictions, so the equity method is not appropriate, and the cost method should be used.

- In its consolidated financial statements, an investor should use the equity method of accounting for investments in associates, other than in the following exceptional circumstances:

    ✓ An investment in an associate that is acquired and held exclusively with a view to its disposal within 12 months from acquisition should be accounted for as held for trading under IAS 39. Under IAS 39, those investments are measured at fair value with fair value changes recognized in profit and loss.

- An investor need not use the equity method if all of the following conditions are met:

    ✓ The investor is itself a wholly-owned subsidiary, or is a partially-owned subsidiary of another entity and its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the investor not applying the equity method;

    ✓ The investor's debt or equity instruments are not traded in a public market;

- Following disclosures are required: IAS 28:

    ✓ Fair value of investments in associates for which there are published price quotations;
    ✓ Summarized financial information of associates, including the aggregated amounts of assets, liabilities, revenues, and profit and loss;
    ✓ Explanations when investments of less than 20% are accounted for by the equity method or when investments of more than 20% are not accounted for by the equity method;
    ✓ Use of a reporting date of the financial statements of an associate that is different from that of the investor;
    ✓ Nature and extent of any significant restrictions on the ability of associates to transfer funds to the investor in the form of cash dividends, or repayment of loans or advances;
    ✓ Unrecognized share of losses of an associate, both for the period and cumulatively, if an investor has discontinued recognition of its share of losses of an associate;
    ✓ Explanation of any associate is not accounted for using the equity method; and
    ✓ Summarized financial information of associates, either individually or in groups, which are not accounted for using the equity method, including the amounts of total assets, total liabilities, revenues, and profit and loss.

Investment in Joint Ventures

Joint Venture:

“It is a contractual arrangement whereby, two or more parties undertake, an economic activity which is subject to joint control.”

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Jointly Controlled Entities:

A jointly controlled entity will operate in the same way as any other enterprise, but for the fact that a contractual arrangement between the venturers establishes joint control over its economic activity. Each venturer takes a share of the results of the joint venture, although in some arrangements they may share the joint ventures output.

- As per IAS 31, there are two treatments of accounting for an investment in jointly controlled entities:

  - ✓ Benchmark Treatment: Proportionate consolidation.
  - ✓ Allowed Alternative Treatment: Equity method of accounting.

Proportionate consolidation:

  - ✓ Under proportionate consolidation, the balance sheet of the venturer includes its share of the assets that it controls jointly and its share of the liabilities for which it is jointly responsible. The income statement of the venturer includes its share of the income and expenses of the jointly controlled entity. IAS 31. Equity method of accounting.

- There are two different formats with which the proportionate consolidation method can be used.

  a) Combine on a line-by-line basis the venturer's share of each of the assets, liabilities, income and expenses of the jointly controlled entity with the similar items in the venturer's consolidated financial statements.

  b) Include in the venturer's consolidated financial statements separate line items for the venturer's share of the assets and liabilities, income and expenses of the jointly controlled entity.

- In both the cases the consolidated income statement would be shown n the same way.

- The proportionate consolidation method differs from normal consolidation in that only the group share of assets and liabilities, income and expenses are brought in to account. There is therefore no minority interest.

- The use of the proportionate consolidation method should be disconnected from the date the venturer ceases to have joint control over the entity, e.g. when external restrictions are placed on the joint venture.

Exceptions:

- Exceptions to both of the above treatments are allowed, so that the interests are treated as investments under the following circumstances.

  a) The interest in the jointly controlled entity was acquired and held entirely with a view to its sale in the near future.

  b) The interest is a jointly controlled entity operating under severe long term restrictions that significantly impair its ability to transfer funds to the venturer.

Separate Financial Statements of a Venturer:

- A venturer will contribute cash or other resources to the jointly controlled entity. These contributions will be included in the accounting records of the venturer and recognized in its separate financial statements as an investment in the jointly controlled entity.

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Equity Method:

- A venturer can report its interest in a joint venture in its consolidated financial statements under the equity method. The argument for this method is that it is misleading to combine controlled items with jointly controlled items. It is also felt by some that venturers have significant influence over the entity, not merely joint control.
  - ✓ Procedures for applying the equity method are the same as those described in IAS 28, Investment in Associates.

- A venturer is required to disclose:
  - ✓ Information about contingent liabilities relating to its interest in a joint venture.
  - ✓ Information about commitments relating to its interests in joint ventures.
  - ✓ A listing and description of interests in significant joint ventures and the proportion of ownership interest held in jointly controlled entities.
  - ✓ The method it uses to recognize its interests in jointly controlled entities.

The use of the equity method should be discontinued from the date on which the venturer ceases to have joint control over, or have significant influence on, a jointly controlled entity.

Long Term Investments

- Other Long Term Investments are classified as (IAS 32 and 39)
  - ✓ Held to maturity investments
  - ✓ Available for sale investments

Summary of different types of Investments:

We can summarize the different types of investment and the accounting treatment for them as follows.

Investment	**Criteria**	**Required treatment in group accounts**
Subsidiary	Control (more than 50% rule)	Full Consolidation
Associate	Significant Influence (20% +rule)	Equity Accounting
Joint Venture (Jointly controlled enterprises)	Contractual Agreement	Benchmark: Proportional Consolidation Alternative: Equity Accounting
Investment which is none of the above. Other Investments	Asset held for accretion of wealth	As for single company accounts

Other investments:

Investments which do not meet the definitions of any of the above should be accounted for as for single company accounts.

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Lecture 16

Long Term Investments

- Long Term investments are classified under following categories.
  - ✓ Investment in Associated Undertaking
  - ✓ Other Investments.
- Investment in associated undertaking can be an investment in
  - ✓ Subsidiary Companies
  - ✓ Associated Companies
  - ✓ Interest in Joint Ventures
- Other Long Term Investments are classified as (IAS 32 and 39)
  - ✓ Held to maturity investments
  - ✓ Available for sale investments

Held to maturity investments are the investments, where the investment has a specific maturity date and the management has both the intent and ability to hold an investment till the date of maturity.

- Investments held to maturity do not include:
  - ✓ Those that the entity designates as available for sale; and
  - ✓ Those that meet the definition of loans and receivables
- Examples of Long Term Investments:
  - ✓ Term Finance Certificates
  - ✓ Certificates of Investments
  - ✓ Defense Saving Certificates
- Available-for-sale financial assets are those financial assets that are not:
  - ✓ Loans and receivables originated by the entity,
  - ✓ Held-to-maturity investments, or

Investments whose fair value cannot be reliably measured should be **measured** at cost

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Associated Undertaking	Subsidiary	IAS 27	-At Cost OR -Under IAS 39
	Associate	IAS 28	-Equity method
	Interest In JV	IAS 31	-Proportionate Consolidation OR -Equity Method
Others	Held to Maturity	IAS 32 & 39	-At Amortized Cost
	Available for Sale	IAS 32 & 39	-Fair Value

Equity Method for Associate

Under the equity method of accounting, an equity investment is initially recorded at cost and is subsequently adjusted to reflect the investor's share of the net profit or loss of the associate**.**

Distributions (dividend) received from the investee reduce the carrying amount of the investment.

Proportionate Consolidation (JV)

- Under proportionate consolidation, the balance sheet of the venturer includes its share of the assets that it controls jointly and its share of the liabilities for which it is jointly responsible.

- The income statement of the venturer includes its share of the income and expenses of the jointly controlled entity.

Equity Method (JV)

The equity method in JV is the same as that in the associate.

Amortized Cost (Held to Maturity)

Amortized cost is calculated using the effective interest method. The effective interest rate is the rate that exactly discounts estimated future cash receipts through the expected life of the financial instrument to the net carrying amount of the financial asset.

Fair Value (Available for Sale)

Fair value is the amount for which an asset could be exchanged or a liability settled between knowledgeable willing parties in an arms length transaction.

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Disclosure Requirements

Disclosure Requirements of Subsidiary, Associate and Interest in JV have been discussed in the last lecture.

- For each class of financial asset and equity instrument, disclose the following:
  - ✓ information about the extent and nature of the financial instruments, including significant terms and conditions that may affect the amount, timing and certainty of future cash flows; and
  - ✓ The accounting policies and methods adopted, including the criteria for recognition and the basis of measurement applied.

Long Term Investments

Disclosures about Fair Value of Financial Instruments

- ✓ Disclose the fair value of each class of financial assets and
- ✓ Also, disclose:
  - ✓ The methods and significant assumptions applied in determining fair values of financial assets and financial liabilities.
  - ✓ Whether fair values of financial assets and financial liabilities are determined directly, in full or in part, by reference to published price quotations in an active market or are estimated using a valuation technique.

Long Term Investments (Notes to the Accounts)

4. Investments:

4.1 Investment in Subsidiary:

Investment in subsidiary is accounted for at cost from the date when control commences until the date when the control ceases.

Long Term Investments (Notes to the Accounts)

4.2 Investments held to maturity:

Investments with fixed maturity, where management has both the intent and ability to hold to maturity are classified as held to maturity and are stated at amortized costs. The resultant change in value is reported directly in the profit and loss account

Long Term Investments (Notes to the Accounts)

4.3 Investments available for sale

These are investments, which do not fall under the held for trading or held to maturity categories. These (except for investments in unlisted securities) are stated at fair values with any resulting gain / (losses) recognized in equity through statement of changes in equity. The Investments representing unlisted shares are stated at cost as relevant financial information is not available to determine their fair values.

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Long Term Investments (Notes to the Accounts)

4.4 Investments held for trading

Investments which are acquired principally for the purpose of generating a profit from short term fluctuations in price or dealer's margins are classified as held for trading. These are stated at fair values with any resulting gain or losses recognized directly in the profit and loss account.

Long Term Investments (Notes to the Accounts)

5 Long term Investments	**Notes**	**2004 (Rupees)**	**2003 (Rupees)**
Investment in Subsidiary	**5.1**	**14,271,654**	-
Held to Maturity	**5.2**	**4,995,996**	5,996,400
Available for Sale	**5.3**	**121,058**	15,552
		19,388,708	**6,011,952**

5.1 Investment in Subsidiary		
Cost of Investment	17,401,095	-
Company's share in loss of subsidiary	(3,129,441)	-
	14,271,654	-

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5.2 LONG TERM INVESTMENTS - Held to maturity

Company	No of Certificates		Type of Certificate	Profits		Face Value	Maturity Date	2004 (Rupees)	2003 (Rupees)
	2004	2003		Repayment Frequency	Rates	(Rupees)		Cost	Cost
ABC Ltd	1200	1200	Term Finance Certificate	Semi-annually	12 - 22%	6,000,000	02-08-2006	4,995,996	4,995,996

Market Value as on 30 June 2004 is Rs. 6,165,600 (2003: Rs. 6,349,288).

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4.3. LONG TERM INVESTMENTS - Available for sale

Companies	No of Ordinary Shares of Rs. 10/- each		Cost		Market Value		Percentage of Holding	
	30-Jun-04	30-Jun-03	30-Jun-04	30-Jun-03	30-Jun-04	30-Jun-03	30-Jun-04	30-Jun-03
Associated Companies								
A Ltd	718,340	718,340	5,418	5,418	12,530	4,326	17.95	17.95
B Ltd	1,178,100	1,178,100	15,902	15,902	21,206	10,721	15.48	15.48
C Ltd	6,972	6,972	268	268	1,046	505		
Bonus Shares	1,847	-	-	-	277	-		
	8,819	6,972	268	268	1,323	505	0.07	0.07
P Ltd	298,500	-	20,032	-	39,999	-	0.63	-
Other Companies								
T Limited	1,000,000	-	10,000	-	46,000	-	1.39	-
			51,620	21,588	121,058	15,552		

Available for sale investments are initially recognized at cost and measured at subsequent reporting dates at fair value. The fair value is determined on the basis of year-end bid prices. Surplus / deficit arising from re-measurement is taken to profit and

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Financial Instruments:

IAS 32 and 39 mainly cover Financial Instruments. Investments that are not covered by IAS 27, 28 and 31 are covered under IAS 32 and 39 as Financial Instruments.

The objective of IAS 32 is

To enhance financial statement users' understanding of the

- Financial Instrument is an agreement that gives rise to both a Financial Asset of one entity and Financial Liability of another entity.

- Shares (equity instruments) are Financial Assets of the Investor and Financial Liability of the Investee Company.

- Other examples could be TFC, Loan Agreements, Trade Receivables / Payables.

- Following are specifically excluded from Financial Assets

  - ✓ Physical Assets
  - ✓ Prepaid Expenses

Financial Instruments - Disclosure

- The main purpose of IAS 32 is to provide full and useful disclosure relating to financial instruments.

  - ✓ "The purpose of the disclosures required by this standard is to provide information to enhance understanding of the significance of financial instruments of an entity's financial position, performance and cash flows and assist in assessing the amounts, timing and certainty of future cash flows associated with those instruments."

Financial Instruments - Disclosure

- A specific monetary disclosure, narrative commentary by issuers is encouraged by the standard. This will enable users to understand management's attitude to risk, whatever the current transactions involving financial instruments are at the end of the period.

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Lecture 17

Risks & Disclosure under IAS 32 and 39 & Long Term Loans and Advances

- Detailed study of IAS 32 and 39 is not included in this course. However, a general understanding of risks discussed in these standards and their disclosures is necessary.

Financial Instruments

- Financial Instrument is an agreement that gives rise to both a Financial Asset of one entity and Financial Liability of another entity.

- Shares (equity instruments) are Financial Assets of the Investor and Financial Liability of the Investee Company.

- Other examples: Physical Assets:

  - ✓ TFC,
  - ✓ Loan Agreements,
  - ✓ Trade Receivables / Payables.

- Following are specifically excluded from Financial Assets

  - ✓ Physical Assets
  - ✓ Prepaid Expenses

Different aspects of risks

- In undertaking transactions in financial instruments, an entity may assume or transfer to another party one or more of different types of financial risk as defined below. The disclosures required by the standard show the extent to which an entity is exposed to these different types of risk.

- Types of financial risk are

  - ✓ **Market risk**
  - ✓ **Credit risk**
  - ✓ **Liquidity risk**
  - ✓ **Cash flow / interest rate risk**

Types of Risks - Market Risks

- **Currency Risk**: is the risk that the value of the financial instrument will fluctuate due to changes in foreign exchange rates.

- **Interest rate risk**: is the risk that the value of the financial instrument will fluctuate due to changes in market interest rates.

- **Price risk**: is the risk that the value of the financial instrument will fluctuate due to changes in market prices whether those changes are caused by factors specific to the individual instrument or its issuer or factors affecting all securities traded in the market.

Types of Risks – Credit Risk

- **Credit risk:** The risk that one party to a financial instrument will fail to discharge an obligation and cause the other party to incur a financial loss.

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Types of Risks – Liquidity Risk

- **Liquidity Risk:** The risk that an entity will encounter difficulty in raising funds to meet commitments associated with financial instruments. Liquidity risk may result for an inability to sell a financial asset quickly at close to its fair value.

Types of Risks – Cash Flow Risk

- **Cash flow / interest rate risk:** The risk that future cash flows of a financial instrument will fluctuate because of changes in market interest rates. In the case of a floating rate debt instrument, for example, such fluctuations result in a change in the effective interest rate of the financial instrument, usually without a corresponding change in its fair value.

Financial Instruments

- The standard does not prescribe the format or location for disclosure of information. A combination of narrative descriptions and specific quantified data should be given, as appropriate.

- The level of detail required is the matter of judgment. Where a large number of very similar financial instrument transactions are undertaken, these may grouped together. Conversely, a single significant transaction may require full disclosure.

- Classes of instruments will be grouped together by management in a manner appropriate to the information to be disclosed.

Financial Instruments - Disclosure

- Information must be disclosed about the following:

  - ✓ Risk management policies
  - ✓ Terms, conditions and accounting policies
  - ✓ Different risks involved
  - ✓ Fair value of the asset or liability
  - ✓ Material items of income, expenses from financial assets and liabilities.

Financial Instruments – Sample Narrative Disclosures

- **Concentration of Credit Risk**

  - ✓ The credit risk represents the accounting loss that would be recognized at the reporting date if counter parties (parties to the agreement) failed to perform as contracted.

Financial Instruments – Sample Disclosures

- The company does not have significant exposure to any individual customer. The company believes that it is not exposed to any major credit risk; however, any such possibility is mitigated by the application of credit limits to its customers and also obtaining collaterals.

Financial Instruments – Sample Narrative Disclosures

- **Foreign Exchange Risk**

  - ✓ Foreign exchange risk arises mainly where receivables and payables exist due to sale and purchase transactions with foreign undertakings. Payables exposed to foreign exchange risks are identified as either "Creditors" or

"Bills payable" and receivables exposed to foreign exchange risks are identified as "Trade debts". The transactions are however immaterial and do not pose a major risk.

Financial Instruments - Disclosure

One of the main purposes of IAS 32 is to provide full and useful disclosure relating to financial instruments.

> "The purpose of the disclosures required by this standard is to provide information to enhance understanding of the significance of financial instruments to an entity's financial position, performance and cash flows and assist in assessing the amounts, timing and certainty of future cash flows associated with those instruments."

As well as specific monetary disclosures, narrative commentary by issuers is encouraged by the standard. This will enable users to understand management's attitude to risk, whatever the current transactions involving financial instruments are at the period end.

Fair Value of Financial Instruments

- ✓ The carrying value of all financial assets and liabilities reflected in the financial statements approximates their fair values. Fair value is determined on the basis of objective evidence at each reporting date.

Liquidity Risk Management

- ✓ Liquidity risk reflects the company's inability of raising funds to meet commitments. Management closely monitors the company's liquidity and cash flow position. This includes maintenance of balance sheet liquidity ratios, debtors and creditors concentration both in terms of the overall funding mix and avoidance of undue reliance on large individual customers.

Recognition of Financial Instruments:

- IAS 39 Financial Instruments: Recognition and measurement establishes principles for recognizing and measuring financial assets and financial liabilities.

Scope:

- IAS 39 applies to all entities and to all type of financial instruments except those specifically excluded, as listed below, for example most investments in subsidiaries, associates and Joint ventures.

- Notice that this is different from the recognition criteria in the Framework and in most other standards. Items are normally recognized when there is a probable inflow or outflow of resources and the item has a cost or value that can be measured reliably.

Example: Initial Recognition.

- An entity has entered into two separate contracts:

  a) A firm commitment (an order) to buy a specific quantity of iron
  b) A forward contract to buy a specific quantity of iron at a specified price on a specified date.

Contract (a) is a normal trading contract. The entity does not recognize a liability for the iron until the goods have actually been delivered. (Note that this contract is not a financial instrument because it involves a physical asset, rather than a financial asset.)

Contract (b) is a financial instrument. Under IAS 39, the entity recognizes a financial liability (an obligation to deliver cash) on the commitment date, rather than waiting for the closing date in which the exchange take place.

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Note that planned future transactions, no matter how likely, are not assets and liabilities of an entity – the entity has not yet become a party to the contract.

De-recognition:

- De-recognition is the removal of a previously recognized financial instrument from an entity's balance sheet.

- An entity should de-recognize a financial asset when:

  a) The contractual rights to the cash flows from the financial asset expires; or
  b) It transfers substantially all the risks and rewards of ownership of the financial assets to another party.

An entity should de-recognize a financial liability when it is extinguished – i.e. when the obligation specified in the contract is discharged or cancelled or expires. It is possible for only one part of a financial asset or liability to be derecognized. For example if an entity holds a bond it has a right to two separate sets of cash flows: those relating to the principal and those relating to the interest. It could sell the right to receive the interest to another party while retaining the right to receive the principal.

Long Term Loans and Advances

- **Disclosure Checklist**

  ✓ Loans and advances must be shown separately.
  ✓ Distinguish between considered good and bad or doubtful
  ✓ Classification (line items on face)

    ✓ Loans and advances to related parties.
    ✓ Other loans and advances

  ✓ In case of loans and advances to related parties:

    ✓ Name
    ✓ Amount
    ✓ Particulars of collateral / security held
    ✓ In case of CEO, Directors and Executives, the purpose and reconciliation of opening and closing balance.

  ✓ The maximum aggregate amount of loans and advances outstanding (month-end basis)
  ✓ In other loans name of borrower with e repayment terms in case of material loans.
  ✓ Provisions if any.

Long Term Loans and Advances

Extracts of Balance Sheet

Non Current Assets

		2004	2003
	Notes	'000	'000
Long Term Loans	6	6,064	5,773
Long Term Advances	7	3,772	-

Long Term Loans and Advances

Notes to the Accounts

6. Long Term Loans - Considered Good

	Notes	2004 '000	2003 '000
Related Parties			
Associated Companies - Unsecured			
ABC Ltd	6.1	2,050	2,300
Loans to Employees - Secured			
House Building	6.2	7,094	7,153
		9,144	9,453
Less: Current portion shown under Current assets		3,080	3,680
		6,064	5,773

Long Term Loans and Advances

6.1 ABC Ltd was given a long term loan of Rs. 5,000,000 in 2000 for renovation of its manufacturing facility. The loan is repayable in 20 equal quarterly installments and carries a markup of rate of 7.5 % p.a.

6.2 Loans to employees are secured against charge on the asset for which loans is given and lien on retirement benefit.

Interest Rate and terms of repayment

Rate of Interest	9%
Number of Monthly Installments	
House Building loans	60% – 90%

The maximum aggregate amount due from executives at the end of any month during the year was Rs. 7,612 thousand (2003: Rs. 7,350 thousand)

During the year no loan was given to directors of the company (2003: Rs. Nil thousand)

Long Term Loans and Advances

7.	Long term advances - Considered Good	**7.1**	3,772	-
			3,772	-

7.1 These advances have been given to suppliers and contractors for capital work in progress and are considered good by the company.

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Lecture 18

Long Term Deposits and Prepayments & Current Assets

Long Term Deposits and Prepayments

- Disclosure:

Following are the disclosures, presented in schedules format which are shown in financial statements

- ✓ Classification:
  - ✓ Long Term Deposits
  - ✓ Prepayments
- ✓ Any material items shall be disclosed separately

Disclosure: Long Term Advances.

8. Long Term Advances - Unsecured

	Notes	2004	2003
		(Rupees in thousands)	
Long term advances - **Considered Good**	**8.1**	**3,772**	-
		3,772	-

8.1 These advances have been given to suppliers and contractors for capital work in progress and are considered good by the company

Disclosure: Long Term Deposits and Prepayments

9. Long Term Deposits And Prepayments

	Notes	2004	2003
		(Rupees in thousands)	
Security Deposits	**9.1**	**1,241**	1,744
Prepayments		**2,833**	2,833
		4,074	4,577

9.1 This mainly comprises of security deposits with leasing companies in respect of leasing facilities availed

Current Assets:

An asset should be classified as current asset when it:

- Is expected to be realized in, or is held for sale or consumption in, the normal course of the entity's operating cycle; or

- Is held primarily for trading purposes or for the short-term and expected to be realized within twelve months of the balance sheet date; or

- Is cash or a cash equivalent asset which is not restricted in its use?

All other assets should be classified as non current assets.

Non current assets include tangible, intangible, operating and financial assets of a long-term nature. Other terms with the same meanings can be used (e.g. fixed, long term)

Current asset include inventories and trade receivables that are sold, consumed and realized as part of the normal operating cycle. This is the case even where they are not expected to be realized with in twelve months.

Current assets will also include marketable securities if they are expected to be realized within twelve months of the balance sheet date. If expected to be realized later, they should be included in non-current assets.

The Current / Non Current Distinction:

- An entity must present current and non current assets as separate classifications on the face of the balance sheet. A presentation based on liquidity should only be used where it provides more relevant and reliable information, in which case all assets and liabilities must be presented broadly in order of liquidity.

- The IAS emphasizes how helpful information on the operating cycle is to users of financial statements. Where there is a clearly defined operating cycle within which the entity supplies goods or services, then information disclosing those net assets that are continuously circulating as working capital is useful.

- Disclosure:
  - ✓ Suggested Classification:
    - ✓ Stores Spares and loose tools
    - ✓ Stock in trade
    - ✓ Trade debts other than loans and advances showing considered good and doubtful or bad
    - ✓ Loans and advances showing considered good and doubtful or bad
    - ✓ Trade deposits and short term prepayments and current account balances with statutory authorities.
    - ✓ Interest accrued
    - ✓ Other receivables specifying material items
    - ✓ Financial assets (IAS 32 and 39)
    - ✓ Tax refunds due from Govt.
    - ✓ Cash and Bank balances
  - ✓ In case of trade debts, loans and advances and financial assets:

    - ✓ The aggregate amount due by CEO, directors and executives
    - ✓ Aggregate amount due by related parties

  - ✓ In case of investments:

    - ✓ Investment in related parties
    - ✓ Other investments

  - ✓ In case of investments:
    - ✓ Held to maturity
    - ✓ Available for sale
    - ✓ Held for trading
    - ✓ Provisions if any;

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Extracts of Current Assets in Balance sheet:

BALANCE SHEET (extracts)
As At 30 JUNE 2004

CURRENT ASSETS	Notes	2004	2003
		(Rupees in thousand)	
Stores and Spares	6	37,706	36,129
Stock and Stores -in-transit - at cost		16,360	16,766
Stock in Trade	7	96,061	94,951
Short Term Investments	8	102,332	102,332
Trade Debts	9	12,162	16,448
Loans, advances, deposits, prepayments and other receivables	10	92,483	96,844
Cash and Bank Balances	11	411,546	311,176
		768,650	674,646

Current Assets (Stores and Spare and Stock in Trade)

Notes to the Accounts (extracts)

		2004	2003
6	**STORES AND SPARES**	(Rupees in thousand)	
	Stores	4,678	6,321
	Spares	31,103	27,583
	Loose Tools	1,400	1,500
	Oil and Lubricants	370	455
	Civil Stores	155	270
		37,706	36,129
7	**STOCK IN TRADE**		
	Raw materials and Chemicals	50,822	55,308
	Packing Materials	10,726	9,859
	Work in Process	22,763	17,913
	Finished goods	11,750	11,871
		96,061	94,951

Current Assets (Investments)

8	**INVESTMENTS**		
	Quoted:		
	Available for Sale - Associated Undertakings		
	A Ltd	-	38,145
	B Ltd	95,332	57,187
	10,114,190 (2003: 8,303,281) ordinary shares of Rs. 10 each fully paid, Equity Held 33.65 %		
	Un-Quoted:		
	Available for Sale - Associated Undertaking		
	ABC Insurance Co.	7,000	7,000
	1,034,108 (2003: 940,098) ordinary shares of Rs. 10 each Equity Held: 9.4%		
	Chief Executive of the company: Mr. A.		
		102,332	102,332

Current Assets (Trade Debts)

9 TRADE DEBTS

Considered good - unsecured	9.1	102,362	120,942
Considered doubtful - unsecured		25,797	24,993
Less: Provision for doubtful debts		(25,797)	(24,993)
		-	-
		102,362	120,942

These relate to normal business of the company and are interest free.

Current Assets

10 LOANS, ADVANCES, DEPOSITS, PREPAYMENTS AND OTHER RECEIVABLES

Current portion of loans to employees - Considered Good and Secured			815		939
Advances: Unsecured - considered good					
To employees	10.1	576		233	
To suppliers		9,174		6,173	
Custom Duty		466		214	
Income Tax		64,912		77,479	
Sales Tax		4,000		-	
			79,128		84,099
Deposits:					
Letters of credit-margin deposits			158		222
Prepayments			763		298
Other Receivables:					
ABC Textile Mills	10.2	458		458	
EFG (Pvt) Ltd	10.2	345		-	
XYZ Company		-		104	
			803		562
Interest Accrued			3,335		7,301
Sales Tax Refund			3,575		4,302
Miscellaneous			5,664		879
			94,241		98,602
Less: Provision for doubtful receivables			(1,758)		(1,758)
			92,483		96,844

Current Assets

10.1 These are interest free advances to company's employees in respect of salary, medical and traveling expenses and are secured against employee retirement benefits. These include an amount of Rs. 456 thousand (2003 190 thousand) receivable from the Executives of the company and does not include any amount receivable from Directors or Chief Executive.

10.2 These amounts represent the balance of interest free current accounts with the associated undertakings.

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10.3 Maximum aggregate amount due from associated companies at the end of any month during the year was Rs. 1,138 thousand (2003: Rs. 1,379 thousand)

Current Assets (Cash and Bank Balance)

11	**CASH AND BANK BALANCES**			
	Cash at Bank:			
	Current accounts			
	Pak Rupee		55,906	44,385
			55,906	44,385
	Saving accounts			
	Pak Rupee	**11.1**	355,515	265,023
	Foreign Currency		125	1,768
			355,640	266,791
			411,546	311,176

11.1 Major portion of this balance is invested in three different banks on which mark-up is being received together with current account facilities.

- The time period used in defining current assets is one year or the length of the operating cycle whichever is longer. Most businesses have an operating cycle far shorter than one year.

- However, companies that sell merchandise on long term installment contracts, or that manufacture products such as ships, may have an operating cycle of several years. The user of financial statements should recognize that certain current assets are less liquid as the length of the operating cycle increases.

Lecture 19

IASB's Framework

In July 1989 the International Accounting Standard Board (IASB) (then IASC) produced a document, called framework for the preparation and presentation of financial statements.

The Framework is, in fact, the conceptual framework upon which all IAS's are based and hence which determines how financial statements are prepared and the information they contain.

- The Framework consist of several sections, these sections are as follows:

  - ✓ The Objective of Financial Statements.
  - ✓ Underlying Assumptions.
  - ✓ Qualitative Characteristics of Financial Statements.
  - ✓ The Elements of Financial Statements.
  - ✓ Recognition of the Elements of Financial Statements.
  - ✓ Measurement of the Elements of Financial Statements.
  - ✓ Concepts of Capital and Capital Maintenance.

Preface:

The preface to the Framework points out the fundamental reason why financial statements are produced worldwide, i.e. to satisfy the requirement of the external users, but that practice varies due to the individual pressure in each country. These pressures may be social, political, economic or legal, but they result in variations in practices from country to country.

It is these differences which the IASB wishes to narrow by harmonizing all aspects of financial statements, including the regulations governing their accounting standards and their preparation and presentation.

The preface emphasizes the way financial statements are used to make economic decisions and thus financial statements should be made to this end. The types of economic decisions for which financial statements are likely to be used include the following.

- Decisions to buy, hold or sell equity investments
- Assessment of management stewardship and accountability
- Assessment of the entity's ability to pay employees
- Assessment of the security of amounts lent to the entity.
- Determination of taxation policies.
- Determination of distributable profits and dividends
- Inclusion in national income statistics.
- Regulations of the activities of entities.

Any additional requirements imposed by national governments for their own purposes should not effect financial statements produced for the benefit of other users.
The Framework recognizes that financial statements can be prepared using a variety of models; the most common is based on historical cost.

Introduction:

The introduction to the Framework lays out the purpose, status and scope of the document. It then looks at different users of financial statements and their information needs.

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Purpose and Status:

The introduction gives a list of the purposes of the Framework.

a) Assist the Board of the IASB in the development of future IAS and in its review of existing IAS.
b) Assist the board of the IASB in promoting harmonization of regulations, accounting standards and procedures relating to the presentation of financial statements by providing a basis for reducing the number of alternative accounting treatments permitted by IAS.
c) Assist national standard setting bodies in developing national standards.
d) Assist preparers of financial statements in applying IAS and in dealing with topics that have yet to form the subject of an IAS.
e) Assist auditors in forming an opinion as to whether financial statements conform with IAS
f) Assist users of financial statements in interpreting the information contained in financial statements prepared in conformity with IAS.
g) Provide those who are interested in the work of IASB with information about its approach to the formulation of IAS (new IFRS)

"The Framework is not an IAS and so does not overrule any individual IAS. In the (rare) cases of conflict between an IAS and the Framework, the IAS will prevail."

Scope:

The framework deals with:

a) The objective of financial statements.
b) The qualitative characteristics that determine the usefulness of information in financial statements.
c) The definition, recognition and measurement of the elements from which financial statements are constructed.
d) Concepts of capital and capital maintenance

A complete set of financial statements include;

a) A balance sheet
b) An income statement
c) A statement of changes in financial position.
d) Notes, other statements and explanatory material.

Supplementary information may be included, but some items are not included namely commentaries and reports by the directors, the chairman, management etc.

Objectives of Financial Statements

The objective of the financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions.

Such financial statements will meet the needs of most users. The information is, however, restricted.

- It is based on past events not expected future events.
- It does not necessarily contain non-financial information.

It is important for users to assess the ability of an entity to produce cash and cash equivalents to pay employees, lenders etc.

- Financial position,
- Performance, and
- Changes in financial position

OBJECTIVES - Financial Position

Financial position (balance sheet) shows the economic resources controlled (assets) by the enterprise, the financial structure (capital structure) and the liquidity and solvency (short and long term commitments and receivables).

OBJECTIVES - Financial Performance

Financial performance (profit and loss) shows the information particularly profitability.

OBJECTIVES - Changes in Financial Position

Changes in financial position (cash flow) is used to assess the entity's investing (non current assets) , financing (equity and long term liabilities) and operating activities.

Underlying Assumptions

• Financial statements are prepared on the following assumptions.
- ✓ Accruals basis
- ✓ Going concern

ASSUMPTIONS – Accrual

The effects of transactions and other events are recognised when they occur (and not at the time of receipt or payment). They are recorded in the accounting records and reported in the financial statements of the periods to which they relate.
Financial statements prepared under the accruals basis show users past transactions involving cash and also obligations to pay cash in the future and resources which represent cash to be received in the future.

ASSUMPTIONS - Going Concern

The concept implies that the business will continue to operate for the foreseeable future. It is assumed that the entity has neither the intention nor the need to liquidate or curtail its operations. The affect of going concern assumption is that assets and liabilities of the business are meant to be held for till their maturity (or useful life to the business) and are therefore measured and reported at their cost. If the business is not considered to be a going concern then the assets and liabilities would have to be shown at their current market value

Qualitative Characteristics

The financial statement should possess following qualitative characteristics:

- ✓ Understandability:
- ✓ Relevance:
- ✓ Materiality:
- ✓ Reliability:
- ✓ Faithful representation:
- ✓ Substance over form:
- ✓ Neutrality:
- ✓ Prudence:
- ✓ Completeness:
- ✓ Comparability:
- ✓ Timeliness:
- ✓ Balance between cost and benefit:
- ✓ Balance between qualitative characteristics:
- ✓ True and fair presentation:

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Understandability:

Users must be able to understand financial statements. They are assumed to have some business, economic and accounting knowledge and to be able to apply themselves to study the information properly. Complex matters should not be left out of financial statements simply due to its difficulty if its difficulty if it is relevant information.

Relevance:

The information is relevant if it effects the decision making of the users (same information could be relevant to one report but irrelevant to another)
The manner of showing information will enhance the ability to make predictions, e.g. by highlighting unusual items.

Materiality:

Information is material if its omission or misstatement could influence the decision of the user. Both the nature and materiality of the information are important. Materiality is not a primary qualitative characteristics itself (like reliability or relevance), because it is merely a threshold or cut-off point

Example - 01

- Items that are material in size, but not in nature:

  - ✓ The total carrying amount of the machinery is Rs. 500,000, and included therein is a particular machine A, with a carrying amount of Rs. 450,000.
  - ✓ The total carrying amount of furniture is Rs. 300,000 and the total carrying amount of office equipment is Rs. 310,000.
  - ✓ The company's materiality limit is Rs. 300,000

  - ✓ Explain whether or not:

    - ✓ Machine A should be separately disclosed from the other material based on its material size, and
    - ✓ The furniture and equipment should be disclosed as two separate categories based on the materiality of the size of the carrying amounts of each category relative to the company's materiality limit.

Solution:

- Machine A and other machinery:

  - ✓ Despite the fact that machine A is material in size, machine A should be separately disclosed since, with reference to most user's need, this is not material in nature (a separate description of machine A would be information more of a technical than a financial nature and would thus mean very little to most user).

- Furniture and Office Equipment:

  - ✓ Similarly, despite the materiality of individual sizes of the carrying amounts involved, office furniture and equipment should be aggregated due to their common nature.

Example - 02

- Items that are material in nature, but not in size:

  - ✓ The total carrying amount of furniture is Rs. 200,000, and the total carrying amount of machinery is Rs. 250,000. The company's materiality limit is Rs. 300,000.
  - ✓ Explain whether or not furniture and machinery should be disclosed as two separate categories.

Solution:

Furniture and machinery should be disclosed as two separate categories even though the carrying amount of each category is below the materiality limit because, as far as the user is concerned, there is a material difference in the nature between furniture and machinery.

Reliability:

Information has a quality of reliability when it is free from material error and bias.
The user must be able to depend on it being a faithful representation.

Even if information is relevant, if it is very unreliable it may be misleading to recognize it, e.g. a dispute claim for damages in a legal action.

Faithful representation:

Information must represent faithfully the transactions it purports to represent in order to be reliable. There is a risk that this may not be the case, not due to bias, but due to inherent difficulties in identifying the transactions or finding an appropriate method of measurement or presentation. Where measurement of the financial effects of an item is so uncertain, entities should not recognise such an item, e.g. internally generated goodwill.

Substance over form:

Transactions and other events are accounted for and presented in accordance with their substance and economic reality (recognising of leased assets).

Neutrality:

Information must be free from bias to be reliable. Neutrality is lost if the financial statements are prepared so as to influence the user to make a Judgment or decision in order to achieve a predetermined outcome.

Prudence:

Uncertainties in preparation and presentation of financial statements are recognized through disclosures and application of prudence.
Prudence does not, however, allow the creation of hidden reserves or excessive provisions, understatement of assets or income or overstatement of liabilities or expenses.

Completeness:

Financial information must be complete within the restrictions of materiality and cost, to be reliable. Omission may cause information to be misleading.

Comparability:

The user must be able to compare an entity's financial statements:

a) Through time to identify trends and
b) With other entities' statements, to evaluate their relative financial position, performance and changes in financial position.

The consistency of treatment is therefore important across like items over time, within the entity and across all entities.

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The disclosure of accounting policies is particularly important here. Users must be able to distinguish between different accounting policies in order to be able to make a valid comparison of similar items in the accounts of different entities.

Comparability is not the same as uniformity. Entities should change accounting policies if they become inappropriate. Corresponding information for preceding periods should be shown to enable comparison over time.

Timeliness:

A balance between timeliness and the provision of reliable information must be maintained. Information may become irrelevant if there is a delay in reporting it. Information may be reported on a timely basis when not all aspects of the transaction are known, thus compromising reliability.

If every detail of a transaction is known, it may be too late to publish the information because it has become irrelevant. The overriding consideration is how best to satisfy the economic decision-making needs of the users.

Balance between cost and benefit:

This is a pervasive constraint, not a qualitative characteristic. When information is provided, its benefits must exceed the costs of obtaining and presenting it. This is a subjective area and there are other difficulties: others than the intended users may gain a benefit; also the cost may be paid by someone other than the users. It is therefore difficult to apply a cost-benefit analysis, but preparers and users should be aware of the constraint.

Balance between qualitative characteristics:

A trade off between qualitative characteristics is often necessary, the aim being to achieve an appropriate balance to meet the objective of financial statements. It is a matter for professional judgment as to the relative importance of these characteristics in each case.

True and fair presentation:

The framework does not attempt to define these concepts directly. It does state, however, that the application of the principal qualitative characteristics and of appropriate accounting standards will usually result in financial statements which show a true and fair view, or present fairly.

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Lecture 20

IASB's Framework (Contd)

Elements of Financial Statements

The transactions and other events are grouped together in broad classes and in this way their financial effects are shown in the financial statements. These broad classes are the elements of financial statements. The framework lays out these elements as follows.

- Measurement of financial position in the balance sheet:
  - ✓ Assets
  - ✓ Liabilities
  - ✓ Equity
- Measurement of performance in the income statement:
  - ✓ Income
  - ✓ Expenses

A process of sub-classification then takes place for presentation in the financial statements, e.g. assets are classified by their nature or function in the business to show information in the best way for users to take economic decisions.

Assets:

It is probable that future economic benefits will flow to the entity and the asset has cost or value that can be measured reliably.

Assets are usually employed to produce goods or services for customers; customers will then pay for these. Cash itself renders a service to the entity due to its command over other resources.

Transactions or events in the past give rise to assets; those expected to occur in the future do not in themselves give rise to assets. For example, an intention to purchase a non-current asset does not, in itself, meet the definition of an asset.

Liabilities:

It is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably. Equity is also a liability.

Liabilities must arise from past transactions or events. In the case of, say, recognition of future rebates to customers based on annual purchases, the sale of goods in the past is the transaction that gives rise to the liability.

Is a Provision a liability?

Provision is a present obligation which satisfies the rest of the definition of a liability, even if the amount of the obligation has to be estimated.

Equity:

Equity is defined above as a residual, but it may be sub-classified in the balance sheet. This will indicate legal or other restrictions on the ability of the entity to distribute or otherwise apply its equity. Some reserves are required by statue or other law, e.g. for the future protection of creditors. The amount shown for equity depends on the measurement of assets and liabilities. It has nothing to do with the market value of the entity's shares.

Income:

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An increase in the future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably. Gains include those arising on the disposal of non-current assets. The definition of income also includes unrealized gains, e.g. on revaluation of marketable securities.
Both revenue and gains are included in the definition of income. Revenue arises in the course of ordinary activities of an entity.

Expenses:

A decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably.

As with income, the definition of expenses includes losses as well as those expenses that arise in the course of ordinary activities of an entity.
Losses will include those arising on the disposal of non-current assets. The definition of expenses will also include unrealized losses, e.g. exchange rate effects on borrowings.

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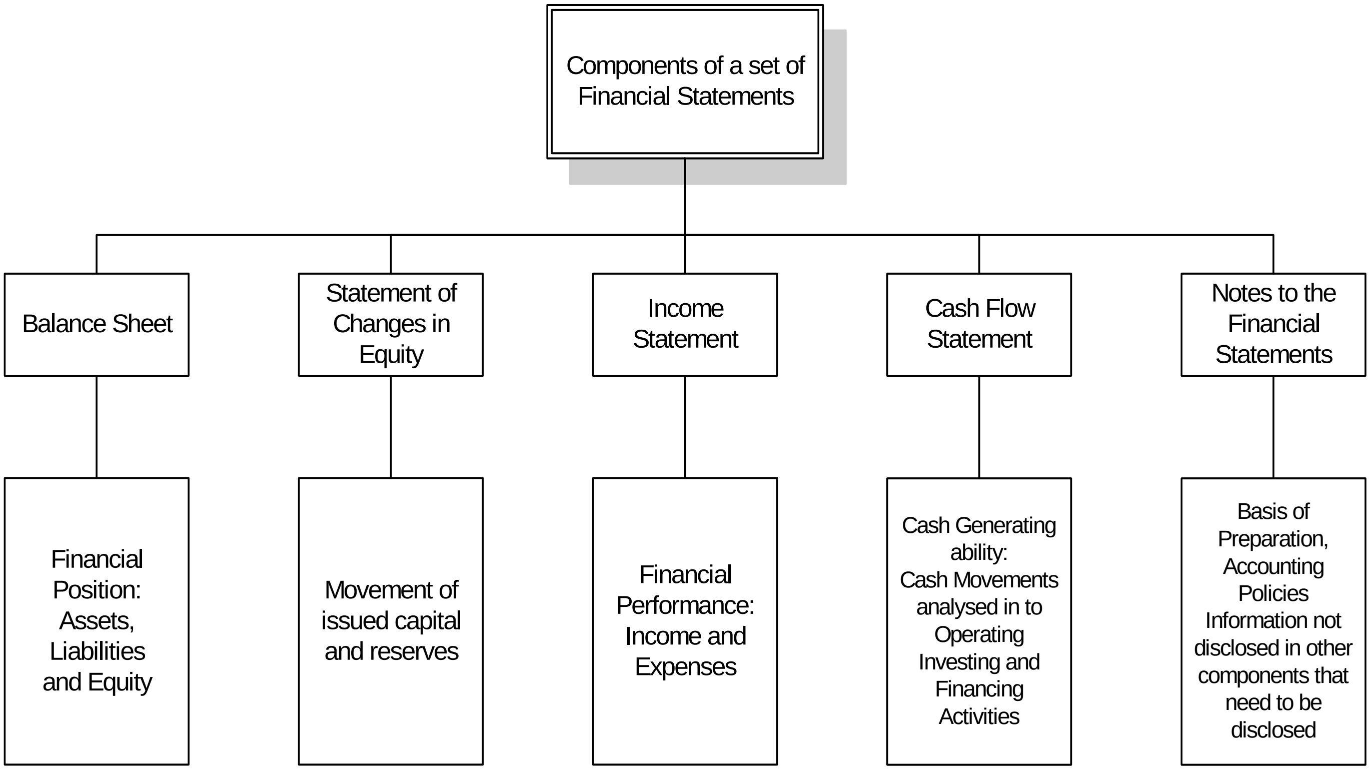

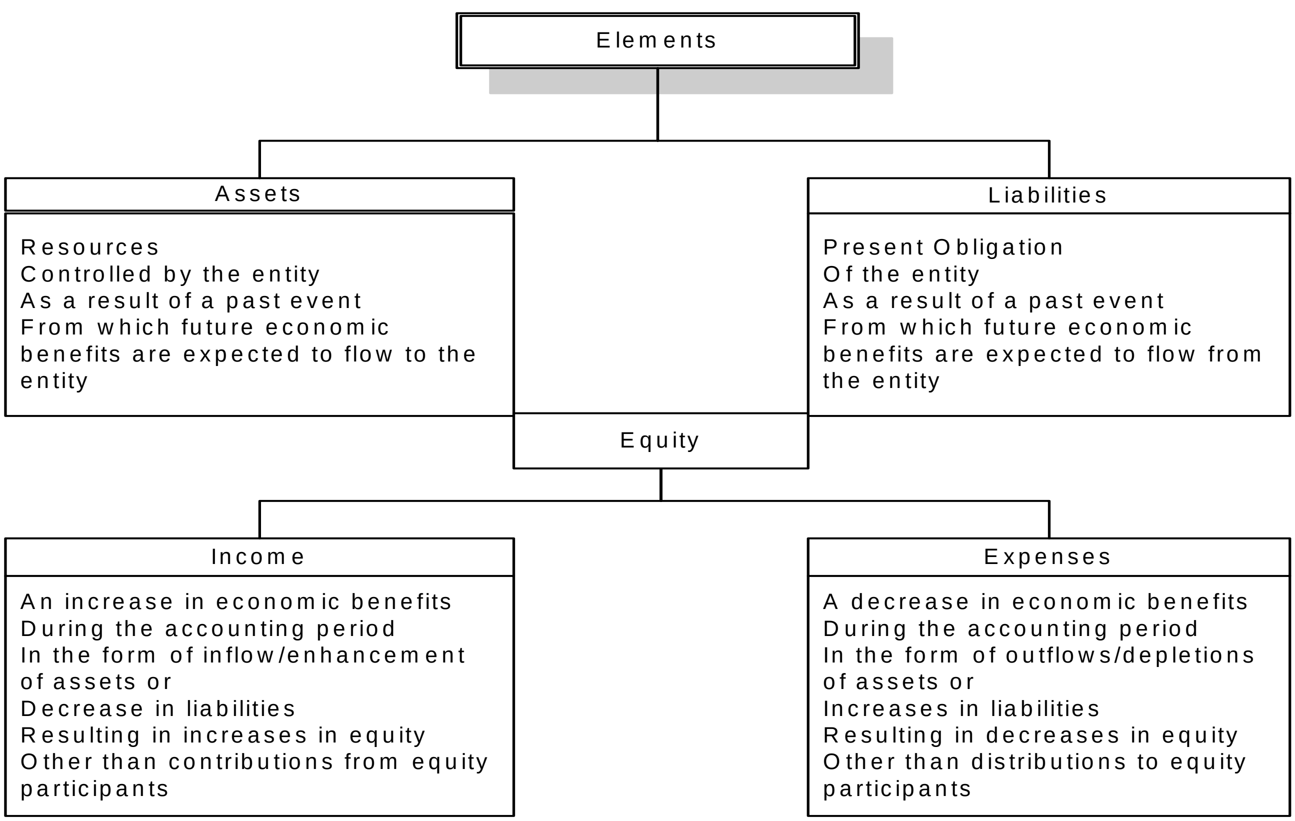

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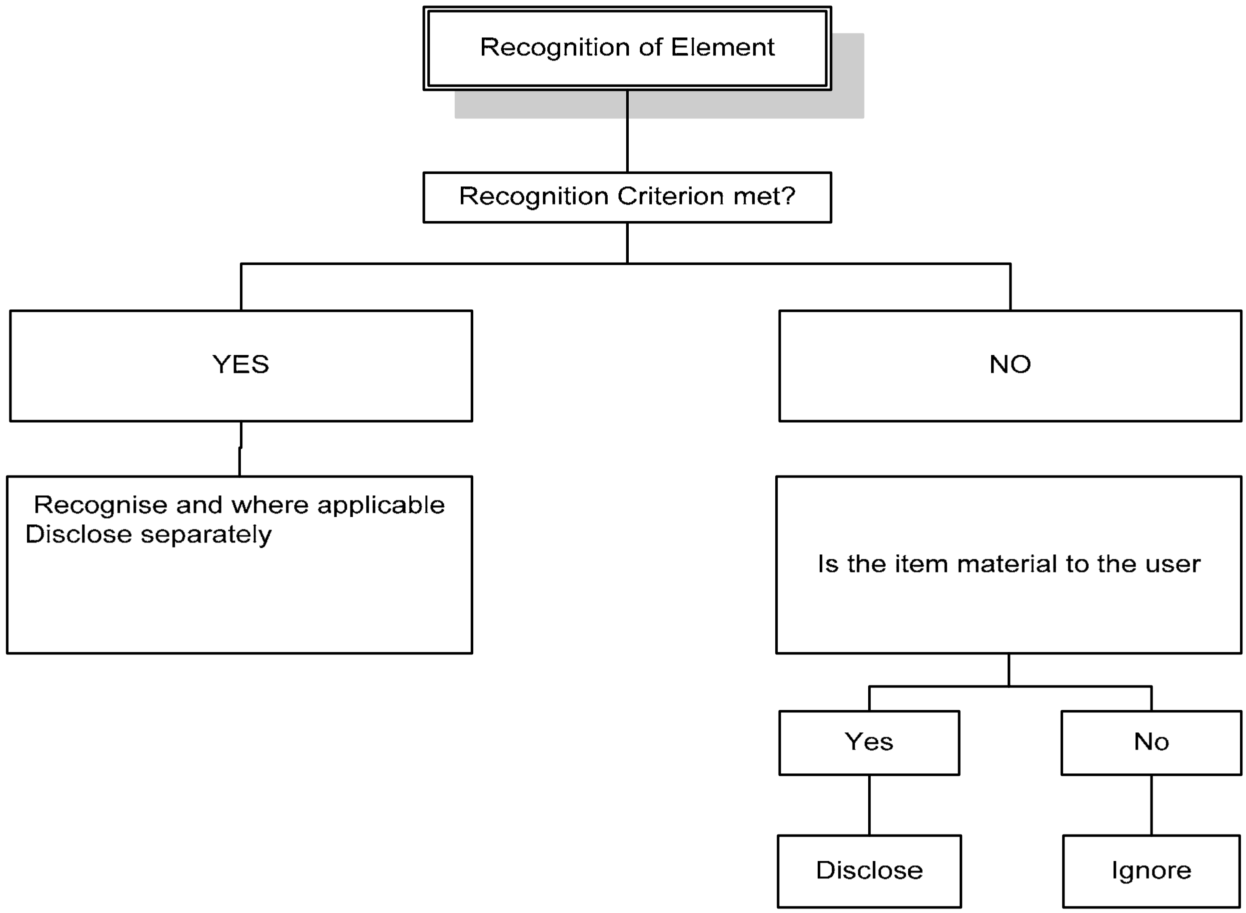
Recognition of the elements of financial statements:



Recognition of the elements of financial statements:

The process of incorporating in the balance sheet or income statement an item that meets the definition of an element and satisfies the following criteria for recognition:

a) It is probable that any future economic benefit associated with the item will flow to or from the entity; and
b) The item has a cost or value that can be measured with reliability.

Probability of future economic benefits:

Probability here means the degree of uncertainty that the future economic benefits associated with an item will flow to or from the entity. This must be judged on the basis of the characteristics of the entity's environment and the evidence available when the financial statements are prepared.

Reliability of measurement:

The cost or value of an item, in many cases, must be estimated. The framework states, however, that the use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability. Where no reasonable estimate can be made, the item should not be recognized, although its existence should be disclosed in the notes, or other explanatory material.

Items may still qualify for recognition at a later date due to changes in circumstances or subsequent events.

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Measurement of Elements of Financial statements:

- The process of determining the monetary amounts at which the elements of F/S are to be recognized and carried in the B/S and P/L. Following measurement methods are used in different situations.

This involves the selection of a particular basis of measurement. A number of these are used to different degrees and in varying combinations in financial statements. They include the following:

- ✓ **Historical cost:** Consideration paid (payable) or received (receivable) at the time of recording of transaction (no relation to current costs).

- ✓ **Current cost:** The consideration that would have to be paid if a same or an equivalent asset is acquired.
  The undisclosed amount of cash or cash equivalents, that would be required to settle an obligation currently.

- ✓ **Realisable value:** The consideration that would be realised by selling an asset in an orderly disposal.

  Settlement value: the undiscounted amounts of cash or cash equivalents expected to be paid to satisfy the liabilities in the normal course of business.

- ✓ **Present value:** A current estimate of the present discounted value of the future net cash flows in the normal course of business.

- Historical Cost is the most commonly adopted measurement basis, but this is usually combined with other bases, e.g. inventory is carried at the lower of cost and net realizable value.

Concept of Capital and Capital Maintenance:

Most entities use a financial concept of capital when preparing their financial statements.
The selection of the appropriate concept of capital by an enterprise should be based on the needs of the users of its financial statements. Thus a financial concept of capital should be adopted if the users of financial statements are primarily concerned with the maintenance of nominal invented capital or the purchasing power of invested capital. If, however, the main concern of users is with the operating capability of the enterprise, a physical concept of capital should be used. The concept chosen indicates the goal to be attained in the determining profit, even though there may be some measurement difficulties in making the concept operational.

There are two concepts of capital maintenance:

a) Financial Capital Maintenance
b) Physical Capital Maintenance

Financial Capital Maintenance:

- Under this concept the profit is earned only if the financial(or money) amount of the net assets at the end of the period exceeds the financial (or money) amount of net assets at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period. Financial capital maintenance can be measured in either nominal monetary units or units of constant purchasing power.

Physical Capital Maintenance:

- Under this concept the profit is earned only if the physical productive capacity (or operating capability) of the enterprise (or the resources or funds needed to achieve that capacity) at the end of the period exceeds the physical productive capacity at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period.

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The concept of capital maintenance is concerned with how an enterprise defines the capital that it seeks to maintain. It provides the linkage between the concepts of capital and the concepts of profit because it provides the point of reference by which profit is measured; it is a prerequisite for distinguishing between an enterprise's return on capital and its return of capital; only inflows of assets in excess of amounts needed to maintain capital may be regarded as profit and therefore as a return on capital. Hence, profit is the residual amount that remains after expenses

The physical capital maintenance concept requires the adoption of the current cost basis of measurement. The financial capital maintenance concept, however, does not require the use of a particular basis of measurement. Selection of the basis under this concept is dependent on the type of financial capital that the enterprise is seeking to maintain.

The principal difference between the two concepts of capital maintenance is the treatment of the effects of changes in the prices of assets and liabilities of the enterprise. In general terms, an enterprise has maintained its capital if it has as much capital at the end of the period as it had at the beginning of the period. Any amount over and above that required to maintain the capital at the beginning of the period is profit.

Under the concept of financial capital maintenance where capital is defined in terms of nominal monetary units, profit represents the increase in nominal money capital over the period. Thus, increases in the prices of assets held over the period, conventionally referred to as holding gains are, conceptually, profit. They may not be recognized as such, however, until the assets are disposed of in an exchange transaction. When the concept of financial capital maintenance is defined in terms of constant purchasing power units, profit represents the increase in invested purchasing power over the period. Thus, only that part of increase in the prices of assets that exceeds the increase in the general level of prices is regarded as profit. The rest of the increase is treated as a capital maintenance adjustment and, hence, as part of equity.

Under the concept of physical capital maintenance when capital is defined in terms of the physical productive capacity, profit represents the increase in that capital over the period. All price changes affecting the assets and liabilities of the enterprise are viewed as changes in the measurement of the physical productive capacity of the enterprise; hence, they are treated as capital maintenance adjustments that are part of equity and not as profit.

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Lecture 21

Presentation of Liabilities in Balance Sheet

In our earlier lectures we have covered the assets side of the balance sheet. We will now start the liabilities side of balance sheet. You will remember that we had shown you a sample balance sheet. Let's have a re-look at it just to refresh our memory and then we will start our discussion on the liabilities side.

Assets side of Balance Sheet

ABC Food Processing and Packing Co Ltd.
Balance Sheet As At June 30, 2004

	Note	2004 Rs'000	2003 Rs'000
ASSETS			
Non-Current Assets			
Fixed Assets	5	588,704	672,466
Capital Work in Progress	6	627,126	231,340
Long Term Loans	7	2,898	2,639
Deferred Cost	8	346	2,419
		1,219,074	908,864
Current Assets			
Stores and Spares	9	95,281	117,811
Stock in Trade	10	1,005,315	1,013,483
Trade Debts	11	136,229	168,346
Advances, Deposits & Prepayments and other receivables	12	23,698	32,185
Cash and Bank Balances	13	24,620	21,725
		1,285,143	1,353,550
		2,504,217	**2,262,414**

This assets side was shown just as a sample. We have had a detailed discussion on the assets. Now let's have a look at the liabilities side.

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Liabilities side of Balance Sheet

ABC Food Processing and Packing Co Ltd.
Balance Sheet As At June 30, 2004

Financed By			
Share Capital and Reserves			
Share Capital		92,364	92,364
General Reserve		1,639,309	1,376,739
Shareholders Equity		1,731,673	1,469,103
Long Term Liabilities			
Deferred Taxation	13	30,796	45,205
Obligation Under Lease Finance	14	-	-
		30,796	45,205
		1,762,469	**1,514,308**
Current Liabilities			
Short Term Finances	15	-	144,331
Current Maturity of Obligation under lease finance	16	-	1,316
Creditors, Accrued and Other liabilities	17	415,362	322,746
Provision for Taxation		181,667	166,164
Other Provisions	18	5,020	4,110
Divided Payable	19	139,699	109,439
		741,748	748,106
		2,504,217	**2,262,414**

You can see that items in the liabilities side are also listed in their liquidity order i.e. items of more permanent nature or longer tenure are listed first and then those of shorter tenure.

Liabilities:

A liability is an obligation of an entity to transfer economic benefits as a result of past transactions or events.

- Three major classifications can be seen in the liabilities side of the balance sheet. i.e.

  ✓ Share Capital and Reserves / Shareholders Equity
  ✓ Long Term Liabilities
  ✓ Current Liabilities

Equity:

- Equity / Shareholders Equity / Shareholders Funds is the liability of the business towards its shareholders. OR

- It is the net balance of the total assets of the business less third party liabilities.

- You should remember the accounting equation:
  Assets = Liabilities + Capital (Equity) OR
  Assets – Liabilities = Capital

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Equity includes:

- ✓ The amount contributed by the shareholders (in case of companies) or owners (in case of other business entities).
- ✓ All undistributed profits whether in the form of Accumulated Profit or Reserves.

Surplus on Revaluation of Fixed Assets

- We had discussed that a surplus arising from revaluation of fixed assets of as entity is shown separately in the balance sheet.
- It is shown as a separate line item after shareholders equity and before long term liabilities.

Long Term Liabilities:

Long Term Liabilities are all those liabilities that will become due for payment after a period of 12 months from the balance sheet date.

- Long Term Liabilities may include any or all of the following heads:

  - ✓ Long term financing
  - ✓ Debentures
  - ✓ Liabilities against assets subject to finance lease;
  - ✓ Long term modaraba;
  - ✓ Long term deposits; and
  - ✓ Deferred liabilities.

Current Liabilities:

Current Liabilities are all those liabilities that are expected to be paid or will become due for payment within 12 months from the balance sheet date.

- Current Liabilities may include any or all of the following heads:

  - ✓ Trade and other payables,
  - ✓ Interest, profit, return or mark-up accrued on loans and other payables
  - ✓ Short term borrowings
  - ✓ Current portion of long term borrowings
  - ✓ Current portion of long term murabaha
  - ✓ Provision for taxation

Contingent Liabilities:

Contingent liabilities are those liabilities that depend on the happening of an event (such as outcome of a court case or a liability arising in case of inability of the company to fulfill a commitment).

IAS 37 defines a contingent liability as:

- 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 entity's control; or
- A present obligation that arises from past events but is not recognized because:

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a) It is not probable that a transfer of economic benefits will be required to settle the obligation; or
b) The amount of the obligation cannot be measured with sufficient reliability.

As a rule of thumb, probable means more than 50% likely. If an obligation is probable, it is not a contingent liability – instead, a provision is needed.

Treatment of contingent liabilities:

Contingent liabilities should not be recognized in financial statements but they should be disclosed. The required disclosures are:

a) A brief description of the nature of the contingent liability,
b) An estimate of its financial effect,
c) An indication of the uncertainties that exist,
d) The possibility of any reimbursement,

Disclosure: Contingent Liabilities:

A brief description must be provided of all material contingent liabilities unless they are likely to be remote. In addition, provide

a) An estimate of their financial effect
b) Details of any uncertainties

Just like the assets side details of amounts shown on the face of the balance sheet are given in the notes to the accounts.

'Let Out'

IAS 37 permits reporting entities to avoid disclosure requirements relating to provisions, contingent liabilities and contingent assets if they would be expected to seriously prejudice the position of the entity in dispute with other parties. However, this should only be employed in extremely rare cases. Details of the general nature of the provision/contingencies must still be provided, together with an explanation of why it has not been disclosed.

Obligating Event:

An obligating event is an event that creates a legal or constructive obligation that results in an enterprise having no realistic alternative to settling 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 operation of law.

Constructive Obligation:

Is an obligation that derives from an enterprise's actions where:

a) By an established pattern of past practice, published policies or a sufficiently specific current statement, the enterprise has indicated to other parties that it will accept certain responsibilities; and

b) As a result, the enterprise has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

Example-01

During 20X0 S Co gives a guarantee of certain borrowings of P Co, whose financial condition at that time is sound. During 20X1, the financial condition of P Co deteriorates and at June 20X1 P Co files for protection from its creditors.

Required: What accounting treatment is required:

a) At 31 December 20X0?
b) At 31 December 20X1?

Solution:

a) At 31 December 20X0

There is a present obligation as a result of a past obligating event. The obligating event is the giving of the guarantee, which gives rise to a legal obligation. However, at 31 December 20X9 no transfer of economic benefits is probable in settlement of the obligation.

No Provision is recognized. The guarantee is disclosed as a contingent liability unless the probability of any transfer is regarded as remote.

b) At 31 December 20X1

As above, there is a present obligation as a result of a past obligating event, namely the giving of the guarantee.

At 31 December 20Y0 it is probable that a transfer of economic events will be required to settle the obligation. A provision is therefore recognized for the best estimate of the obligation.

- The amount of contingent liabilities is not known with certainty at the balance sheet date
- Therefore no amount is shown on the face of the balance sheet
- Instead only the line item "Contingent Liabilities" with a reference to the note number is shown on the face.

A description of all contingent liabilities is given in the note with the estimate of the liability that may arise in the opinion of the management of the company.

Relationship between Provisions and Contingent Liabilities:

In general sense all provisions are contingent because they are uncertain in timing or amount. However, within this standard the term contingent is used for liabilities and assets that are not recognized because their 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 enterprise. In addition, the term 'contingent liability' is used for liabilities that do not meet the recognition criteria.

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- IAS 37 (Provisions, Contingent Assets and Contingent Liabilities) distinguishes between provisions and contingent liabilities as:

  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, Possible obligations, as it has yet to be confirmed whether the enterprise has a present obligation that could lead to an outflow of resources embodying economic benefits; or

Present obligation 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)

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Lecture 22

Liabilities side area of Balance Sheet (Share Capital and Reserves)

From this lecture we will start our detailed discussion on the area of liabilities. We will start from share capital and reserves / shareholders equity. First item in shareholders equity is the share capital.

Summary of Liabilities

Accrual and other Liabilities	**Provisions**	**Contingent Liability Type 01**	**Contingent Liability Type 02**
Present obligation. As a result of past events. The settlement of which will result in outflow of economic benefits.	Present obligation. As a result of past events. The settlement of which will result in outflow of economic benefits.	Present obligation. As a result of past events. The settlement of which is expected to result in outflow of economic benefits.	Possible obligation. As a result of past events. The existence of which is to be confirmed.
	Where the amount and timing of the payment is uncertain.	But where the liability may not be recognized since the recognition criteria are not met. The amount is not reliably measured. or	By the occurrence or non occurrence of uncertain future events That are not wholly in control of the enterprise
		It is not probable that the future economic benefits are needed to settle the obligation.	

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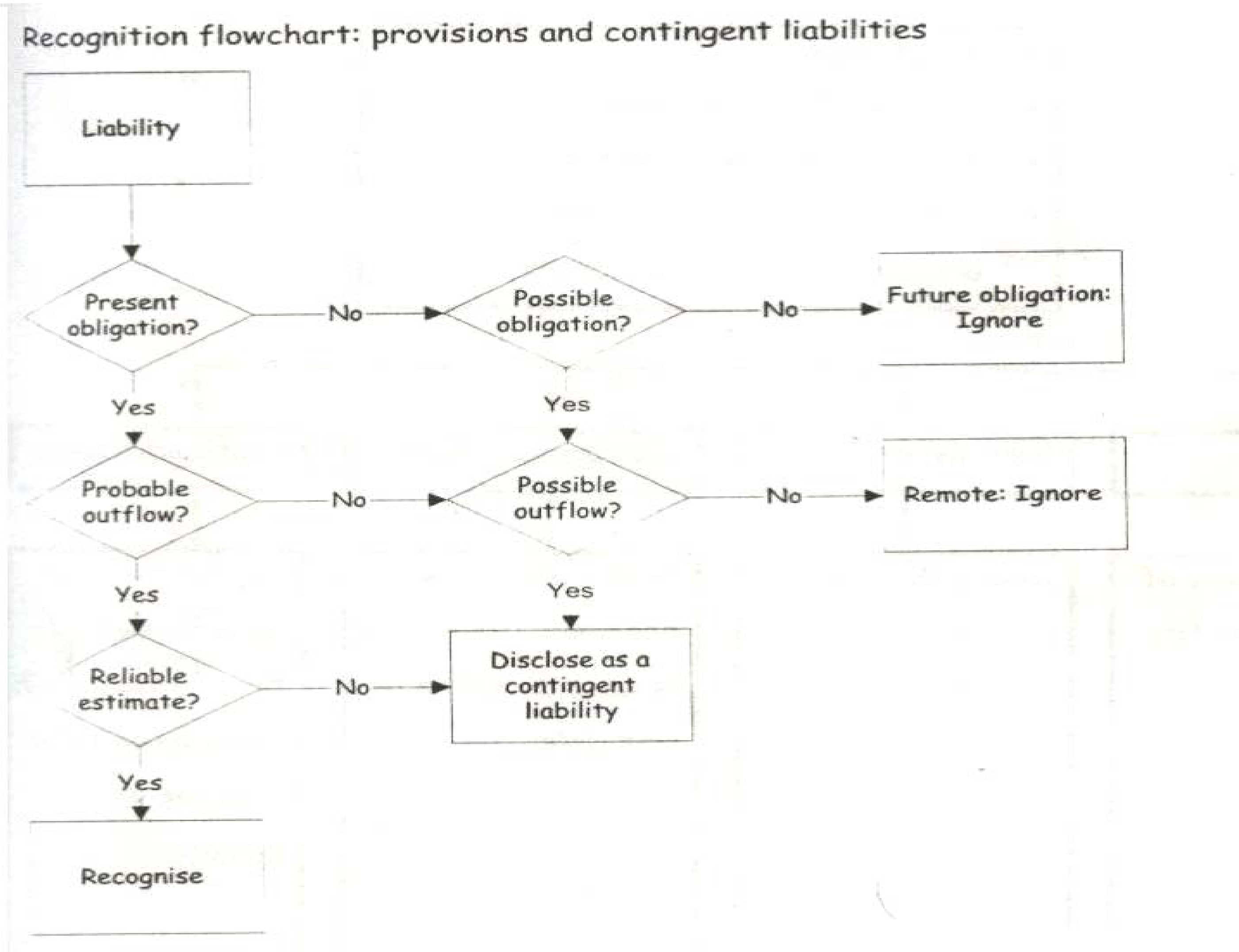
Flow Chart for Recognition of Liabilities:



Liabilities side of Balance Sheet

Deferred Taxation	13	30,796	45,205
Obligation Under Lease Finance	14	-	-
		30,796	45,205
		1,762,469	**1,514,308**
Current Liabilities			
Short Term Finances	15	-	144,331
Current Maturity of Obligation under lease finance	16	-	1,316
Creditors, Accrued and Other liabilities	17	415,362	322,746
Provision for Taxation		181,667	166,164
Other Provisions	18	5,020	4,110
Divided Payable	19	139,699	109,439

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Capital

- Capital is the funds contributed by the owners of the entity to run the business of the entity.
- Funds may also be provided by the owners in the form of a loan. Such funds will be treated as a loan and not as Capital.

Treatment of Capital in Sole Proprietorship

- All money payable to the owner of a sole proprietorship is shown as capital.
- Profit earned during the period (year) is added to his capital.
- Any funds taken out for personal use (drawings) are subtracted from the capital.
- Any funds contributed are also added to the capital.

Presentation in the balance sheet:

	2--1	2--0
Capital		
Opening Balance	xxx	xxx
Add: Capital Introduced	xxx	xxx
Add: Profit for the Period	xxx	xxx
Less: Drawings	(xxx)	(xxx)
Closing Balance	xxx	xxx

Treatment of Capital in Partnership

- The only difference of treatment and presentation of capital in partnership from that in sole proprietorship is that in partnership record of capital of each partner is maintained.
- In case of profit, share of individual partner is shown in the reconciliation of opening and closing balance of capital individual partner.

NGO's / NPO's

- In case of NGO's and NPO's there is no concept of capital.
- Funds introduced by the sponsors and any accumulated surplus are shown as a General Fund.

Companies

- In case of companies or limited companies share capital is subdivided into shares of smaller denominations. e.g. A share capital of Rs. 100,000 may be subdivided into 1,000 shares of Rs. 100 each or 10,000 shares of Rs. 10 each.
- An individual can own a minimum of one share and a maximum of all shares (in case of single member company).
- These shares are serially numbered i.e. in case of the earlier example No. 1 to No. 1,000 in case of Rs 100 share and No. 1 to No. 10,000 share in case of Rs. 10 share.
- Every person who owns the shares is called shareholder or member of the company.

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- The company issues a certificate to every member as an evidence of ownership of shares.

- These certificates are called share certificates.

Section 89 of Companies Ordinance 1984

- **Nature of shares and certificate of shares:**

    (1) The shares or other interest of any member in a company shall be moveable property, transferable in the manner provided by the articles of the company.

    (2) Each share in a company shall have a distinctive number.

    (3) A certificate under the common seal of the company specifying any shares held by any member shall be *prima facie* evidence of the title of the member to the shares therein specified.

- **Authorized Capital:**

  A maximum limit of the amount of capital that a company can issue is mentioned in the Memorandum and Articles of Association of the company. Company cannot issue capital exceeding this amount unless it amends the memorandum and articles of association.

- **Paid Up Capital:**

  Paid up capital is amount that the company issues out of the authorized capital.

- The minimum amount of capital that a company can issue is one share each for each of its members and the maximum is equal to the authorized capital.

- A company can issue shares of different classes having different denominations and different rights attached to them.

Section 90 Companies Ordinance 1984

- **Classes and kinds of share capital**.- A company limited by shares may have different kinds of share capital and classes therein as provided by its memorandum and articles:

- Provided that different rights and privileges in relation to the different classes of shares may only be conferred in such manner as may be prescribed.

Information to be Disclosed

- Share capital shall be classified under the following subheads:

  ✓ Issued, subscribed and paid up capital, distinguishing in respect of each class between,

    (a) Shares allotted for consideration paid in cash;
    (b) Shares allotted for consideration other than cash, showing separately shares issued against property and others (to be specified); and
    (c) Shares allotted as bonus shares.

Lecture 23

Share Capital

Shares issued at Premium, issued at Discount, Further issue of Capital, Reduction in share capital and Repurchase of shares.

Share capital or issued capital or capital stock refer to the portion of a company's equity that has been obtained (or will be obtained) by trading stock to a shareholder for cash or an equivalent item of capital value. For example, a company can set aside share capital to exchange for computer servers instead of directly purchasing the servers from existing equity

Shares Issued at Premium.

- A company may issue shares at price greater than the face value of the shares. i.e. the company would offer a Rs. 10 share for say Rs. 20 or any amount greater than Rs. 10.

- The amount in excess of the face value of the share is called Premium.

- Companies Ordinance 1984 allows issuance of shares at premium and prescribes following treatment for the premium:

Shares Issued at Premium (Contd.) – Section 83 of Companies Ordinance 1984.

- **(1)** Where a company issues shares at a premium, whether in cash or otherwise, a sum equal to the aggregate amount or the value of the premiums on those shares shall be transferred to an account, to be called "the share premium account"; and the provisions of this Ordinance relating to the reduction of the share capital of a company shall, except as provided in this section, apply as if the share premium account were paid-up capital of the company.

- **(2)** The share premium account may, notwithstanding anything contained in sub-section (1), be applied by the company:

  (a) In writing off the preliminary expenses of the company;

  (b) In writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company;

  (c) In providing for the premium payable on the redemption of any redeemable preference shares or debentures of the company; or

  (d) In paying up un-issued shares of the company to be issued to members of the company as fully paid bonus shares.

- **(3)** Where a company has before the commencement of this Ordinance, issued any shares at a premium, this section shall apply as if the shares had been issued after such commencement.
  Provided that any part of the premium which has been so applied that it does not at the commencement of this Ordinance form an identifiable part of the company's reserves within the meaning of the Fourth Schedule or the Fifth Schedule shall be disregarded in determining the sum to be included in the share premium account.

Share Issued at Discount.

- Issuance of shares at discount is the inverse of issuance at premium i.e. the company would issue Rs. 10 shares at an amount less than Rs. 10.
- The conditions and treatment of discount is as follows:

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Share Issued at Discount – Section 84.

- **(1)** Subject to the provisions of this section, it shall be lawful for a company to issue shares in the company at a discount: Provided that;

  (a) The issue of the shares at a discount must be authorized by resolution passed in general meeting of the company and must be sanctioned by the Commission;

  (b) The resolution must specify the maximum rate of discount, at which shares are to be issued;

  (c) Not less than one year must at the date of issue have elapsed since the date on which the company was entitled to commence business; and

  (d) The share to be issued at a discount must be issued within sixty days after the date on which the issue is sanctioned by the Commission or within such extended time as the Commission may allow.

Share Issued at Discount (Contd.)

- Discount allowed on shares will not be treated as a reduction in share capital but will be written off as expense or charged to a share premium account as allowed by Section 83.

Share Issued at Discount – Section 84 (2).

- Where a company has passed a resolution authorizing the issue of shares at a discount, it may apply to the Commission for an order sanctioning the issue; and on such application the Commission may, if, having regard to all the circumstances of the case, it thinks proper so to do, make an order sanctioning the issue on such terms and conditions as it thinks fit.

Share Issued at Discount – Section 84 (3).

- Issue of shares at a discount shall not be deemed to be reduction of capital.

Share Issued at Discount – Section 84 (4).

- Every prospectus relating to the issue of shares, and every balance sheet issued by the company subsequent to the issue of shares, shall contain particulars of the discount allowed on the issue of the shares or of so much of that discount as has not been written off at the date of the issue of the prospectus or balance sheet.

Share Issued at Discount – Section 84 (5).

- If default is made in complying with sub-section (4), the company and every officer of the company who is in default shall be liable to a fine not exceeding two thousand rupees.

Further Issuance of Capital

- It is not necessary that all of the capital of a company is issued in one go. A company can increase its share capital subject to certain condition within the limits of authorized capital.

- Increase in share capital can take place in one of the following forms:

- **Further issue:**
  "Where the new shares are offered to people other than current share holders, in case of public companies, subject to approval of Federal Govt"

- **Right issue:**
    - Offer to existing share holders, to subscribe new shares in the ratio of their existing holding
- **Bonus issue:**
    - Where accumulated profit is capitalized by issuance of shares,

Following conditions have been laid down by Companies Ordinance for further issue of capital.

Further Issue of Capital – Section 86.

- **(1)** Where the directors decide to increase the capital of the company by the issue of further shares, such shares shall be offered to the members in proportion to the existing shares held by each member, irrespective of class, and such offer shall be made by notice specifying the number of shares to which the member is entitled and limiting a time, within which the offer, if not accepted, will be deemed to be declined:

  Provided that the Federal Government may, on an application made by any public company on the basis of special resolution passed by it, allow such company to raise its further capital without issue of right shares:

  Provided, further that a public company may reserve a certain percentage of further issue of its employees under "Employees Stock Option Scheme" to be approved by the Commission in accordance with the rules made under this Ordinance.

- **(2)** The offer of new shares shall be strictly in proportion to the number of existing shares held:

  Provided that fractional shares shall not be offered and all fractions less than a share shall be consolidated and disposed of by the company and the proceeds from such disposition shall be paid to such of the entitled shareholders as may have accepted such offer.

- **(3)** The offer of new shares shall be accompanied by a circular duly signed by the directors or an officer of the company authorized by them in this behalf in the form prescribed by the Commission containing material information about the affairs of the company, latest statement of the accounts and setting forth the necessity for issue of further capital.

- **(4)** A copy of the circular referred to in sub-section (3) duly signed by the directors or an officer authorized as aforesaid shall be filed with the registrar before the circular is sent to the shareholders.

- **(5)** The circular referred to in sub-section (3) shall specify a date by which the offer, if not accepted, will be deemed to be declined.

- **(7)** If the whole or any part of the shares offered under sub-section (1) is declined or is not subscribed, the directors may allot and issue such shares in such manner as they may deem fit.

Repurchase of Shares – Section 95 A.

- Following are the requirements and condition of repurchase of shares:

  ✓ Special resolution, indicating the maximum number of shares to be repurchased and the maximum price to be offered

  ✓ The purchase shall be in cash and out of the distributable profits.

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- ✓ In case of purchase at premium the amount of premium shall be charged to share premium account, in the absence of share premium the difference would be charged to distributable profits.
- ✓ If shares are purchased at a discount the discount will be credited to "Capital Repurchase Reserve Account"
- ✓ The shares purchased shall be cancelled forthwith
- ✓ The amount of paid up capital account would be reduced by the nominal amount of the shares repurchased.
- ✓ An amount equal to the nominal value of the shares repurchased will be transferred from distributable profits of the company and credited to "Capital Repurchase Reserve Account"

Reduction in Share Capital:

- There are two ways through which a company can reduce its paid up capital:
  - ✓ Repurchase of shares Section 95 A
  - ✓ Reduction in share capital Section 96

Reduction in Share Capital – Section 96

- Following are the requirements and condition of reduction in share capital:
  - ✓ Special resolution and approval of court,
  - ✓ The company may:
    - ✓ Extinguish or reduce liability on any shares in respect of unpaid share capital (not applicable)
    - ✓ Cancel any paid up share capital that is lost or not presented by any assets
    - ✓ Pay off any share capital that is in excess of its needs

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Lecture 24

Repurchase of Shares – Section 95 A

Following are the requirements and condition of repurchase of shares:

- ✓ Special resolution, indicating the maximum number of shares to be repurchased and the maximum price to be offered.
- ✓ The purchase shall be in cash and out of the distributable profits.
- ✓ In case of purchase at premium the amount of premium shall be charged to share premium account, in the absence of share premium the difference would be charged to distributable profits.
- ✓ If shares are purchased at a discount the discount will be credited to "Capital Repurchase Reserve Account".
- ✓ The shares purchased shall be cancelled forthwith.
- ✓ The amount of paid up capital account would be reduced by the nominal amount of the shares repurchased.

- An amount equal to the nominal value of the shares repurchased will be transferred from distributable profits of the company and credited to "Capital Repurchase Reserve Account"
- Capital Repurchase Account is considered as if it was the paid up share capital of the company except that the reserve account may be applied by the company to issue fully paid up bonus shares to the members of the company

Repurchase of Shares - Accounting

- Shares repurchased at premium Rs. 10/- share purchased for Rs. 12/-

i)	Debit Paid up Capital	10	
	Debit Share Premium OR Accumulated P & L	2	
	Credit Cash		12
ii)	Debit Accumulated. P & L Account	10	
	Credit Capital Repurchase Reserve		10

Repurchase of Shares - Accounting

- Shares repurchased at discount Rs. 10/- share purchased for Rs. 8/-

i)	Debit: Paid up Capital	10	
	Credit: Cash		8
	Credit: Capital Repurchase Reserve		2
ii)	Debit: Accumulated P & L Account	8	
	Credit: Capital Repurchase Reserve		8

Reduction in Share Capital

There are two ways through which a company can reduce its paid up share capital:

- ✓ Repurchase of shares Section 95 A
- ✓ Reduction in share capital Section 96

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Reduction in Share Capital – Section 96

- Following are the requirements and condition of reduction in share capital:
  - ✓ Special resolution and approval of court,
  - ✓ The company may:
    - ✓ Extinguish or reduce liability on any shares in respect of unpaid share capital Cancel any paid up share capital that is lost or not presented by any assets
    - ✓ Pay off any share capital that is in excess of its needs

Difference between Repurchase and Reduction in share capital:

Repurchase Section 95 A	**Reduction Section 96**
Applies to listed companies only	Applies to all companies
Approval of court is not required	Approval of court is required
The purchase shall always be out of cash. An amount equal to face value of shares repurchased will be transferred from distributable profits to capital repurchase account	Any paid-up share capital which is lost or un-represented by available assets can be cancelled
Creditors are not entitled to object to repurchase.	Creditors are entitled to object to a reduction and the company will have to settle with the creditors to the satisfaction of the court.
Company is required to maintain a capital repurchase reserve	There is no such requirement.

Disclosure Requirements of Share Capital

- Share capital classified under the following sub-heads, namely:
  - ✓ Issued, subscribed and paid up capital, distinguishing in respect of each class between:
  - ✓ Shares allotted for consideration paid in cash;
  - ✓ Shares allotted for consideration other than cash, showing separately shares issued against property and others (to be specified); and
  - ✓ Shares allotted as bonus shares.

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- If the share capital is divided into different classes of shares, namely ordinary, preference etc. For each separate class of share capital, the following is disclosed:

  a) Authorized Capital
     Number of Shares
     Nominal value
  b) Paid up Capital
     Number of Shares
     Nominal value

  c) Reconciliation of number of shares outstanding at beginning and end of the year.

  d) The rights, preferences and restrictions attaching to each class of share capital including restrictions on the distribution of dividends and the repayment of capital.

  e) Shares in the Company held by the Company itself or by subsidiaries or associates of the Company.

  f) Shares reserved for issuance under options and sales contracts, including the terms and amounts.

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Lecture 25

Prospectus & Non-Current Liabilities – 4th Schedule

Prospectus – Section 2 (1) 29

- A prospectus is defined as:

  ✓ “Prospectus" means any document described or issued as prospectus, and includes any notice, circular, advertisement, or other communication, inviting offers from the public for the subscription or purchase of any shares in, or debentures of, a body corporate, or inviting deposits from the public, other than deposits invited by a banking company or a financial institution approved by the Federal Government, whether described as prospectus or otherwise;

Prospectus

A private company is not required to issue a prospectus as it is prohibited by its articles from inviting general public to subscribe for its shares.

- A public company that does not intend to approach the public for rising of capital is not required to issue prospectus.
- It is required to file a statement in lieu of prospectus with SECP before allotment of shares.

In case of public companies, that intend to raise capital from general public, directors / promoters invite general public to subscribe to the shares of the company after the company has been incorporated.

Contents of Prospectus – Section 53 (1)

- **Matters to be stated and reports to be set out in prospectus.-**

  (1) Every prospectus issued:

    a) by or on behalf of a company, or

    b) by or on behalf of any person who has been engaged or interested in the formation of a company, shall state the matters specified in section 1 of Part I of the Second Schedule and set out the reports specified in section 2 of that Part and the said sections 1 and 2 shall have effect subject to the provisions contained in section 3 of that part.

Contents of Prospectus

- Objects of the company and signatories to the memorandum
- Capital structure
- Redeemable capital
- Qualification shares, if any for the directors
- Particulars of directors, chief executive
- Minimum subscription
- Face value of the share

- Time for opening of subscription list
- Shares issued for consideration other than cash.
- Premium or discount on issue of shares.
- Particulars of property purchased
- Underwriters
- Particulars of underwriting commission
- Preliminary Expenses
- Benefits to promoters
- Particulars of contracts
- Auditors
- Nature and extent of interest or directors
- Nature and extent of interest or directors promoters
- Voting and other rights

Non-Current Liabilities – 4th Schedule

- **8(A)** Non-current liabilities shall be classified under appropriate subheads, duly itemized such as:

  (i) **L**ong term financing;
  (ii) Debentures;
  (iii) Liabilities against assets subject to finance lease;
  (iv) Long term Murabaha;
  (v) Long term deposits; and
  (vi) Deferred Liabilities.

- **8.(B)** Long term loans shall be classified as secured and unsecured, and under each class shall be shown separately:

  (i) Loans from banking companies and other financial institutions, other than those as specified in clause (ii) below;
  (ii) Loans from related parties; and
  (iii) Other loans

- **8. (C)** Long-term deposits shall be classified according to their nature.

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Non-Current Liabilities – IAS

(i) Long Term Financing;	**IAS 32 & 39 (Financial Instruments)** **Already covered**
(ii) Debentures;	**IAS 32 & 39 (Financial Instruments)**
(iii) Liabilities against assets subject to finance lease;	**IAS 17 Leases** **(Will be covered later)**
(iv) Long Term Murabaha; (Trade financing where Islamic bank purchased goods & services on behalf of the customer, means financing is done by bank and client pay back to bank for its services and financing).	**IAS 32 & 39 (Financial Instruments)**
(v) Long Term Deposits;	**IAS 32 & 39 (Financial Instruments)**
(vi) Deferred Liabilities.	**Deferred Tax IAS 12** **Not included in course**

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Lecture 26

Leasing – IAS 17

Lease (IAS-17)

Where goods are acquired other than on immediate cash terms, arrangements have to be made in respect of the future payments on those goods. In the simplest case of credit sales, the purchaser is allowed a period of time (say one month) to settle the outstanding amount and the normal accounting procedures in respect of receivables /payables will be adopted.

However, in recent years there has been considerable growth in leasing agreements some types of lease are called hire purchase agreements in some countries.

A finance lease may be a hire purchase agreement. The difference between these two is that under a hire purchase agreement the customer eventually, after paying an agreed number of installments, becomes entitled to exercise an option to purchase the asset.

A lessee may use a finance lease to fund the acquisition of a major asset which he will then use in his business perhaps for many years. The substance of the transaction is that he has acquired a non-current asset, and this is reflected in the accounting treatment prescribed by IAS 17, even though in law the lessee never becomes the owner of the asset.

Leasing transactions are extremely common so this is an important practical subject. Lease accounting is regulated by IAS 17 which was introduced because of abuses in the use of lease accounting by companies.

These companies effectively 'owned' an asset and 'owed' a debt for its

A lease is an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time.

The definition of lease includes contracts for the hire of an asset which contains the provision giving the hirer option to acquire title to the asset upon fulfillment of agreed conditions. These contracts are sometimes known as hire purchase contracts.

Lessor:

Lessor is the person who originally owns the rights to use the asset in other words he owns the asset and allows the lessee to use it.

Lessee:

Lessee is the person who utilizes the right to use the asset for a specific period against a payment or series of payments.

Finance Lease:

A lease is classified as a finance lease if it transfers substantially all the risks and rewards incident to ownership.

Operating Lease:

A lease is classified as an operating lease if it not transfers substantially all the risks and rewards incident to ownership.

Classification of Leases

Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract.

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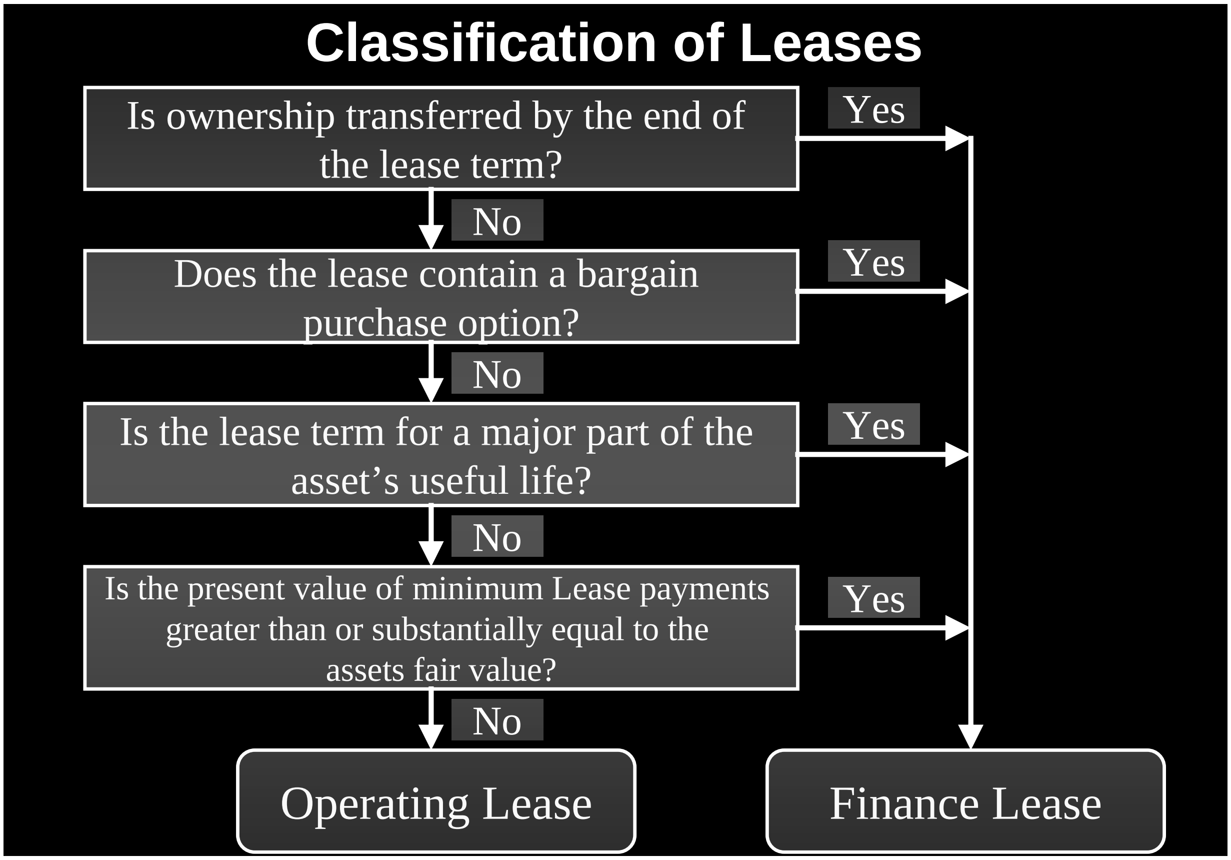

Substance over Form

Transactions and other events are accounted for and presented in accordance with their substance and economic reality and not merely their legal form.

Classification of Leases (Contd.)

Examples of situations which individually or in combination would normally lead to a lease being classified as a finance lease are:

1. Lease transfers ownership of assets by the end of lease term from lessor to lessee.

2. The lessee has an option to purchase the asset at a price that is expected to be sufficiently lower than the fair market value at the date the option becomes exercisable such that, at the inception it is reasonably certain that the option will be exercised.

3. The lease term is for the major part of the economic life of the asset even if title is not transferred.

4. At the start of the lease the present value of minimum lease payments amount to at least substantially all of the fair value of the leased asset.

5. The leased assets are of the specialized nature such that only the lessee can use them without major modifications.

Finance Lease – IAS 17

Finance Lease is a lease that transfers substantially all the risks and rewards incident to ownership of an asset. Title may or may not be transferred.

Finance Lease

Risks and rewards associated with the ownership:

- ✓ Unrestricted right to use the asset.
- ✓ Gain from appreciation in the value of the asset.
- ✓ Loss due to any accident or improper handling of the asset.

In finance lease asset is recognized in the books of the lessee because in substance the asset is owned by the lessee even if in the legal form (legal title) it is owned by the lessor.

Operating Lease (IAS-17)

An operating lease is a lease other than a finance lease.

Minimum Lease Payments:

All the payments over the lease term that the lessee is or can be required, to make excluding contingent rent, cost of services and taxes to be paid by and reimbursed to the lessor, together with:

a. In case of lessee, any amount guaranteed by the lessee or by a party related to lessee.

b. In case of lessor, any residual value guaranteed to the lessor by either

c. The lessee,

- ➢ Any party related to lessee, or
- ➢ Any independent third party financially capable of meeting the guarantee.

Contingent Rent

Future rentals are not fixed per period, but depend upon future events and therefore cannot be ascertained at the inception of lease. The rentals are based upon any basis other than time period examples are rentals based on future sales volume and future machine hours etc.

It is that portion of the lease payment that is not fixed in amount but is based on the future amount of a factor that changes other than with the passage of time for example. Percentage of future sales, amount of future use, future price indices, future market rate of interest.

Minimum Lease Payments

- Minimum Lease Payments include:
  - ✓ Initial payment OR down payment
  - ✓ All lease rentals
  - ✓ Any amount that is guaranteed to be paid during or at the end of the lease term.

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- Minimum Lease Payments do not include:
  - ✓ Contingent rent
  - ✓ Any processing charges
  - ✓ Taxes (such as registration fee of vehicles) paid by lessor and recovered from lessee
  - ✓ Insurance paid by lessor and recovered from lessee

Fair Value

- Is the amount for which an asset could be exchanged or a liability settled, between knowledgeable, willing parties in an arms length transaction.

Economic Life

- Is either: the period over which an asset is expected to be economically usable by one or more users; or the number of production or similar units expected to be obtained from the asset by one or more users.

Guaranteed Residual Value

- ✓ In case of the lessee, that part of the residual value that is guaranteed by the lessee or by a party related to the lessee; and the amount of the guarantee being the maximum amount that could in any event become payable.
- ✓ In case of the lessor, that part of the residual value which is guaranteed by the lessee or by a third party unrelated to the lessor who is financially capable of discharging the obligation.

Un-guaranteed Residual Value

- It is that portion of the residual value of the leased asset, the realization of which by the lessor is not assured, or is solely guaranteed by a party related to the lessor.
- The interest rate implicit in the lease is the discount rate that, at the inception of the lease causes the aggregate present value of:
  - ✓ The minimum lease payment; and
  - ✓ The un-guaranteed residual value
- To be equal to the fair value of the leased asset.

Summary

- Classification of leases amongst Finance and Operating is based on the extent to which risks and rewards incident to ownership of the leased asset lie with the lessor or lessee.
- Risks include possibilities of losses from idle capacity or technological obsolescence.
- Variations in return due to changing economic conditions.
- Rewards may be represented by expectation of profitable operation over the assets economic life and of gain from the appreciation in the value or realization of residual value.

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- Indicators of situations which individually or in combination could also lead to a lease being classified as a finance lease are:

  a. If the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;

  b. Gains or losses from the fluctuation in the fair value of the residual fall to the lessee; and

  c. The lessee has the ability to continue the lease for a secondary period at a rent which is substantially lower than market rent.

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Lecture 27

Leasing – IAS 17 (Contd.)

Sale and Lease Back

Under this type of transaction, the holder of an asset sells it to another party and then immediately leases it back again. Both the lease payments and the sale price are interdependent upon each other because they are negotiated as a package.

As the sale is dependent upon a lease being entertained the apparent profit or loss which is the difference between the carrying value and the sale price, will be recorded on the type of lease being entertained.

Sale and Lease Back (Finance lease)

- Any profit or excess of sale proceeds over the carrying amount shall not be immediately recognized as income by the seller that is lessee.

- Instead it shall be deferred and amortized over the lease term (IAS-17 Para 59).

Sale and Lease Back (Operating lease)

a. If the sale price is at fair value profit or loss is recognized immediately.

b. If the sale value is below the fair value profit or loss is recognized immediately unless the loss is compensated by future rentals at below market price of commercial rate. In such event the loss is amortized in proportion to lease payments over a period of which the asset is expected to be used.

c. If the sale price is above fair value the excess shall be deferred and amortized over the period of which the asset is expected to be used.

d. If fair value is less than the carrying amount the loss shall be recognized immediately.

Operating Lease:

A lease is classified as an operating lease if it not transfers substantially all the risks and rewards incident to ownership.

In other words:

- "A lease other than a finance lease".

Recording of operating lease in the books of lessee:

✓ Asset is not recorded in the books of lessee.

✓ Rentals paid are recorded as expense.

Operating Leases – IAS 17

Lease payments under an operating lease should be recognized as an expense in the income statement on a straight line basis over the lease term unless another systematic basis is representative of the time pattern of the user's benefit.

Operating Lease – Disclosure

- Lessees should, in addition to the requirements of IAS 32, Financial Instruments: Disclosure and presentation, make the following disclosers for operating leases:

a) The total of future minimum lease payments under non-cancelable operating leases for each of the following periods;

   - Not later than one year,
   - Later than one year and not later than five years,
   - Later than five years;

- Although no liability is recorded, but as the agreement is non-cancelable and future payments will become due, a disclosure is given for the future commitments.

b) The total future minimum sublease payments expected to be received under non-cancelable sublease at the balance sheet date;

- If the lessee has given the asset on a sublease then there is a committed receivable in the future, which is disclosed in the financial statements.

c) Lease and sublease payments recognized in income for the period, with separate amounts for minimum lease payments, contingent rents, and sublease payments;

- Lease payments are recognized as expense and sublease payments received are recognized as income. A disclosure of both along with any contingent rent recorded in the Profit and Loss is disclosed.

d) A general description of the lessee's significant leasing arrangements including, but not limited to, the following;

   a. The basis on which contingent rent payments are determined;

   b. The existence and terms of renewal or purchase options and escalation clauses; and

   c. Restrictions imposed by lease agreements, such as those concerning dividends, additional debts, and further leasing.

Finance Lease:

A lease is classified as a finance lease if it transfers substantially all the risks and rewards incident to ownership.

Recording of Finance lease in the books of lessee:

- Lessee records the asset at its fair value and a liability with the same amount.

- Lessee also claims depreciation on the leased asset.

- Lease payments are apportioned between principal repayment and markup portion.

- Lessee should recognize finance lease as asset and liabilities in their balance sheets at amounts equal at the inception of the lease to the fair value of the leased property or, if lower, at the present value of the minimum lease payments. In calculating the present value of minimum lease payments the discount factor is the interest rate implicit in the lease.

- Lease payments should be apportioned between the finance charge and the reduction of the outstanding liability. The finance charge should be allocated to periods during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability for each period.

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- A finance lease gives rise to a depreciation expense for the asset as well as a finance expense for each accounting period.

- The depreciation policy for leased asset should be consistent with that for depreciable assets which are owned and the depreciation recognized should be calculated on the basis set out in IAS 16 Property plant and equipment

- If there is no reasonable certainty that the lessee will obtain ownership by the end of lease term, the asset should be fully depreciated over the shorter of lease term or its useful life.

Accounting Treatment:

- IAS 17 requires that, when an asset changes hands under a finance lease, lessor and lessee should account for the transaction as though it were a credit sale. In the lessee's books therefore:

DR. Asset subject to Finance Lease (Asset Account)
CR. Liability subject to Finance Lease (Lessor's liability account)

The amount to be recorded in this way is the lower of the fair value and the present value of the minimum lease payments.

- A variant approach which produces the same net result is to debit the asset account with the fair value, and to debit an interest suspense account with the total amount of interest or finance charges payable under the agreement and to credit a lessor account with the total amount (capital and interest) payable under the agreement.

- IAS 17 states that it is not appropriate to show liabilities for leased assets as deductions from the leased assets. A distinction should be made between current and non-current lease liabilities, if the entity makes this distinction for other assets.

- The asset should be depreciated (on the basis setout in IAS 16 and 38) over the shorter of:

  a. The lease term,
  b. The asset's useful life,

- If there is reasonable certainty of eventual ownership of the asset, then it should be depreciated over its useful life.

Apportionment of rental payments:

- When the lessee makes a rental payment it will comprise two elements.

  a) An interest charge of the finance provided by the lessor. This proportion of each payment is interest payable and interest receivable in the income statements of the lessee and lessor respectively.

  b) A repayment of part of the capital cost of the asset. In the lessee's books this proportion of each rental payment must be debited to the lessor's account to reduce the outstanding liability. In the lessor's books, it must be credited to the lessee's account to reduce the amount owing (the debit of course is to cash)

Finance Lease – Disclosure

The disclosures of finance leases are approximately same as disclosures of operating leases.

- The net carrying amount at the balance sheet date for each class of asset.

- Reconciliation between the total of minimum lease payments at the balance sheet date, and their present value. In addition, an enterprise should disclose the total of minimum lease payments at the balance sheet date, and their present value, for each of the following periods:

  - Not later than one year,
  - Later than one year and not later than five years,
  - Later than five years;

- Contingent rents recognized in income for the period.

- Total of future minimum sublease payments expected to be received under non-cancelable sublease at the balance sheet date.

- A general description of the lessee's significant leasing arrangements including, but not limited to, the following:

  - ✓ The basis on which contingent rent payments are determined,
  - ✓ The existence and terms of renewal or purchase options and escalation clauses.
  - ✓ Restrictions imposed by lease agreements, such as those concerning dividends, additional debts, and further leasing.

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Lecture 28

Leasing – IAS 17 (Contd.)

Finance Lease – IAS 17

- Lessee should recognize finance lease as asset and liabilities in their balance sheets at amounts equal at the inception of the lease to the fair value of the leased property or, if lower, at the present value of the minimum lease payments. In calculating the present value of minimum lease payments the discount factor is the interest rate implicit in the lease.

- Lease payments should be apportioned between the finance charge and the reduction of the outstanding liability. The finance charge should be allocated to periods during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability for each period.

- If there is no reasonable certainty that the lessee will obtain ownership by the end of lease term, the asset should be fully depreciated over the shorter of lease term or its useful life.

Finance Lease - Disclosures

- Lessee should in addition to meeting the requirements of IAS 32 Financial Instruments: Disclosure and Presentation, make following disclosures for finance leases:

  a. For each class of asset, the net carrying amount at the balance sheet date (fixed assets schedule)

  b. Reconciliation between the total of future minimum lease payments at the balance sheet date, and their present value. In addition, an entity shall disclose the total future minimum lease payments and their present value, for each of the following periods:

     – Not later than one year,
     – Later than one year and not later than five years
     – Later than five years

  c. Contingent rents recognized as an expense in the period in which they occur.

  d. The total of future minimum sublease payments expected to be received under a non-cancelable sublease at the balance sheet date.

  e. A general description of the lessee's material leasing arrangements including but not limited to, the following:

     i. The basis on which contingent rent payable is determined;
     ii. The existence and terms of renewal or purchase options and escalation clauses
     iii. Restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and future leasing.

- In addition, the requirements for disclosure in accordance with IAS 16 (Property Plant and Equipment), IAS 36 (Impairment of Assets), IAS 40 (Investment Property) and IAS 41 (Agriculture) apply to lessees for assets leased under finance lease.

Recognition and Disclosure of Leases

✓ Transfer of ownership at the end of lease term.

✓ Option to purchase the asset at a price sufficiently lower than the FV of the asset

- ✓ Lease term for major part of economic life of asset.
- ✓ PV of MLP substantially equals the FV of leased asset.
- ✓ Specialized nature of assets

Minimum Lease payments (MLP)

Definitions – IAS 17

- MLP include:
  - ✓ Initial payment OR down payment
  - ✓ All lease rentals
  - ✓ Any amount that is guaranteed to be paid during or at the end of the lease term.
- MLP do not include:
  - ✓ Contingent rent
  - ✓ Any processing charges
  - ✓ Taxes (such as registration fee of vehicles) paid by lessor and recovered from lessee
  - ✓ Insurance paid by lessor and recovered from lessee

Recognition and Disclosure of Leases

- Present value of minimum lease payments is calculated using the interest rate implicit in the lease. This present value is then compared with the current fair value of the asset.
- This Present Value (PV) should be substantially equal the Fair value (FV) of the asset.
- "Substantially Equal" is not defined anywhere but generally 90% or more is considered to be substantially equal.

Example

Consider the following example:

- ✓ An asset costs Rs. 112,550.
- ✓ A leasing company is willing to lease it on 12 monthly lease rentals of Rs. 10,000.
- ✓ The interest rate implicit in the lease is 1% p.m.
- ✓ Present value of these

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Fair Value:	112,550
Installments:	12
	10,000
IRR p.m.	1%

Calculation of PV		PV	
1	10,000	9,901	$=10000x(1.01)^{-1}$
2	10,000	9,803	$=10000x(1.01)^{-2}$
3	10,000	9,706	$=10000x(1.01)^{-3}$
4	10,000	9,610	$=10000x(1.01)^{-4}$
5	10,000	9,515	$=10000x(1.01)^{-5}$
6	10,000	9,420	$=10000x(1.01)^{-6}$
7	10,000	9,327	$=10000x(1.01)^{-7}$
8	10,000	9,235	$=10000x(1.01)^{-8}$
9	10,000	9,143	$=10000x(1.01)^{-9}$
10	10,000	9,053	$=10000x(1.01)^{-10}$
11	10,000	8,963	$=10000x(1.01)^{-11}$
12	10,000	8,874	$=10000x(1.01)^{-12}$
		112,550	

Example (Contd.):

We have restricted the above example to 12 months to explain the present value concept. In real life lease agreements are of 3 to 7 years duration.

Now let's try and separate the principal and finance charge from these lease rentals.

Fair Value:	112,550
Installments:	12
	10,000
IRR p.m.	1%

	Lease Rental	Fin. Charge	Principal	Principal Outstanding
				112,550.00
1	10,000	1,126	8,874	103,676
2	10,000	1,037	8,963	94,713
3	10,000	947	9,053	85,660
4	10,000	857	9,143	76,517
5	10,000	765	9,235	67,282
6	10,000	673	9,327	57,955
7	10,000	580	9,420	48,535
8	10,000	485	9,515	39,020
9	10,000	390	9,610	29,410
10	10,000	294	9,706	19,704
11	10,000	197	9,803	9,901
12	10,000	99	9,901	-
Total	120,000	7,450	112,550	

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Recognition and Disclosure of Leases

- In the first month the amount utilized by the lessee is Rs. 112,550. The IRR is 1%.Therefore financial charges for the first month are 1,126. The remaining amount (10,000 – 1,126 = 8,874) is considered to be a payment towards principal outstanding.

- In the second month the principal outstanding is Rs. 103,676. Therefore financial charges for the month are 1,037. The remaining amount 8,963 is the repayment of principal outstanding. And so on.

Recognition and Disclosure of Leases

- Its accounting will be done as follows:
  - ✓ The asset will be recorded at its fair value i.e. Rs. 112,550 and depreciated according to company policy,
  - ✓ A corresponding lease liability will be recorded,
  - ✓ Every lease payment is split between finance charge and principal amount.

- By the end of the lease term of 12 months a loan repayment of 112,550 and finance charge payment of 7,450 would have been made.

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Lecture 29

Leasing – IAS 17 (Contd.)

Present Value

- Present value has been defined in the framework as:
  - ✓ A current estimate of the present discounted value of the future net cash flows in the normal course of business.

- Time Value of Money
- Present Value &
- Future Value

$(1 + 0.12)^1$

Today	One Year Later
Rs. 100	Rs. 112

Compounding / Future Value

Present Value x $(1 + r)^{time}$

$100 \times (1+0.12)^1 = 112$

Discounting / Present Value

Future Value x $(1 + r)^{-time}$

$112 \times (1+0.12)^{-1} = 100$

Fair Value:	112,550
Installments:	12
	10,000
IRR p.m.	1%

Calculation of PV			PV	
	1	10,000	9,901	$=10000\text{x}(1.01)^{-1}$
	2	10,000	9,803	$=10000\text{x}(1.01)^{-2}$
	3	10,000	9,706	$=10000\text{x}(1.01)^{-3}$
	4	10,000	9,610	$=10000\text{x}(1.01)^{-4}$
	5	10,000	9,515	$=10000\text{x}(1.01)^{-5}$
	6	10,000	9,420	$=10000\text{x}(1.01)^{-6}$
	7	10,000	9,327	$=10000\text{x}(1.01)^{-7}$
	8	10,000	9,235	$=10000\text{x}(1.01)^{-8}$
	9	10,000	9,143	$=10000\text{x}(1.01)^{-9}$
	10	10,000	9,053	$=10000\text{x}(1.01)^{-10}$
	11	10,000	8,963	$=10000\text{x}(1.01)^{-11}$
	12	10,000	8,874	$=10000\text{x}(1.01)^{-12}$
	Total	120,000	112,550	

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Present Value Factor

Future Value x $(1+i)^{-time}$

Present Value Factor

Interest Rate Implicit in the Lease (IRR)

- Interest rate implicit in the lease is the discount rate that, at the inception of the lease, causes the aggregate present value of (a) the minimum lease payments and (b) the Unguaranteed residual value to be equal to the sum of (i) the fair value of the leased asset and (ii) any initial direct costs of the lessor.

Presentation and Disclosure of Finance Leases

- Cash price of the asset Rs. 771,000.
- Assets leased on Jul 01, 05
- Lease payments:

  - ✓ Security deposit Rs. 200,000
  - ✓ Lease rentals include 4 annual installments starting from June 30, 06.
  - ✓ IRR 15% p.a.
  - ✓ Depreciation charged at 20% on WDV.
  - ✓ Residual value Rs. 200,000. The contract has an option to adjust the security deposit against the residual value.

Fair Value / Cost	771,000	
No of Installments:	4	Yearly
Installment Amount	200,000	
Security Deposit	200,000	
IRR p.a.	15%	
Principal Outstanding (771,000 - 200,000)	571,000	

	Lease Rental	Fin. Charge	Principal	Principal Outstanding
				571,000
1	200,000	85,650	114,350	456,650
2	200,000	68,498	131,502	325,148
3	200,000	48,772	151,228	173,920
4	200,000	26,080	173,920	-
	800,000	229,000	571,000	

Recording

- Recording of asset at the inception of lease July 01, 2005:

Dr. Asset Subject to Finance Lease a/c	771,000	
Cr. Liability Subject to Finance Lease a/c		771,000

- Transfer to current maturity at the inception of lease July 01, 2005:

Dr. Liability Subject to Finance Lease a/c	114,350	
Cr. Current Maturity of Lease a/c		114,350

- Payment of security deposit July 01, 2005

Dr. Security Deposits a/c	200,000	
Cr. Bank a/c		200,000

- Payment of first rental June 30, 2006:

Dr. Current Maturity of Lease a/c	114,350	
Dr. Financial Charges a/c	85,650	
Cr. Bank a/c		200,000

- Transfer to current maturity at the inception of lease June 30, 2006:

Dr. Liability Subject to Finance Lease a/c	131,502	
Cr. Current Maturity of Lease a/c		131502

- Depreciation June 30, 2006:

Dr. Depreciation Exp. a/c	154,200	
Cr. Accumulated Dep. a/c		154,200

Information to be Disclosed

- Profit and Loss Account for the Year June 30, 2006:

Depreciation	Rs. 154,200
Lease finance charges	Rs . 85,650

- Balance Sheet as at June 30, 2006:
- Non-current Assets
  Carrying amount of the Asset Rs. 616,800
  "Assets Subject to Finance Lease"
  Security Deposit Rs. 200,000

- Balance Sheet as at June 30, 2006:
- Current Liabilities
  Current Maturity of Long Term Liabilities Rs. 131,502

- Balance Sheet as at June 30, 2006 (Non Current Liabilities):

  ✓ On the face of the balance sheet, sum of following figures will be shown under "Liabilities Against Asset Subject to Finance Lease"

  ✓ Principal portion of 3rd and 4th Installments (to be paid on June 30, 2008 and 2009 amounting to Rs. 151,228 and 173,920 respectively)

  ✓ Residual value of the asset amounting to Rs. 200,000.

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Disclosure Balance Sheet

- Balance Sheet as at June 30, 2006 (Non Current Liabilities):
  - ✓ In the notes to the accounts following information will be disclosed other than the narrative notes
  - ✓ Reconciliation between the opening and closing balance of the non-current liability
  - ✓ Disclosure of minimum lease payments payable within; 1 year; 2 to 5 years; and more than 5 years (if required) and a reconciliation of MLP and their Present Values.

Liabilities Against Assets Subject to Finance Lease:

	2006 Rupees	2005 Rupees
Balance as at 01 July	-	-
Assets acquired during the year	771,000	-
	771,000	-
Less: Repayments made during the year	114,350	-
	656,650	-
Transferred to current maturity	131,502	-
	525,148	-

Liabilities Against Assets Subject to Finance Lease:

	2006			2005		
	Minimum Lease Payments	Financial Charges For Future Periods	Present Value	Minimum Lease Payments	Financial Charges For Future Periods	Present Value
Not later than One year	200,000	68,498	131,502	-	-	-
Later than One year and not later than Five years.	600,000	74,852	525,148	-	-	-
	800,000	143,350	656,650	-	-	-

Lecture 30

Leasing – IAS 17 (Contd.) & Provisions, Contingent assets and Contingent Liabilities IAS 37

Security Deposit	200,000
IRR p.a.	15%
Principal Outstanding (771,000 - 200,000)	571,000

	Lease Rental	Financial Charges	Principal	Principal Outstanding
				571,000
1	173,915	-	173,915	397,085
2	173,915	59,563	114,352	282,733
3	173,915	42,410	131,505	151,228
4	173,915	22,687	151,228	-
	695,660	124,660	571,000	

Calculation of IRR

	Rental in Advance	Rental in Arrears
IRR	15%	15%
Loan Amount	(771,000)	(771,000)
Security Deposit	200,000	200,000
First Rental	173,915	
Net Amount Outstanding	(397,085)	(571,000)
Lease Rentals	173,915	200,000
	173,915	200,000
	173,915	200,000
		200,000

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Fair Value / Cost	771,000	
No of Installments:	4	Yearly (in advance)
Installment Amount	180,020	
Security Deposit	180,020	
IRR p.a.	15%	
Principal Outstanding (771,000 - 200,000)	590,980	

	Lease Rental	Finanacial Charge	Principal	Principal Outstanding
				590,980
1	180,020	-	180,020	410,960
2	180,020	61,644	118,376	292,584
3	180,020	43,888	136,132	156,452
4	180,020	23,568	156,452	-
	720,080	129,100	590,980	

Sample Notes to the Accounts

- **Policy:**

  ✓ Leased assets held under finance lease are stated at cost less accumulated depreciation at the rates and basis applicable to company owned assets. The outstanding obligations under the lease less finance charges allocated to future period is shown as liability. The financial charges are calculated at the interest rates implicit in the lease and are charged to the profit and loss account.

  ✓ Repairs and maintenance are charged to revenue. Material renewals and improvements are capitalized.

  ✓ Gain and loss on disposal of fixed assets are recognized in the profit and loss account.

- **Disclosure:**

  ✓ The average rate of interest used as the discounting factor (i.e. implicit in the lease) is 14.73% to 15.25% (2004: 14.75% to 15.25%) per annum. the lease agreements have the option for purchase of the assets at the end of the lease period. There are no financial restrictions in the lease agreements.

Current Liabilities – 4th Schedule Part II

9(A) Current liabilities and provisions shall, so far as they are appropriate to the company's business, be classified under the following sub- heads, namely:

(i) Trade and other payables, which shall be classified as:

(a) Creditors;
(b) Murabaha;
(c) Accrued liabilities;
(d) Advance payments;
(e) Payable to employee retirement benefits funds;
(f) Unpaid and unclaimed dividend; and
(g) Others (to be specified, if material);

(ii) Interest, profit, return or mark-up accrued on loans and other payables;
(iii) Short term borrowings which shall be classified as:

(a) Short-term borrowings, distinguishing between secured and unsecured and between loans taken from:

(i) Banking companies and other financial institutions other than related parties;
(ii) Related parties; and
(iii) Others;

(b) Short-term running finance, distinguishing between secured and unsecured;
(iv) Current portion of long term borrowings;
(v) Current portion of long term murabaha; and
(vi) Provision for taxation, showing separately income tax and other taxes.

Provisions, Contingent assets and Contingent Liabilities IAS 37

Definitions – IAS 37

Provision:

A provision is a liability of uncertain timing or amount.

Liability:

A liability is a present obligation of the entity arising from a past event the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

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Lecture 31

Provisions, Contingent Assets & Contingent Liabilities (Contd)

- **Accruals** are liabilities to pay for goods or services that have been received but have not been paid, invoiced or formally agreed with the supplier including amounts due to employees.

- Although it is sometimes necessary to estimate the amount or timing of accrual, the uncertainty is generally much less than provision

- **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; or

     ii) The amount of obligation cannot be measured with sufficient reliability.

- **A contingent asset** is a possible asset that arises from past events and whose existence will be confirmed only by the occurrence of one or more uncertain future events not wholly within the control of the entity.

- **An obligating event** is an event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation.

- **A legal obligation** is an obligation that derives from:

  a) A contract
  b) Legislation; or
  c) Other operation of law.

- **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 the other parties that it will accept certain responsibilities; and
  b) as a result, the entity has created valid expectation on the part of those other parties that it will discharge those responsibilities.

- **An onerous contract** is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.

Relationship between Provisions and Contingent Liabilities – IAS 37

- In general sense, all provisions are contingent because they are uncertain in timing or amount. However, within this standard the term 'Contingent' is used for liabilities and assets that are not recognized because their existence will be confirmed only by occurrence or non-occurrence of one or more uncertain future events not wholly with in the control of the entity.

Recognition – IAS 37

- A provision shall be recognized when:
  - ✓ An entity has a present obligation (legal or constructive) as a result of a past event;
  - ✓ It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
  - ✓ A reliable estimate can be made of the amount of obligation.

If these conditions are not met, no provision shall be recognized.

- 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:
  - Where a settlement of obligation can be enforced by law; or
  - In the case of a constructive obligation, where the event (which may be an action of the entity) created valid expectation in other parties that the entity will discharge the obligation.

- An entity should not recognize a contingent liability.

- A contingent liability is disclosed, unless the possibility of an outflow of resources embodying the economic benefits is remote.

- An entity should 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 process, where the outcome is uncertain.

- A contingent asset is disclosed, where an inflow of economic benefits is probable.

Disclosure Requirements – IAS 37

- For each class of provision, an entity will disclose:

  a) The carrying amount at the beginning and end of the period;
  b) Additional provisions made in the period, including increases to existing provisions;
  c) Amounts used (i.e. incurred and charged against the provision) during the period; and
  d) Unused amounts reversed during the period;
     Comparative information is not required

- An entity shall disclose the following for each class of provision:

  a) A brief descriptions of the nature of the obligation and the expected timing of any resulting outflows of economic benefit;
  b) An indication of the uncertainties about the amount or timing of those outflows. Where necessary to provide adequate information, an entity shall disclose the major assumptions made concerning future events; and

- The amount of any expected reimbursement, stating the amount of any asset that has been recognized for the expected reimbursement.

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- Unless the possibility of any outflow in settlement is remote, an entity shall disclose for each class of contingent liability at the balance sheet date a brief description of the nature of the contingent liability, and where practicable:

    a) An estimate of its financial effect;
    b) An indication of the uncertainties relating the amount or timing of any outflow; and
    c) The possibility of any reimbursement.

- Where an inflow of economic benefit is probable, an entity shall disclose a brief description of the nature of the contingent asset at balance sheet date, and, where applicable, an estimate of their financial effect.

- Where any of the information required by paragraphs above is not disclosed because it is not practicable to do so, the fact shall be stated.

- Disclosure of some or all of the information required by earlier can be expected to prejudice seriously the position of the entity in a dispute with other parties on the subject matter of the provision, contingent liability or contingent asset. In such cases, an entity need not disclose the information, but shall disclose the general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed.

Example - Warranties

- A manufacturer gives warranties at the time of sale to the purchaser of its products. Under the terms of the contract for sale the manufacturer undertakes to make good, by repair or replacement, manufacturing defects that become apparent within three years from the date of sale. On past experience, it is probable (i.e. more probable than not) that there will be some claims under the warranties.

- Present obligation as a result of past obligating event – the obligating event is the sale of the product with warranty, which gives rise to a legal obligation.
- An outflow of resources embodying economic benefits in settlement – probable for the warranties as a whole.

- Conclusion – a provision is recognized for the best estimates of the costs of making good under the warranty products sold before the balance sheet.

Example - Refund Policy

- A retail store has a policy of refunding purchases by dis-satisfied customers, even though it is under no legal obligation to do so. Its policy of making refunds is generally known.

Lecture 32

Provisions, Contingent Assets & Contingent Liabilities (Contd) and Income Statement

Example Warranties – IAS 37

A manufacturer gives warranties at the time of sale to the purchaser of its products. Under the terms of the contract for sale the manufacturer undertakes to make good, by repair or replacement, manufacturing defects that become apparent within three years from the date of sale. On past experience, it is probable (i.e. more probable than not) that there will be some claims under the warranties.

- **Present obligation as a result of past obligating event** – the obligating event is the sale of the product with warranty, which gives rise to a legal obligation.
- **An outflow of resources embodying economic benefits in settlement** – probable for the warranties as a whole.
- **Conclusion** – a provision is recognized for the best estimates of the costs of making good under the warranty products sold before the balance sheet.

Example Refund Policy – IAS 37

A retail store has a policy of refunding purchases by dis-satisfied customers, even though it is under no legal obligation to do so. Its policy of making refunds is generally known.

- **Present obligation as a result of past obligating event** – the obligating event is the sale of the product, which gives rise to a constructive obligation because the conduct of the store has created a valid expectation on the part of its customers that the store will refund the purchases.
- **An outflow of resources embodying economic benefits in settlement** – probable, a proportion of goods are returned for refund.
- **Conclusion** – a provision is recognized for the best estimates of the costs of refunds (constructive obligation).

Example Onerous Contract – IAS 37

An entity operates profitably from a factory that it has leased under an operating lease. During Dec 2000 the entity relocates its operations to a new factory. The lease on the old factory continues for the next four years, it cannot be cancelled and the factory cannot be re-let to another user.

- **Present obligation as a result of past obligating event** –The obligating event is the signing of the lease contract, which gives rise to a legal obligation.
- **An outflow of resources embodying economic benefits in settlement –** when the lease becomes onerous, an outflow of resources embodying economic benefits is probable. (until the lease becomes onerous the entity accounts for the lease under IAS 17)
- **Conclusion** – A provision is recognized for the best estimate of the unavoidable lease payments.

Example A Court Case – IAS 37

- After a wedding in 2000, 10 people died, possibly as a result of food poisoning from products sold by the entity. Legal proceedings are started, seeking damages from the entity, but it disputes liability. Up to the date of authorization of the financial statements for the year to 31 Dec 2000 for issue, the entity's lawyers advise that it is probable that the entity will not be found liable. However, when the entity prepares the financial statements for

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the year to 31 Dec 2001, its lawyers advice that, owing to developments in the case, it is probable that the entity will be found liable.

Example A Court Case – IAS 37 31 Dec 2000

- **Present obligation as a result of past obligating event** – On the basis of the evidence available when the financial statements were approved there is no obligation as a result of past events.

- **Conclusion** – No provision is recognized. The matter is disclosed as a contingent liability unless the probability of any outflow is regarded as remote.

Example A Court Case – IAS 37 31 Dec 2001

- **Present obligation as a result of past obligating event** – On the basis of the evidence available there is a present obligation.

- **An outflow of resources embodying economic benefits in settlement** – probable

- **Conclusion** – A provision is recognized for the best estimate of the amount to settle the obligation.

Example Refurbishment Costs (No Legislative Requirement) – IAS 37

A furnace has a lining that needs to be replaced every 5 years for technical reasons. At the balance sheet date, the lining has been in use for 3 years.

- **Present obligation as a result of past obligating event** – There is no present obligation.

- **Conclusion** – no provision is recognized.

- The cost of replacing the lining is not recognized because, at the balance sheet date, no obligation to replace the lining exists independently of the company's future actions – even the intention to incur the expenditure depends on the company deciding to continue operating the furnace or to replace the lining.

  Instead of provision being recognized, the depreciation of the lining takes account of its consumption, i.e. it is depreciated over 5 years. The re-lining costs then incurred are capitalized with the consumption of each new lining shown by depreciation over the subsequent 5 years.

Example Refurbishment Costs (Legislative Requirement) – IAS 37

- An airline is required by law to overhaul its aircraft once every 3 years.

- **Present obligation as a result of past obligating event** – There is no present obligation.

- **Conclusion** – no provision is recognized.

- The costs of overhauling aircraft are not recognized as a provision for the same reasons as the cost of replacing the lining is not recognized as a provision in the previous example.

- Even a legal requirement to overhaul does not make the costs of overhauling a liability, because no obligation exists to overhaul the aircraft independently of the entity's future actions – the entity could avoid the future expenditure by its future actions, for example by selling the aircraft. Instead of a provision being recognized, the depreciation of the aircraft takes account of the future incident of maintenance costs, i.e. an amount equivalent to the expected maintenance costs is depreciated over 3 years.

Profit and Loss Account / Income Statement

- We will now start our study of Profit or Loss Account (used in 4th Schedule) or Income Statement (used in IAS).

- We will start with the disclosure requirements as per the 4th Schedule:

Profit and Loss Account – 4th Schedule Part III

- **1.** The profit and loss account shall be so drawn up as to disclose separately the manufacturing, trading and operating results. In the case of manufacturing concern, the cost of goods manufactured shall also be shown.

- **2.** The profit and loss account shall disclose all material items of income and expenses including the following, namely:

- **2. (A)** the turnover and showing as deduction there from trade discount and sales tax.

- **2.(B)** expenses, classified according to their function under the following sub-heads, along with additional information on their nature, namely:

  (i) Cost of sales;

  (ii) Distribution cost;

  (ii) Administrative expenses;

  (iv) Other operating expenses; and

  (v) Finance cost.

- **2.(C)** Other operating income, which shall include the following, namely:

  (i) Income from financial assets;

  (ii) Income from investments in and debts, loans, advances and receivables to each related party; and

  (iii) Income from assets other than financial assets.

- **2. (D)** Finance cost shall show, inter alia, separately the amount of interest on borrowings from related parties, if any.

- **2. (E)** Other information relating to the following, namely:

  (i) Debts written off as irrecoverable distinguishing between trade debts, loans, advances and other receivables; and

  (ii) Provisions for doubtful or bad debts distinguishing between trade debts, loans, advances and other receivables.

- **2. (F)** The aggregate amount of auditors' remuneration, showing separately fees, expenses and other remuneration for services rendered as auditors and for services rendered in any other capacity and stating the nature of such other services. In the case of joint auditors, the aforesaid information shall be shown separately for each of the joint auditors.

- **2. (G)** In the case of donations where any director or his spouse has interest in the donee, the names of such directors, their interest in the donee and the names and address of all donees shall be disclosed.

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Lecture 33

Income statement IAS-01

Profit and Loss Account 4th Schedule Part III (Contd.)

- **3.** There shall be stated by way of a note the respective amounts included in items (E) (i) and (ii) of paragraph 2 of this Part for:

  (i) Debts due by directors, chief executive, and executives of the company and any of them severally or jointly with any other person; and

  (ii) Debts due by related parties (other than in clause (i) above).

- The following shall be stated by way of a note, namely:

  (i) The aggregate amount charged in the financial statements in respect of the directors, chief executive and executives by the company as fees, remuneration, allowances, commission, perquisites or benefits or in any other form or manner

And for any services rendered, and shall give full particulars of such aggregate amounts separately for the directors, chief executive and executives together with the number of such directors and executives, under appropriate heads, such as,

(a) Fees;

(b) Managerial remuneration;

(c) Commission or bonus, indicating the nature thereof;

(d) Reimbursable expenses which are in the nature of a perquisite or benefit;

(e) Pension, gratuities, company's contribution to provident, superannuation and other staff funds, compensation for loss of office and in connection with retirement from office;

(f) Other perquisites and benefits in cash or in kind stating their nature and, where practicable, their approximate money values; and

(g) The amounts, if material, by which any items shown above are affected by any change in an accounting policy.

(ii) In the case of sale of fixed assets, if the book value of the asset or assets exceeds in aggregate fifty thousand rupees, particulars of the assets and in aggregate,

(a) Cost or valuation, as the case may be;

(b) The book value; and

(c) The sale price and the mode of disposal (e.g. by tender or negotiation) and the particulars of the purchaser."

IAS 1 – Income Statement

- **Profit or Loss for the period**:
  - ✓ All items of income and expenses recognized in a period shall be included in profit or loss unless a Standard or an Interpretation requires otherwise.
- Information to be presented on the face of the Income Statement:
  - ✓ As a minimum, the face of the income statement shall include line items that present the following amounts for the period:
  - ✓ Revenue;
  - ✓ Finance costs;
  - ✓ Share of the profit or loss of associates and joint ventures accounted for using the equity method;
  - ✓ Tax expense;
  - ✓ A single amount comprising the total of (i) the post-tax profit or loss of discontinued operations and (ii) the post-tax gain or loss recognized on the measurement to fair value less costs to sell or on the disposal of the assets or disposal group(s) constituting the discontinued operation; and
  - ✓ Profit or loss.
- The following items shall be disclosed on the face of the income statement as allocations of profits or loss for the period:
  - ✓ Profit or loss attributable to minority interest; and
  - ✓ Profit or loss attributable to equity holders of the parent.
- Additional line items, headings and subtotals shall be presented on the face of the income statement when such presentation is relevant to an understanding of the entity's financial performance.

Income Statement - Formats

1st Classification of Expenses by Function

2nd Classification of Expenses by Nature

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1st Classification of Expenses by Function

XYZ GROUP - INCOME STATEMENT FOR
THE YEAR ENDED 31 DECEMBER 20-2
(Illustrating the classification of expenses by function)
(in thousands of currency units)

	20x2	20x1
Revenue	X	X
Cost of sales	(X)	(X)
Gross profit	X	X
Other income	X	X
Distribution costs	(X)	(X)
Administrative expenses	(X)	(X)
Other expenses	(X)	(X)
Financial costs	(X)	(X)
Share of profit of associates	X	X
Profit before tax	X	X
Income tax expense	(X)	(X)
Profit for the period	X	X
Attributable to:		
Equity holders of the parent	X	X
Minortiy interest	X	X
	X	X

XYZ GROUP - INCOME STATEMENT FOR
THE YEAR ENDED 31 DECEMBER 20-2
(Illustrating the classification of expenses by nature)
(in thousands of currency units)

	20-2	20-1
Revenue	X	X
Other income	X	X
Changes in inventories of finished goods and work in progress	(X)	X
Work preformed by the entity and capitalized	(X)	X
Raw material and consumables used	X	X
Employee benefits expenses	(X)	(X)
Depreciation and amortization expense	(X)	(X)
Impairment of property, plant and equipment	(X)	(X)
Other expenses	(X)	(X)
Finance costs	(X)	(X)
Share of profit of associates	X	X
Profit before tax	X	X
Income tax expense	(X)	(X)
Profit for the period	X	X
Attributable to:		
Equity holders of the parent	X	X
Minority interest	X	X
	X	X

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Profit and Loss Account 4th Schedule Part III

- The profit and loss account shall be so drawn up as to disclose separately the manufacturing, trading and operating results. In the case of manufacturing concern, the cost of goods manufactured shall also be shown.

XYZ GROUP - INCOME STATEMENT FOR THE YEAR ENDED 31 DECEMBER 20-2

	20x2	20x1
Revenue	X	X
Cost of sales	(X)	(X)
Gross profit	X	X
Administrative expenses	(X)	(X)
Distribution costs	(X)	(X)
Operating profit	X	X
Other income	X	X
Other expenses	(X)	(X)
Financial costs	(X)	(X)
Share of profit of associates	X	X
Profit before tax	**X**	**X**
Income tax expense	(X)	(X)
Profit for the period	**X**	**X**
Attributable to:		
Equity holders of the parent	X	X
Minortiy interest	X	X
	X	**X**

IAS 1 – Income Statement

An entity shall not present any items of income and expense as extraordinary items, either on the face of the income statement or in the notes.

- Extraordinary items of income or expenses were shown separately but now it is specifically prohibited to classify anything as an extraordinary item.

- Information to be presented either on the face of the Income Statement or in the Notes:
  - ✓ When items of income and expense are material, their nature and amount shall be disclosed separately.

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- ✓ An entity shall present an analysis of expenses using a classification based on either the nature of expenses or their function within the entity, whichever provides information that is reliable and more relevant.

- ✓ Entities classifying expenses by function shall disclose additional information on the nature of expenses, including depreciation and amortization expense and employee benefits expense.

- ✓ An entity shall disclose, either on the face of the income statement or the statement of changes in equity, or in the notes, the amount of dividends recognized as distributions to equity holders during the period, and the related amount per share.

- ✓ IAS 1 suggests a certain order for notes to the financial statements. This will assist users when comparing the statements of different entities.

  - ✓ Statement of compliance with IASs,

  - ✓ Statement of the measurement basis and accounting policies applied.

  - ✓ Supporting information for items presented on the face of each financial statement in the same order as each line item and each financial statement is presented

  - ✓ Other disclosures, e.g.

    i) Contingent liabilities commitments and other financial disclosure

    ii) Non-financial disclosures

The order of specific items may have to be varied occasionally, but a systematic structure is still required.

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Lecture 34

Revenues IAS 18

Definition – IAS 18

- The IAS defines Revenue as

'Revenue is the gross inflow of economic benefits during the period arising in the course of ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants.

Identification of Transaction

Normally, each transaction can be looked at as a whole. Sometimes, however, transactions are more complicated, and it is necessary to break a transaction down in to its component parts. For example, a sale may include the transfer of goods and the provision of future servicing, the revenue for which should be deferred over the period the service is performed.

At the other end of the scale, seemingly separate transactions must be considered together if apart they lost their commercial meaning. An example would be to sell an asset with an agreement to buy it back at a later date. the second transaction cancels the first and so both must be considered together.

Measurement of Revenue – IAS 18

- Revenue shall be measured at the fair value of the consideration received or receivable.
- When the flow of cash or cash equivalent is deferred (eg. supplier credit) the fair value of the consideration may be less than the nominal amount of cash received or receivable.
- The future cash flows are discounted at market interest rates and the present value is treated as the consideration whereas the difference of the present value and nominal values of cash flows is treated as finance income.
- When goods are sold or services are rendered in exchange for dissimilar goods or services, the exchange is regarded as a transaction which generates revenue.
- The revenue is measured at the fair value of the goods or services received, adjusted by the amount of any cash or cash equivalents transferred.
- When the fair value of goods and services received cannot be measured reliably, revenue is measured at the fair value of the goods or services given up, adjusted by the amount of any cash or cash equivalents transferred.

Matching should be take place, i.e. the revenue and expenses relating to the same transaction should be recognized at the same time. It is usually easy to estimate expenses at the date of sale (e.g. warranty costs, shipment costs, etc). Where they cannot be estimated reliably, then revenue cannot be recognized; any consideration which has already been received is treated as a liability.

Sale of Goods - IAS 18

- Revenue from the sale of goods shall be recognized when all of the following conditions are satisfied;

  a) The entity has transferred to the buyer the significant risks an rewards of the ownership of goods;

b) The entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;

c) The amount of revenue can be measured reliably;

d) It is probable that the economic benefits associated with the transaction will flow to the entity; and

e) The costs incurred or to be incurred in respect of the transaction can be measured reliably.

Rendering of Services - IAS 18

- When the outcome of a transaction involving rendering of services can be estimated reliably, revenue associated with the transaction shall be recognized by reference to the stage of completion of transaction at the balance sheet date. The outcome of the transaction can be estimated reliably when all of the following conditions are satisfied;

a) The amount of revenue can be measured reliably

b) It is probable that economic benefits associated with the transaction will flow to the entity;

c) The stage of completion of the transaction at the balance sheet date can be measured reliably; and

d) The costs incurred for the transaction and the costs to complete the transaction can be measured reliably.

Interest, Royalties and Dividends - IAS 18

- Revenue arising from the use by other entity assets yielding interests, royalties and dividends shall be recognized on the bases set out in the next paragraph (next slide) when;

a) It is probable that economic benefits will flow to the entity; and

b) The amount of revenue can be measured reliably.

- Revenue shall be recognized on following bases;

a) Interest shall be recognized using effective interest method as set out in IAS 39

b. Royalties shall be recognized on an accrual basis in accordance with the substance of the relevant agreement; and

c. Dividends shall be recognized when the shareholders right to receive the payment is established

Disclosure - IAS 18

- An entity shall disclose;

a) The accounting policies adopted for the recognition of revenue, including the methods adopted to determine the stage of completion of transitions involving rendering of services;

b) The amount of each significant category of revenue recognized during the period including revenue arising from;
    i) The sale of goods;
    ii) The rendering of services;
    iii) Interest;
    iv) Royalties;
    v) Dividend; and

c) The amount of revenue arising from exchanges of goods or services included in each significant category of revenue.

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Lecture 35

Presentation and Disclosure of Expenses in Income statement

- In our previous few lectures we started our discussion of Income Statement.

We discussed:

- ✓ Disclosure requirements of 4th Schedule to the Companies Ordinance 1984.
- ✓ Disclosure requirements laid down in IAS 1 "Presentation of Financial Statements"
- ✓ IAS 18 "Revenues"

- In this lecture we will discuss about expenses and conclude our discussion on Income Statement.
- Expenses have been distributed in five major classifications that are to be presented on the face of the Income Statement:

- ✓ Cost of Goods Sold
- ✓ Administrative Costs
- ✓ Distribution Costs (Selling Expenses)
- ✓ Finance Costs
- ✓ Other Expenses

- There is no specific IAS for disclosure of expense items. However these are covered in various IASs.
- We have already discussed some of these standards in our earlier lectures.
- The standards that effect Income and Statement which we have already discussed include:

Cost of Goods Sold

- Cost of Goods Sold is the direct cost of manufacturing the goods that were sold by the entity during the reporting period.
- Cost of goods sold includes:

- ✓ Cost of materials used
- ✓ Direct labour
- ✓ Overheads such as supervisory staff costs, factory costs.

- Note that total cost incurred during the period is not treated as expense for the period. The portion of the cost that relates to unsold finished goods is carried forward as Finished Goods Inventory.

Administrative Costs

- Administrative costs include expense incurred on administration and management of the business.
- Administrate costs include:

- ✓ Administrative staff salaries and related costs
- ✓ Depreciation, maintenance, rent, utilities and management costs of administrative offices
- ✓ Other administrative costs such as printing, entertainment, postage etc.

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Distribution Costs

- Distribution (selling) costs are expenses directly related to selling the products of the entity.
- These include:

  ✓ Salaries and related costs of the sales and marketing staff.
  ✓ Advertisement costs
  ✓ Sales and distribution costs etc.

Finance Costs

- Finance costs include mark up paid on loans and leases and other costs paid to obtain financial services such as service charges of banks, LC's / Guarantees charges etc.
  Other Expense
- Any expense that cannot be classified in any of the above categories is classified as other expense.
- IAS 2 "Inventories"
- IAS 16 "Property Plant and Equipment"
- IAS 17 "Leases"
- IAS 23 "Borrowing Costs"
- IAS 28 "Investments in Associates"
- IAS 38 "Intangible Assets"
- Here we will briefly discuss and revise how these standards effect Income Statement and what are the reporting requirements.

IAS 2 "Inventories"

- Inventories are carried in the books of accounts according to the methods of valuation given in IAS 2.

- When these items of inventory are consumed or there value is changed, the resulting difference is charged to Income.
- Cost of Inventories (raw material, packing material, work in process, finished goods and spares / consumables) usually become part of Cost of Goods Sold.
- However in certain cases it may become part of Administrative or Selling Expenses depending upon the utilization of the inventory item.
- Disclosure of Inventories relating to Income Statement that we have already discussed include:
- The amount of any reversal of any write down that is recognized as the income.
- The circumstances and events that led to the reversal of write down.
- The financial statements should also disclose the cost of inventories recognized as expense during the period.

IAS 16 "Property Plant and Equipment"

- Property plant and equipment is carried in the books of accounts in accordance with the requirements of IAS 16.
- The gradual reduction in the carrying amount of the assets is charged to Income through a depreciation charge.

IAS 16 "Property Plant and Equipment"

- Any impairment in the value of Property, plant and equipment (IAS 36 "Impairment of Assets" *not covered in syllabus*) is also charged to Income.
- Maintenance and normal repairs are also charged to income for the period.

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IAS 17 "Leases"

- Operating Leases (in the case of lessee)
  - ✓ Rental is treated as expense for the period.
  - ✓ Any running and maintenance cost borne by lessee is also charged as expense in the income statement.
- Finance Leases (in the case of lessee)
  - ✓ Rental is apportioned between principal repayment and markup and the markup is treated as expense for the period.
  - ✓ The asset is recognized in the books of the lessee and the lessee charges its depreciation as expense.
  - ✓ Any running and maintenance cost borne by lessee is also charged as expense in the income statement.

IAS 23 "Borrowing Costs"

- The treatment of borrowing costs is governed by IAS 23 "Borrowing Costs".
  - ✓ The standard generally requires that the borrowing costs should be charged as an expense.
  - ✓ However it allows capitalization of these costs as an alternate treatment, if certain conditions are met.

IAS 28 "Investment in Associates"

- Under IAS 28 investment in associates is recorded using equity method. Under equity method:
  - ✓ The investment in associate is initially recorded at cost which is subsequently adjusted for investor's share of profits or losses of associate.
  - ✓ The investor's share of profit / loss is recognized as income / expense in the books of investor.

Investment in Associates

- Investments in associates are also subject to IAS 36 "Impairment of Asset" and IAS 39 "Financial Instruments Recognition and Measurement", and any impairment in the value of the investment in associate is also recorded as expense in the period in which the impairment takes place.

IAS 38 – "Intangible Asset"

- Intangible asset is amortized over its useful life and the amortization is charged as expense for the period. (The maximum useful life for an intangible asset is 20 years).
- Subsequent expenditure on an intangible asset after its purchase or its completion should be recognized as an expense when it is incurred, unless it is probable that this expenditure will enable the asset to generate future economic benefits in excess of its originally assessed standards.

IAS 38 – "Intangible Asset"

- Expenditure on research (or from research phase of an internal project) should be recognized as an expense when incurred.

- Other IAS also effect recognition, presentation and disclosure of expenses.
- Generally these IAS include:

  - ✓ IAS 11 "Construction Contracts" – specifies the recognition of revenue and related costs in case of construction contracts spread over more than one accounting periods.
  - ✓ IAS 12 "Income Taxes" – specifies the procedure for calculation of recording and reporting of income tax.
  - ✓ IAS 19 "Employee Benefits" – specifies calculation, recording and reporting of retirement benefit related costs of the entity.
  - ✓ IAS 20 "Accounting for Government Grants and Disclosure of Government Assistance" – recording of receipts of government grants and assistance received and costs incurred in relation to fulfilling the conditions attached with the grants.
  - ✓ IAS 21 "The Effects of Changes in Foreign Exchange Rates" – Recording and disclosure on gains / losses arising from foreign currency transactions.
  - ✓ IAS 36 "Impairment of Assets" – recognition of gains / losses due to change in fair value of the assets.
  - ✓ IAS 39 "Financial Instruments Recognition and Measurement" – Income / Expenses such as finance income / costs or impairment related to financial instrument

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Lecture 36

Statement of Changes in Equity, Accounting Policies, Changes in Accounting Estimates and Errors

Statement of Changes in Equity – IAS 1

1. Statement of changes in equity shows the movement in the elements of equity during the reporting period.
2. An entity shall present a statement of changes in equity showing on the face of the statement:
   a. Profit or loss for the period;
   b. Each item of income and expense for the period that, as required by other standards or interpretations, is recognized directly in equity, and the total of these items
   c. Total income and expense for the period (calculated as sum of a and b), showing separately
   d. The total amounts attributable to equity holders of the parent and to minority interest; and
   e. For each component of equity, the effects of changes in accounting policies and corrections of errors recognized in accordance with IAS 8 "Accounting Policies, Changes in Accounting Estimates and Errors"
3. An entity shall also present, either on the face of the statement of changes in equity or in the notes:
   a. The amount of transactions with equity holders acting in their capacity as equity holders, showing separately distributions to equity holders;
   b. The balance retained earnings (i.e. accumulated profit or loss) at the beginning of the period and at the balance sheet date, and the changes during the period; and
   c. Reconciliation between the carrying amount of each class of contributed equity and each reserve at the beginning and the end of the period, separately disclosing each change.

IAS 8 – Accounting Policies, Changes in Accounting Estimates and Errors

The material on accounting policies has been transferred in to IAS 8 from IAS 1.

Where there is no applicable IFRS / IAS management should use its Judgment in developing and applying an accounting policy that results in information that is relevant and reliable. Management should refer to:

a) The requirements and guidance in IFRS dealing with similar and related issues.
b) The definitions, recognition criteria and measurement concepts for assets, liabilities and expenses in the framework.

4. Management may also consider the most recent pronouncements of other standard setting bodies that use a similar conceptual framework to develop standards, other accounting literature and accepted industry practices if these do not conflict with the sources above.

- This standard is applied in selecting and applying accounting policies, and accounting for changes in accounting estimates and corrections of prior period errors.

5. The same accounting policies are usually adopted from period to period, to allow users to analyze trends over time in profit, cash flows and financial position. Changes in accounting policy will therefore be rare and should be made only if required by one of three things.

a) By statue

b) By an accounting standard setting body

c) If the change will result in a more appropriate presentation of events or transactions in the financial statements of the entity.

6. The standard highlights two types of event which do not constitute changes in accounting policy.

a) Adopting an accounting policy for a new type of transaction or event not deal with previously by the entity.

b) Adopting a new accounting policy for a transaction or event which has not occurred in the past or which was not material.

7. In the case of tangible non-current assets, if a policy of revaluation is adopted for the first time then this is treated, not as a change of accounting policy under IAS 8, but as a revaluation under IAS 16 Property, plant and equipment. The following paragraphs do not therefore apply to changes in policy to adopt revaluations.

Selection and Application of Accounting Policies – IAS 8

- 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 Implication Guidance issued by 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 the user; and
  b. Reliable, in that the financial statements;

- Represents faithfully the financial position, financial performance and cash flow of the entity;
- Reflects the economic substance of transactions, other events and conditions, and not merely the legal form;
- Are neutral, i.e. free from bias;
- Are prudent; and
- Are complete in all material respects.

Consistency of Accounting Policies – IAS 8

- 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.
- 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 – IAS 8

- An entity shall change an accounting policy only if the change:
  a. Is required by a standard or an interpretation; or
  b. Results in financial statements providing reliable and more relevant information about the effects of transactions, other events or contributions on the entity's financial position, financial performance or cash flows.
- The following are not 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; and
  b. The application of a new accounting policy for transactions, other events or conditions that did not occur previously or were immaterial.
- 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 accounting policy to be dealt with as revaluation in accordance with IAS 16 or IAS 38, rather than in accordance with this Standard

Certain disclosures are required when a change in accounting policy has a material effect on the current period or any prior period presented, or when it may have a material effect in subsequent periods.

a) Reason for the change
b) Amount of the adjustment for the current period and for each period presented.

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c) Amount of the adjustment relating to periods prior to those included in the comparative information.
d) The fact that comparative information has been restated or that it is impracticable to do so.

The entity should also disclose information relevant to assessing the impact of new IFRS on the financial statements where these have not yet come in to force.

Lecture 37

Changes in Accounting Policies – IAS 8, Errors and Cash Flows

- In the last lecture we started our discussion on IAS 8, Accounting Policies, Changes in Accounting Estimates and Errors.
- Following portion of the IAS was covered in the last lecture:
  a. Selection and application of accounting policies
  b. Consistent application of accounting policies
  c. Changes in accounting policies
- following key things were discussed:
- In cases where a Standard or an Interpretation available, the accounting policy or policies shall be determined by applying the Standard or Interpretation.
- In the absence of a Standard or an Interpretation, management shall use its judgment in developing and applying an accounting policy that results in information that is relevant and reliable
- Accounting policies should be applied consistently for similar transactions, unless a Standard or an Interpretation specifically requires or permits categorization of items for which different policies may be appropriate.
- Accounting policy should be changed only when a standard requires doing so or when it results in providing more reliable and relevant information to the user.
- In the current lecture we will study:
  a. How to apply changes in accounting policies
  b. What are changes in accounting estimates
  c. Disclosure requirements

Changes in Accounting Policies – IAS 8

- (Para 19) Subject to Para 23 (Para 23 is on limitation of application of retrospective application):
  - ✓ An entity shall account for a change in accounting policy resulting from the initial application of a standard or an interpretation in accordance with the specific transitional provisions, if any, in the standard or interpretation; and
- When an entity changes an accounting policy upon initial application of a standard or interpretation that does not include specific transitional provisions applying to that change or changes an accounting policy voluntarily it shall apply that change voluntarily.

Explanation

- Valuation of inventory is using FIFO or average method is an accounting policy.
- If for instance IAS 2 is revised and one of the methods, say FIFO, is no longer allowed, then;
  a. The change can either be applied prospectively or retrospectively.
  b. Prospective application means that the policy of valuation will be changed from current period only.
  c. Retrospective application means that the opening balance of the inventory will also have to be changed according to the new policy.

Retrospective Application – IAS 8

- (Para 22) subject to Para 23, when a change in accounting policy is applied retrospectively in accordance with Para 19, the entity shall adjust the opening balance of each affected component of equity for the earliest period presented and the other comparative amounts disclosed for each prior periods presented as if the new accounting policy has always been applied.

Explanation

- In the example that we discussed earlier if a retrospective effect is required for a change in the policy of valuation of inventory, the second effect of change in the value of inventory will shown in the statement of changes in equity as adjustment in the balance of retained earnings.

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Limitation on Retrospective Application – IAS 8

- (Para 23) When retrospective application is required by Para 19, a change in accounting policy shall be applied retrospectively except to the extent that it is impracticable to determine either the period-specific effects or the cumulative effects of change.
- (Para 24) When it is impracticable to determine period-specific effects of changes in accounting policy on comparative information for one or more periods presented, the entity shall apply the new accounting policy to the carrying amounts of assets and liabilities as at the beginning of the earliest period for which retrospective application is practicable, which may be current period, and shall make a corresponding adjustment to the opening balance of each affected component of equity for the period.

Changes in Accounting Estimates – IAS 8

- As a result of uncertainties inherent in the business activities, many items in financial statements cannot be measured with precision but can only be estimated. Estimation involves judgment based on the latest available, reliable information. For example, estimates may be required of:

    a. Bad debts,
    b. Inventory obsolescence,
    c. Fair value of financial assets / liabilities
    d. Useful lives of depreciable assets
    e. Warranty obligations

- An estimate may need revision if changes occur in the circumstances on which the estimate was based or as a result of new information or more experience. By its nature, the revision of an estimate is does not relate to prior periods and is not the correction of an error.

- (Para 36) The effect of a change in an accounting estimate, other than change to which Para 37 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 change and future periods, if change affects both

- (Para 37) To the extent that a change in 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 related assets, liability or equity item in the period of change.

Errors– IAS 8

- Errors can arise in respect of recognition, measurement, presentation or disclosure of elements of financial statements. Financial statements do not comply with IFRS 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 flows.

- 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.

- (Para 42) subject to Para 43, an entity shall correct material prior period errors retrospectively in the first set of financial statements authorized for issue after their discovery by;
    - ✓ Restating the comparative amounts for the prior period(s) presented in which the error occurred; or

- If the error occurred before the earliest prior period presented, restating the opening balances of assets, liabilities and equity of the earliest prior period presented.

Cash Flow Statement

- Cash Flow Statement
    1. Cash flow statement shows the movement in cash resources of the business.
    2. This statement shows the sources from which business generated cash and its application.

- For any business it is important to ensure that:
    1. Sufficient profits are made to compensate owners for the investment made, efforts put in and the risk taken for the business,
    2. Sufficient funds are available to meet the obligations of the business as and when required.

- The information as to profitability is provided by the Profit and Loss Account.

- The information as to availability of funds or financial health is provided by the balance sheet.

- But we know that the balance sheet is prepared on a specific date and can provide information of financial position as on that date only.

- Cash flow on the other hand provides more detailed information about the movement of funds during the period.

- With the help of cash flow we can determine the amount of cash generated form different sources and the areas on which it is utilized

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Lecture 38

Cash Flow Statement IAS-7

Cash Flow Statement

- Cash Flow Statement:
  1. Cash flow statement shows the movement in cash resources of the business.
  2. This statement shows the sources from which business generated cash and its application.

- For any business it is important to ensure that:
  1. Sufficient profits are made to compensate owners for the investment made, efforts put in and the risk taken for the business,
  2. Sufficient funds are available to meet the obligations of the business as and when required.

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Difference between Profitability and Liquidity:

- **Liquidity.**
  It is the ability of a business to pay its debts in time. By having good liquidity we mean that a business has sufficient liquid funds (cash and cash equivalents) so that it can repay liabilities.

- **Cash**
  Cash includes cash in hand and demand deposits.

- **Cash Equivalents**
  Cash equivalents are those short term investments that can be converted into a known amount of cash at any time. Usually investments up to three months maturity are included in cash equivalents.

- **Profitability** is generally mixed-up with liquidity.
  One might think that if a business has earned say One Million Rupees of profit than it should have approximately the same amount of cash in it.
  But mostly this is not the case.
- Consider the following example:
  - A small business is started with a capital of 20,000.
  - During the first accounting period goods worth Rs. 15,000 are purchased. Out of the total 15,000, Rs.10, 000 are paid in cash while the remaining amount will be paid in 15 days.
  - All the goods are sold on credit for Rs. 35,000, receivable in 30 days
  - Expenses incurred during the period amount to Rs. 10,000 – 5,000 paid in cash and balance payable in 15 days time.
  - What is the profitability and liquidity position of the business
- **Profitability:**
  - The business earned a total profit of Rs. 10,000 (35,000 sale – 15,000 purchases – 10,000 expenses).

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- **Liquidity:**
  - ➢ The business has 5,000 cash on reporting date (20,000 capital – 10,000 purchases – 5,000 expenses). This cash will be utilized either for payment of expenses or payments, both becoming due in 15 days.
- Although the business earned a profit but it is going to face problems in paying its liabilities.

- By taking this simple example we have tried to explain that liquidity is different from profitability

- But it is as important as profitability. Some people even say that it is more important than profitability.

Components of Cash Flow Statement:

- Cash flow statement is divided into three components

✓ Cash Flow from Operating Activities

✓ Cash Flow from Investing Activities

✓ Cash Flow from Financing Activities

Cash Flow from Operating Activities:

- Cash flow from operating activities is generally derived from the principal revenue producing activities of the business.

- Examples of cash flows from operating activities are:
  - Cash receipt from sale of goods and rendering of services.
  - Cash receipts from fees, commission and other revenues.
  - Cash payments to suppliers for goods and services.
  - Cash payments to and on behalf of the employees.
  - Cash payments or refunds of income taxes.

Cash Flow from Investing Activities:

- Cash flow from investing activities includes cash receipts and payments that arise from Fixed and Long Term assets of the organization.

- Examples of cash flows from investing activities are:
  - Cash payments to acquire property plant and equipment. These also include payments made for self-constructed assets.
  - Cash receipts from sale of property plant and equipment.
  - Cash payments and receipts from acquisition and disposal other long term assets e.g. Shares, debentures, TFC, long term loans given etc.
  - If assets are held for trading purposes or in normal course of business e.g. car / property dealers and loans given by banks, then cash flows from them are included in Operating Cash Flow.

Cash Flow from Financing Activities

- Cash flow from financing activities includes cash receipts and payments that arise from Owners of the business and other long term liabilities of the organization.

- Examples of cash flows from financing activities are:

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- Cash received from owners i.e. share issue in case of company and capital invested by sole proprietor or partners.
- Cash payments to owners i.e. dividend, drawings etc.
- Cash receipts and payments for other long term loans and borrowings.

Procedure of Preparing Cash Flow

- It is constructed as follows:
    - We start from the Profit / Loss for the period before taxation.
    - Adjustments are made for non-cash items that are included in the profit and loss account such as Depreciation, Provisions and other items that relate to investing and financing activities.
    - This gives us Operating Profit before Working Capital Changes.
    - Then Working Capital Changes, i.e. increase or decrease in items of current assets and liabilities, are added / subtracted (Remember, Cash and Cash Equivalents are not included here)
    - This gives the Cash Flow from Operations.
    - To this figure we add / subtract cash flows from investing and financing activities.
    - This gives us Net Increase / Decrease in Cash and Cash Equivalents.
    - To this figure we add Opening Balance of Cash and Cash Equivalents (that we excluded from current assets)
    - This gives us the Closing Balance of Cash and Cash Equivalents.
- Increase or Decrease is generally taken as difference in opening and closing balances of accounts reported in balance sheets.

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Format of Cash flow statement

Name of the Entity

Cash Flow Statement for the Period Ending -----

Net Profit Before Tax

Adjustment for Non-Cash Items

- Depreciation for the year
- Provision for Doubtful Debts
- Exchange Gain / Loss
- Gain / Loss on Disposal of Assets
- Return on Investments
- Mark-up on Loans

Operating Profit Before Working Capital Changes

Working Capital Changes

- Add Decrease / Less Increase in Current Assets
- Add Increase / Less Decrease in Current Liabilities

Cash Generated From Operations

- Markup paid on loans
- Taxes Paid

Net Cash Flow from Operating Activities

Cash Flow from Investing Activities

- Add Disposal / Less Purchase of Fixed Asset
- Add Disposal / Less Purchase of Long Term Investments
- Dividend / Returns on Investment Received

Net Cash Flow from Investing Activities

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Cash Flow from Financing Activities

Shares Issued / Capital Invested

Dividend Paid / Drawings

Long Term Borrowings

Net Cash Flow from Financing Activities

Net Increase / Decrease in Cash and Cash Equivalents

Opening Balance of Cash and Cash Equivalents

Closing Balance of Cash and Cash Equivalents

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Lecture 39

Cash Flow Statement (Contd)

Illustration 01

- In the following example we have provided you with a Balance Sheet with comparative figures and some additional information.
- All figures including those given in additional information are in thousands of Rupees.

Following are the Extracts from Financial Statements of United Company for 20X1 and 20X2

BALANCE SHEET

	20X2 " 000 "	20X1 " 000 "
Fixed Assets:		
Plant and Machinery	329	364
Current Assets:		
Inventories	150	210
Marketable Securities	60	110
Interest Receivable	50	20
Trade Receivable	301	91
Cash	135	120
	696	551
Current Liabilities:		
Trade Payable	100	90
Interest Payable	20	15
	120	105
Working Capital	576	446
	905	810
Financed By:		
Capital	500	500
Retained Earnings	400	310
General Reserves	5	
	905	810

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Additional Information:

1 The Amounts of Following Expenses are available:	" 000 "
Interest Expense	30
Depreciation Expense	35
Income Tax Expense	100
Dividend Declared	150
2 The Amounts of Following Incomes are available:	
Interest Income	50
Dividend Income	5
Gain On Sale Of Shares	15

3 The cost of Plant and Machinery is Rs 400 and its Accumulated Depreciation of year 20X1 and 20X2 is Rs 36 and Rs 71 respectively.

4 The Company sold Marketable Securities Costing Rs 50 for Rs 65

5 Dividend Paid during the year Rs 150.

6 Profit Before Tax Is Rs 345.

Required:

Prepare a Cash Flow Statement for 20X2

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United Company Limited
Cash Flow Statement
Year ended 31 December 20X2

		20X2
		" 000 "
Cash Flow From Operating Activities:		
Profit Before Tax		345
Add: Non Cash Items		
Depreciation	35	
Interest Expense	30	
Interest Income	(50)	
Gain on Investment	(15)	
Dividend Income	(5)	
		(5)
Cash Flow From Investing Activities:		
Proceeds From Sale Of Investment	65	
Net Cash Flow From Investing Activities: (b)		65
Cash Flow From Financing Activities: (c)		-
Net Increase / (Decrease) in Cash and Cash Equivalents (a + b + c)		15
Add: Cash and Cash Equivalents Beginning Of the Period.		120
Cash and Cash Equivalents at the End Of the Period.		135

Cash flow statement- Explanation

- We have started with profit before tax that was provided in the additional information; otherwise it can be obtained from income statement.
- Next we have adjusted the profit figure for non-cash items and other items that are to be shown separately.
- Non cash items usually include depreciation, provisions.
- Items to be shown separately usually include interest income / expense and dividend income and other items that are to be dealt with in investing or financing activities such as gain / loss on sale of fixed assets.
- Working capital changes are calculated as a difference of opening and closing balance (worked out from current and comparative figures of balance sheet)
- Payments / receipts of interest and dividend and tax payment are calculated through "T" accounts as follows:

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Interest Receivable

O/B 20	Cash Received 20
Income for the Year 50	(Balancing fig)
	C/B 50

Interest Payable

Cash Paid 25	O/B 15
(Balancing fig)	Expense for the Year 30
C/B 20	

- In case of dividend income and expense and tax expense there is no receivable or payable therefore we assume that the receipt / payment is equal to income / expense. Otherwise payment / receipt from these heads would also have been worked out like interest payable or receivable.

- Investment in Shares was sold for Rs. 65 and a gain of Rs. 15 was realized. Therefore Rs. 15 has been adjusted as non cash item and a receipt of Rs. 65 has been shown.

- In this example there is no addition or disposal of fixed assets which is evident from opening and closing balance of the WDV of fixed assets.

Fixed Assets WDV

O/B 364	Depreciation 35
	C/B 329

Lecture 40

Cash Flow Statement (Contd)

- If the closing balance is higher than the difference of opening balance and depreciation for the year it means that an addition of fixed assets has taken place.

- If the closing balance is lower than the difference of the O/B and Depreciation for the Year, it shows a disposal of fixed assets.

- In case of disposal we have to prepare T accounts of Fixed Assets Cost Account, Accumulated Depreciation Account and Fixed Assets Disposal Account in order to calculate the Cash received on disposal of Assets.

- Another area that is to be considered carefully while preparing cash flows is the finance lease.

- At the time of inception of lease Asset and Liability is recorded in Balance Sheet. However in case of cash flows only payment of Lease Rentals is shown as outflow.

- Principal portion of lease rentals is shown under investing activities as payments towards addition in fixed assets whereas the markup portion is either shown in financing activities or separately as shown in this example,

- Cash is not synonymous with profit on an annual basis, but you should also remember that the "behavior" of profit and cash flows will be very different. Profit is smoothed out through accruals prepayments, provisions and other accounting conventions. This does not apply to cash, so the cash flow figures are likely to be lumpy in comparison. You must distinguish between this lumpiness and the trends which will appear over time.

- The relationship between profit and cash flows will vary constantly. Note that healthy companies do not always have reported profits exceeding operating cash flows. Similarly, unhealthy companies can have operating cash flows well in excess of reported profit. The value of comparing them is in determining the extent to which earned profits are being converted into the necessary cash flows.

- Cash flow figures should also be considered in terms of their specific relationships with each other over time. A form of cash flow gearing can be determined by comparing operating cash flows and financing flows, particularly borrowing, to establish the extent of dependence of the reporting entity on external funding.

- A cash flow statement, when used in conjunction with the rest of the financial statement, provides information that enables user to evaluate the changes in net assets of an enterprise, its financial structure (including its liquidity and solvency) and its ability to affect the amounts and timing of cash flows in order to adapt to changing circumstances and opportunities.

- Cash flow information is useful in assessing the ability of the enterprise to generate cash and cash equivalents and enables users to develop models to assess and compare the present value of the future cash flows of different enterprises. It also enhances the comparability of the reporting of operating performance by different enterprises because it eliminates the effect of using different accounting treatments for the same transactions and events.

- Historical cash flow information is often used as an indicator of the amount, timing and certainty of future cash flows. It is also useful in checking the accuracy of past assessments of future cash flows and in examining the relationship between profitability and net cash flow and the impact of changing prices.

Reporting cash flows from operating activities IAS 7

- The standard offers a choice of method for this part of the cash flow statement.
  a) **Direct Method**: Disclose major classes of gross cash receipts and gross cash payments.

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b) **Indirect method**: Net profit or loss is adjusted for the effects of transactions of a non-cash nature, any deferrals or accruals of past or future operating cash receipts or payments, and items of income or expenses associated with investing or financing cash flows.

Reporting cash flows from operating activities

- The direct method is the preferred method by IAS-7 because it discloses information, not available elsewhere in the financial statements, which could be of use in estimating future cash flows.

Using the Direct Method

- There are different ways in which the information about gross cash receipts and payments can be obtained. The most obvious way is simply to extract the information from the accounting records. This may be a laborious task, however, the indirect method is easier than direct method.

Using the Indirect Method

- This method is undoubtedly easier from the point of view of the preparer of the cash flow statement. The net profit or loss for the period is adjusted for the following.

  a) Changes during the period in inventories, operating receivables and payables.
  b) Non cash items, e.g. depreciation, provisions, profits/losses on the sales of assets.
  c) Other items, the cash flows from which should be classified under investing or financing activities

Indirect Method VS Direct Method

- The direct method is encouraged where the necessary information is not too costly to obtain, but IAS 7 does not require it, and favors the indirect method. In practice, therefore, the direct method is rarely used.

- It is not obvious that IAS 7 is right in favoring the indirect method. It could be argued that companies ought to monitor their cash flows carefully enough on an ongoing basis to be able to use the direct method at minimal extra cost.

Treatment of Interest and Dividend

- Cash flows from interest and dividends received and paid should each be disclosed separately. Each should be classified in a consistent manner from period to period as operating, investing or financial activities.

- The total amount of interest paid during a period is disclosed in the cash flow statement whether it has been recognized as an expense in the income statement or Capitalized in accordance with the allowed alternative treatment in IAS 23 Borrowing Costs.

- Interest paid and interest and dividends received are usually classified as operating cash flows for a financial institution. However, there is no consensus on the classification of these cash flows for other entities. Interest paid and interest and dividends received may be classified as operating cash flows because they enter in to the determination of profit or loss.

- Alternatively, interest paid and interest dividends received may be classified as financing cash flows and investing cash flows respectively, because they are costs of obtaining financial resources or returns on investments.

- Dividends paid may be classified as a financing cash flow because they are a cost of obtaining financial resources. Alternatively, dividends paid may be classified as a component of cash flows from operating activities in order to assist users to determine the ability of an entity to pay dividends out of operating cash flows.

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The advantages of cash flow accounting:

a) Survival in business depends on the ability to generate cash. Cash flow accounting directs attention towards this critical issue.

b) Cash flow is more comprehensive than profit which is dependent on accounting conventions and concepts.

c) Creditors (long and short term) are more interested in an entity's ability to repay them than in its profitability. Whereas profits might indicate that cash is likely to be available, cash flow accounting is more direct with its message.

d) Cash flow reporting provides a better means of comparing the results of different companies than traditional profit reporting.

e) The accruals concept is confusing, and cash flows are more easily understood.

f) Cash flow forecasts are easier to prepare, as well as more useful, than profit forecasts.

g) For shareholders and auditors, cash flow accounting can provide a satisfactory basis for stewardship

Other disclosures

- All entities should disclose, together with a commentary by management, any other information likely to be of importance, for example:

a) Restrictions on the use of or access to any part of cash equivalents.

b) The amount of un-drawn borrowing facilities which are available.

c) The separate disclosure of cash flows that represent increases in operating capacity and cash flows that are required to maintain operating capacity is useful in enabling the user to determine whether the entity is investing adequately in the maintenance of its operating capacity. An entity that does not invest adequately in the maintenance of its operating capacity may be prejudicing future profitability for the sake of current liquidity and distributions to owners.

d) The disclosure of segmental cash flows enables users to obtain a better understanding of the relationship between the cash flows of the business as a whole and those of its components parts and the availability and variability of segmental cash flows.

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Lecture 41

Events after the Balance Sheet Date IAS-10

- The Objective of this standard is to prescribe:
  a) When an entity should adjust its financial statements for events after the balance sheet date; and
  b) The disclosure that an entity should give about the date when the financial statements were authorized for issue and about events after the balance sheet date.
- The standard also requires that an entity should not prepare its financial statements on a going concern basis if events after the balance sheet date indicate that the going concern assumption is not appropriate.

Definitions

- Events after the balance sheet date: 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 that provide evidence of conditions that existed at the balance sheet date (adjusting events after the balance sheet date) and
  b) Those that are indicative of conditions that arose after the balance sheet date (non adjusting events after the balance sheet date)

- 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 – Authorisation of Financial Statements

- The management of an entity completes draft F/S for the year to December 31, 20X1 on January 31, 20X2. On March 18, the BOD of the entity reviews the F/S and authorizes them for issue. The F/S are made available to shareholders and others on March 21, 20X2.

- The shareholders approve the F/S at their AGM on April 15, 20X2 and the approved F/S are then filed with the regulatory body on April 21, 20X2.

- The F/S are authorized for issue on March 18, 20X2 (date of board authorization for issue)

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.
  - ✓ The following are examples of adjusting events after the balance sheet date that require an entity to adjust the amounts recognized in its financial statements, or to recognize items that were not previously recognized.
    a) The settlement after the balance sheet date of a court case that confirms that the entity had a present obligation at the balance sheet date. The entity adjusts any previously recognized provision related to this court case in accordance with IAS 37 Provisions, Contingent Liabilities and Contingent assets or recognizes a new provision.
    b) The discovery of fraud or errors that show that the financial statements are incorrect.
    c) The receipt of information after the balance sheet date indicating that an asset was impaired at the balance sheet date, or that the amount of a previously recognized impairment loss for that asset needs to be adjusted e.g.

- The bankruptcy of a customer that occurs after the balance sheet date usually confirms that a loss existed at the balance sheet date on a trade receivable and that the entity needs to adjust the carrying amount of the trade receivable.

- 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 e.g.

- A decline in market value of investments between the balance sheet date and the date when the financial statements are authorized for issue. The decline in market value does not normally relate to the condition of the investments at the balance sheet date, but reflects circumstances that have arisen subsequently. Therefore, an entity does not adjust the amounts recognized in its financial statements for the investments.

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 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 according to IAS 37. Such dividends are disclosed in the notes in accordance with IAS 1 Presentation of Financial Statements.

- Decision about dividend is taken by Directors usually after the balance sheet date on the basis of draft financial results for the year.

- This dividend is called final dividend. Any dividend declared during the year is called Interim dividend.

- In Pakistan we used to recognize final dividend as liability under the requirement of 4th Schedule.

- However this requirement has been removed from the revised 4th Schedule and from 2004-2005 IAS 10 will be followed.

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 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.

- IAS 1 specifies required disclosure if:
  - a) The financial statements are not prepared on a going concern basis; or
  - b) Management is aware of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern. The events or conditions requiring disclosure may arise after the balance sheet date.

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Disclosure IAS -10

- An entity shall disclose the date when the financial statements were authorized for issue and who gave that authorization. If the entity's owners or others have the power to amend the financial statements after issue, the entity shall disclose that fact.

Disclosure about Conditions at the Balance Sheet Date

- If an entity receives information after the balance sheet date about conditions that existed at the balance sheet date, it shall update disclosures that relate to those conditions, in the light of the new information.

Disclosure

- Non-adjusting Events after the Balance Sheet Date.

- If non-adjusting events after the balance sheet date are material, non-disclosure could influence the economic decisions of users taken on the basis of the financial statements. Accordingly, an entity shall disclose the following for each material category of non-adjusting events after the balance sheet date:
  a) The nature of the event; and
  b) An estimate of its financial effect or a statement that such an estimate cannot be made.

- The following are examples of non-adjusting events after the balance sheet date that would generally result in disclosure:
  a) A major business combination after the balance sheet date (IFRS 3 Business combinations requires specific disclosures in such cases) or disposing of a major subsidiary.
  b) Announcing a plan to discontinue an operation.
  c) The destruction of a major production plant by a fire after a balance sheet date.
  d) Announcing, or commencing the implementation of, a major restructuring.
  e) Entering in to significant commitments or contingent liabilities, for example, by issuing significant guarantees.
  f) Commencing major litigation arising solely out of events that occurred after the balance sheet date.
  g) Major purchases of assets, classification of assets as held for sale in accordance with IFRS-5 (Non current assets held for sale and discontinued operations and other disposals of assets.
  h) Major ordinary share transactions and potential ordinary share transactions after the balance sheet date (IAS 33 Earnings per share requires an entity to disclose a description of such transaction, other than when such transactions involve Capitalization or bonus issues)

Summary of Accounting Treatments

- Adjust: Assets and liabilities where events after the B/S date provide further evidence of conditions existing at the B/S Date.

- Do Not Adjust: But instead disclose important events after the B/S date that does not affect condition of assets / liabilities at the B/S Date.

- Dividends: for the period proposed/disclosed after the B/S date but before Financial Statements are approved should be disclosed but not included in liabilities.

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Lecture 42

IAS-33 Earnings per Share

- Earnings Per Share (EPS) is widely used by investors as a measure of a company's performance and is of particular importance in:

    a) Comparing the results of a company over a period of time.

    b) Comparing the performance of one company's equity against the performance of another company's equity.

Objectives IAS 33

- The objective of IAS 33 is to improve the comparison of the performance of different entities in the same period and of the same entity in different accounting periods by prescribing methods for determining the number of shares to be included in the calculation of earnings per share and other amounts per share and by specifying their presentation.

Definition IAS 33

- Ordinary Share: An equity instrument that is subordinate to all other classes of equity instruments.

- Potential Ordinary Shares: A financial instrument or other contract that may entitle its holder to ordinary shares.

- Warrants or Options: Financial Instruments that give the holder the right to purchase ordinary shares.

Ordinary share

- There may be more than one class of ordinary shares, but ordinary shares of the same class will have the same rights to receive dividends. Ordinary shares participate in the net profit for the period only after other types of shares, e.g. preference shares.

Potential Ordinary Shares

- Debt or equity instruments, including preference shares that are convertible in to ordinary shares.

Scope IAS 33

- IAS 33 has the following scope restrictions:

    a) Only companies with (potential) ordinary shares which are publicly traded need to present EPS (Including companies in the process of being listed)

    b) Where companies choose to present EPS, even when they have no (potential) ordinary shares which are traded, they must do so according to IAS 33.

Basic EPS

- Basic EPS should be calculated by dividing the net profit or loss for the period attributable to ordinary shareholders by the weighted average number of ordinary shares outstanding during the period.

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The formula is shown as:

$$\frac{\text{Net profit / (loss) attributable to ordinary shareholders}}{\text{Weighted Average number of ordinary shares outstanding during the period}}$$

OR

$$\frac{\text{Earnings – Profit attributable to Preference Shareholders}}{\text{Weighted Average number of ordinary shares outstanding during the period}}$$

Earnings

- Earnings include all items of income and expenses (including tax, extraordinary items) less net profit attributable to preference shareholders, including preference dividend.

Per Share

- The number of ordinary shares used should be the weighted average number of ordinary shares during the period. This figure should be adjusted for events, other than the conversion of potential ordinary shares (Discussed later), that have changed the number of shares outstanding without a corresponding changes in resources.

- The time-weighting factor is the number of days the shares were outstanding compared with the total number of days in the period; a reasonable approximation is usually adequate.

- Shares are usually included in the weighted average number of shares from the date consideration is receivable which is usually the date of issue. In other cases consider the substance of any transaction.

Weighted Average Number of Shares

Example: 01

ABC Company, a listed company, has the following share transactions during 20X7

Date	Details	Shares Transaction	Shares Outstanding
01 January 20X7	Balance at beginning of year	170,000	170,000
31 May 20X7	Issue of new shares for cash	80,000	250,000
01 December 20X7	Purchase of own shares	25,000	225,000
31 December 20X7	Balance at year end	275,000	225,000

Required:
Calculate the weighted average number of shares for 20X7

Answer:

The weighted average number of shares can be calculated in two ways

(a) (170,000 X 5 / 12) + (250,000 X 6 / 12) + (225,000 X 1 / 12) = 214,583 Shares

(b) (170,000 X 12 / 12) + (80,000 X 7 / 12) - (25,000 X 1 / 12) = 214,583 Shares

- Shares are usually included in the weighted average number of shares from the date consideration is receivable which is usually the date of issue. In other cases consider the substance of any transaction.

Example: 02

XYZ Company is a company with a called up and paid up capital of 100,000 ordinary shares of Rs. 10/- each and also 20,000 10% preference shares of Rs. 10/- each. The company manufactures gas appliances. The gross profit was Rs. 200,000. XYZ Company paid the required preferred share dividend and declared a dividend of Rs. 1/- per share.

Required:

Assuming an income tax rate of 30%, show the trading results and EPS of the Company.

ANSWER
XYZ COMPANY
TRADING RESULTS

			Rupees
Profit for the Financial Year			200,000
Tax on Profit (30%)			(60,000)
Profit after tax			140,000
Less dividends:			
Preferred	(20,000 X 10 / 100)	2,000	
Ordinary	(100,000 X 1)	100,000	
			(102,000)
			38,000

EARNINGS PER SHARE

$$\frac{138{,}000^*}{100{,}000} = \text{1 Rupee and 38 paisas per share}$$

* (Rs. 140,000 - Rs. 2,000 preferred Dividend = Rs. 138,000)

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Lecture 43

IAS-33 Earnings per Share & Financial Statements

Diluted EPS

- 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 loan stock 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) Options or Warrants.

- In such circumstances, the future number of shares ranking for dividend might increase, which in turn results in a fall in the EPS. In other words, a future increase in the number of equity shares will cause a dilution or "watering down" 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.

Example 03

ABC Company has a paid up capital of Rs. 50,000,000 consisting of 5,000,000 ordinary shares of Rs.10/- each on June 30, 20X5. There was no movement during the year 20X4-X5. The company has two outstanding loans that are convertible into ordinary shares:

a) Rs. 1,000,000 of 14 % convertible loan, convertible in three years time at the rate of 3 shares per Rs. 10/- of loan amount;

b) Rs. 2,000,000 of 10 % convertible loan, convertible in one years time at the rate of 4 shares per Rs. 5/- of loan amount.

The Total Earnings in 20X5 were Rs. 6,500,000/-
The rate of Income Tax is 35%

Required:
Calculate the EPS and diluted EPS.

Answer

a) EPS $= \dfrac{6,500,000}{5,000,000} =$ 1 Rupee and 30 Paisas

b) On dilution, the (maximum) number of shares in issue would be:

Current		5,000,000
On Conversion of 14% stock	1,000,000 / 10 x 3	300,000
On Conversion of 10% stock	2,000,000 / 5 x 4	1,600,000
		6,900,000

Current Earnings	6,500,000
Add: Interest saved (140,000+200,000)	340,000
Less: Increase in Tax thereon at 35% (due to increase in earning)	(119,000)
Net Increase in Earnings	221,000
Revised Earnings	6,721,000

Diluted EPS $= \dfrac{6,721,000}{6,900,000} =$ 97 Paisas

Effects on EPS of Changes in Capital Structure

- We looked at the effect of issues of new shares or buy-backs of shares on basic EPS above. In these situations, the corresponding figures for EPS for the previous year will be comparable with the current year because, as the weighted average of shares has risen or fallen, there has been a corresponding increase or decrease in resources. Money has been received when shares were issued, and money has been paid out to repurchase shares. It is assumed that the sales or purchases have been made at full market price.

- But there are other events, however, which change the number of shares outstanding, without a corresponding change in resources. In these circumstances it is necessary to make adjustments so that the current and prior period EPS figures are comparable.

- Four such events are considered by IAS 33 these are

  a) Capitalization or bonus issue.

  b) Bonus element in any other issue. e.g. a right issue to existing shareholders.

  c) Share split

  d) Reverse share split (Consolidation of shares)

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Presentation of EPS

- Basic and diluted EPS should be presented by an enterprise on the face of the income statement for each class of ordinary share that has a different right to share in the net profit for the period.

- The basic and diluted EPS should be presented with equal prominence for all periods presented.

Disclosure of EPS

- Disclosure must still be made where the EPS figures (basic and/or diluted) are negative (i.e. a loss per share)

- The amounts used as the numerators in calculating basic and diluted EPS, and a reconciliation of those amounts to the net profit or loss for the period.

- The weighted average number of ordinary shares used as the denominator in calculating basic and diluted EPS, and a reconciliation of these denominators to each other.

Significance of Earnings per Share

- EPS has served as a means of assessing the stewardship and management role performed by company directors and managers. Remuneration packages might be linked to EPS growth, thereby increasing the pressure on management to improve EPS. The danger of this, however, is that management effort may go into distorting results to produce a favorable EPS.

Balance Sheet
as at December 31, 2004

	Note	2004	2003
		(Rupees in thousands)	
EQUITY AND LIABILITIES			
SHARE CAPITAL AND RESERVES			
Authorised capital			
60,000,000 (2003: 60,000,000)			
ordinary shares of Rs. 10 each		600,000	600,000
Issued, subscribed and paid up capital			
47,537,080 (2003: 47,537,080)			
ordinary shares of Rs. 10 each	**3**	475,371	475,371
Reserves	**4**	3,311,625	2,752,625
Unappropriated profit		404,864	404,727
		4,191,860	3,632,723

LONG-TERM AND DEFERRED LIABILITIES			
Long-term finances and other payables	**5**	-	854,870
Liabilities against assets subject to finance lease	**6**	6,351	1,702
Deferred liabilities	**7**	527,390	566,681
		533,741	1,423,253
CURRENT LIABILITIES			
Current portion of long-term liabilities	**8**	859,330	96,224
Finances under mark up arrangements - secured	**9**	234,197	499,115
Creditors, accrued and other liabilities	**10**	595,213	498,108
Dividends	**11**	5,960	4,861
Provision for taxation		54,185	-
		1,748,885	1,098,308
CONTINGENCIES AND COMMITMENTS	**12**	-	-
		6,474,486	**6,154,284**
ASSETS			
FIXED CAPITAL EXPENDITURE			
Property, plant and equipment	**13**	2,937,656	2,782,007
Intangible assets	**14**	6,385	28,071
Investment property	**15**	14,865	14,842
Assets subject to finance lease	**16**	12,155	129,082
Capital work-in-progress	**17**	329,867	344,747
		3,300,928	3,298,749
OTHER LONG-TERM ASSETS			
Investments	**18**	691,176	643,461
Long-term loans and deposits	**19**	5,840	3,981
Retirement and other benefits	**20**	51,725	37,336
		748,741	684,778

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CURRENT ASSETS

Stores and spares	**21**	380,556	318,880
Stock-in-trade	**22**	1,094,329	844,120
Trade debts	**23**	640,537	577,548
Investments	**18**	9,067	-
Loans, advances, deposits, prepayments			
and other receivables	**24**	155,442	332,043
Cash and bank balances	**25**	144,886	98,166
		2,424,817	2,170,757
		6,474,486	6,154,284

The annexed notes 1 to 46 form an integral part of these finanncial statements

Profit and Loss Account
for the year ended December 31, 2004

	Note	2004	2003
		(Rupees in thousand)	
Local sales		6,804,861	6,243,603
Export sales		88,124	49,616
		6,892,985	6,293,219
Less: Sales tax and excise duty		898,166	848,992
Commission		7,842	8,038
		906,008	857,030
Net Sales		5,986,977	5,436,189
Cost of goods sold	**26**	(4,678,375)	(4,242,476)
Gross profit		1,308,602	1,193,713

Gross profit		1,308,602	1,193,713
Administration expenses	**27**	(347,030)	(344,155)
Distribution and marketing expenses	**28**	(172,561)	(165,629)
Other operating expenses	**29**	(84,699)	(70,164)
Other operating income	**30**	84,398	104,541
Profit from operations		788,710	718,306
Finance cost	**31**	(139,008)	(151,308)
Investment income	**32**	542,619	469,907
Profit before taxation		1,192,321	1,036,905
Taxation	**33**	(229,119)	(223,392)
Profit after taxation		**963,202**	**813,513**
Earnings per share - basic and diluted (Rupees)	**42**	20.26	17.11

Appropriations have been reflected in the statements of changes in equity.

The annexed notes 1 to 46 form an integral part of these financial statements.

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Statement of Changes in Equity
for the year ended December 31, 2004

	Share Capital	Share Premium	General Reserve	Unappropriated Profit	Total
			(Rupees in thousands)		
Balance as on December 31, 2002 as previously reported	475,371	203,589	2,140,036	214	2,819,210
Effect of change in accounting policy (note 11.1) Final dividend for the year ended December 31, 2002 declared subsequent to year end	-	-	-	332,760	332,760
Balance as on December 31, 2002 as restated	475,371	203,589	2,140,036	332,974	3,151,970
Final dividend for the year ended December 31, 2002 Rs. 7.00 per share	-	-	-	(332,760)	(332,760)
Net profit for the year				813,513	813,513
Transferred from profit and loss account			409,000	(409,000)	-
Balance as on December 31, 2003 as restated	475,371	203,589	2,549,036	404,727	3,632,723
Final dividend for the year ended December 31, 2003 Rs. 8.50 per share	-	-	-	(404,065)	(404,065)
Net profit for the year	-	-	-	963,202	963,202
Transferred from profit and loss account	-	-	559,000	(559,000)	-
Balance as on December 31, 2004	475,371	203,589	3,108,036	404,864	4,191,860

The annexed notes 1 to 46 form an integral part of these financial statements.

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Presentation and Disclosure Requirements of Financial Statements – Revision

Balance Sheet
as at December 31, 2004

	Note	2004	2003
		(Rupees in thousands)	
EQUITY AND LIABILITIES			
SHARE CAPITAL AND RESERVES			
Authorized capital			
60,000,000 (2003: 60,000,000)			
ordinary shares of Rs. 10 each		600,000	600,000
Issued, subscribed and paid up capital			
47,537,080 (2003: 47,537,080)			
ordinary shares of Rs. 10 each	3	475,371	475,371
Reserves	4	3,311,625	2,752,625
Un-appropriated profit		404,864	404,727
		4,191,860	3,632,723
LONG-TERM AND DEFERRED LIABILITIES			
Long-term finances and other payables	5	527,390	1,421,551
Liabilities against assets subject to finance lease	6	6,351	1,702
		533,741	1,423,253
CURRENT LIABILITIES			
Current portion of long-term liabilities	7	859,330	96,224
Finances under mark up arrangements - secured	8	234,197	499,115
Creditors, accrued and other liabilities	9	595,213	498,108
Dividends	10	5,960	4,861
Provision for taxation		54,185	-
		1,748,885	1,098,308
CONTINGENCIES AND COMMITMENTS	11	-	-
		6,474,486	**6,154,284**

	Note	2004	2003
		(Rupees in thousands)	
ASSETS			
FIXED CAPITAL EXPENDITURE			
Property, plant and equipment	**12**	2,937,656	2,782,007
Intangible assets	**13**	6,385	28,071
Assets subject to finance lease	**14**	12,155	129,082
Capital work-in-progress	**15**	344,732	359,589
		3,300,928	3,298,749
OTHER LONG-TERM ASSETS			
Investments	**16**	691,176	680,797
Long-term loans and deposits	**17**	57,565	41,317
		748,741	722,114
CURRENT ASSETS			
Stores and spares	**18**	380,556	318,880
Stock-in-trade	**19**	1,094,329	844,120
Trade debts	**20**	640,537	577,548
Investments	**16**	9,067	-
Loans, advances, deposits, prepayments and other receivables	**21**	155,442	332,043
Cash and bank balances	**22**	144,886	98,166
		2,424,817	2,170,757
		6,474,486	**6,191,620**

The annexed notes 1 to 32 form an integral part of these financial statements

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Profit and Loss Account
for the year ended December 31, 2004

		Note	2004	2003
			(Rupees in thousand)	
Local sales			6,804,861	6,243,603
Export sales			88,124	49,616
			6,892,985	6,293,219
Less:	Sales tax and excise duty		898,166	848,992
	Commission		7,842	8,038
			906,008	857,030
Net Sales			5,986,977	5,436,189
Cost of goods sold		23	(4,678,375)	(4,242,476)
Gross profit			1,308,602	1,193,713
Administration expenses		24	(347,030)	(344,155)
Distribution and marketing expenses		25	(172,561)	(165,629)
Other operating expenses		26	(84,699)	(70,164)
Other operating income		27	84,398	104,541
Profit from operations			788,710	718,306
Finance cost		28	(139,008)	(151,308)
Investment income		29	542,619	469,907
Profit before taxation			1,192,321	1,036,905
Taxation			(229,119)	(223,392)
Profit after taxation			**963,202**	**813,513**
Earnings per share - basic and diluted (Rupees)		32	20.26	17.11

Appropriations have been reflected in the statements of changes in equity.

The annexed notes 1 to 32 form an integral part of these financial statements.

Cash Flow Statement
for the year ended December 31, 2004

	Note	2004	2003
		(Rupees in thousands)	
Cash flow from operating activities:			
Cash generated from operations	**30**	950,098	1,137,599
Finance cost paid		(142,422)	(162,918)
Taxes paid		(9,543)	(61,273)
Payments for accumulating compensated absences		(3,951)	(5,135)
Retirement and other benefits paid		(25,249)	(23,415)
Net cash from operating activities		768,933	884,858
Cash flow from investing activities:			
Fixed capital expenditure		(470,598)	(599,824)
Net increase in long-term loans and deposits		(1,859)	(302)
Sale proceeds of property, plant and equipment		19,406	28,951
Dividend received		535,836	457,554
Investments		(49,999)	(60,480)
Net cash from/used in investing activities		32,786	(174,101)
Cash flow from financing activities:			
Repayment of long-term finances and other payables		(60,238)	(100,000)
Payment of finance lease liabilities		(26,877)	(32,712)
Dividend paid		(402,966)	(331,770)
Net cash used in financing activities		(490,081)	(464,482)
Net increase in cash and cash equivalents		311,638	246,275
Cash and cash equivalents at the beginning of the year		(400,949)	(647,224)
Cash and cash equivalents at the end of the year	**31**	(89,311)	(400,949)

The annexed notes 1 to 32 form an integral part of these financial statements.

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Statement of Changes in Equity
for the year ended December 31, 2004

	Share Capital	Share Premium	General Reserve	Un-appropriated Profit	Total
				(Rupees in thousands)	
Balance as on December 31, 2002 as previously reported	475,371	203,589	2,140,036	214	2,819,210
Effect of change in accounting policy (note 11.1) Final dividend for the year ended December 31, 2002 declared subsequent to year end	-	-	-	332,760	332,760
Balance as on December 31, 2002 as restated	475,371	203,589	2,140,036	332,974	3,151,970
Final dividend for the year ended December 31, 2002 Rs. 7.00 per share	-	-	-	(332,760)	(332,760)
Net profit for the year				813,513	813,513
Transferred from profit and loss account			409,000	(409,000)	-
Balance as on December 31, 2003 as restated	475,371	203,589	2,549,036	404,727	3,632,723
Final dividend for the year ended December 31, 2003 Rs. 8.50 per share	-	-	-	(404,065)	(404,065)
Net profit for the year	-	-	-	963,202	963,202
Transferred from profit and loss account	-	-	559,000	(559,000)	-
Balance as on December 31, 2004	475,371	203,589	3,108,036	404,864	4,191,860

The annexed notes 1 to 32 form an integral part of these financial statements.

Disclosure Requirements of Share Capital

- Share capital classified under the following sub-heads, namely:

  ✓ Issued, subscribed and paid up capital, distinguishing in respect of each class between:-

  (a) Shares allotted for consideration paid in cash;

  (b) Shares allotted for consideration other than cash, showing separately shares issued against property and others (to be specified); and

  (c) Shares allotted as bonus shares.

- If the share capital is divided into different classes of shares, namely ordinary, preference etc. For each separate class of share capital, the following is disclosed:

  a) Authorized Capital
  Number of Shares
  Nominal value

  b) Paid up Capital
  Number of Shares
  Nominal value

Reserves

- Reserves distinguishing between capital and revenue reserves

- Long Term Finances and Other Payables

  Disclosure of financial instruments is covered under IAS 32 And 39. Detailed knowledge of these standards is not included in the course.

Finance Lease - Disclosures

- Lessee should in addition to meeting the requirements of IAS 32 Financial Instruments: Disclosure and Presentation, make following disclosures for finance leases:

  a. For each class of asset, the net carrying amount at the balance sheet date (fixed assets schedule)

  b. Future minimum lease payments at the balance sheet date, and their present value. In addition, an entity shall disclose the total future minimum lease payments and their present value, for each of the following periods:

     Not later than one year,
     Later than one year and not later than five years
     Later than five years

  c. Contingent rents recognized as expense in the period.

  d. The total of future minimum sublease payments expected to be received under a non-cancelable sublease at the balance sheet date.

  e. A general description of the lessee's material leasing arrangements including but not limited to, the following:

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i. The basis on which contingent rent payable is determined;

ii. The existence and terms of renewal or purchase options and escalation clauses

iii. Restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and future leasing.

- In addition, the requirements for disclosure in accordance with IAS 16 (Property Plant and Equipment), IAS 36 (Impairment of Assets), IAS 40 (Investment Property) and IAS 41 (Agriculture) apply to lessees for assets leased under finance lease.

Dividends - IAS 10

- 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 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 according to IAS 37. Such dividends are disclosed in the notes in accordance with IAS 1 Presentation of Financial Statements.

Disclosure Requirements – Fixed Assets

✓ A reconciliation of the carrying amount at the beginning and end of the period.

✓ Comparative figures are not required for reconciliation.

✓ The financial statements should also disclose.

✓ The existence and amount of restrictions on title, and property plant and equipment pledged as security.

✓ The accounting policy for estimated costs of restoring site of items of property plant and equipment

✓ The reconciliation of carrying amount at the beginning and at the end of the period.

✓ The amount of expenditures on account of account of property, plant and equipment in the course of construction

✓ The amount of commitments for the acquisition of property, plant ant equipment.

Disclosure Requirements - Intangibles

- The financial statements should also disclose:

  ✓ If an intangible asset is amortized over a period of more than 20 years the reason why the presumption of useful life was rebutted.

  ✓ Description, carrying amount and remaining amortization period of any individual asset that is material to financial statements.

- The financial statements should disclose the following for each class of intangible assets, distinguishing between internally generated assets and other assets:

- ✓ The useful lives or the amortization rates used.
- ✓ The amortization method used.
- ✓ The gross carrying amount and the accumulated amortization at the beginning and at the end of the period.

- For intangible assets acquired by way of Government grants:
  - ✓ The fair value initially recognized
  - ✓ The carrying amount
  - ✓ Whether they are carried at bench mark (cost less acc amortization) or the allowed alternative treatment (revalued amount less acc amortization)
  - ✓ The existence of intangible assets whose title is restricted and the carrying amount intangible assets pledged as security for liabilities.
  - ✓ The amount of commitments for acquisition of intangible assets.

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Lecture 45

Presentation and Disclosure Requirements of Financial Statements – Revision (Contd)

Disclosure Requirements – IAS 02

- The accounting policy adopted
- The total carrying amount and the carrying amount in classification appropriate to the enterprise.
- The carrying amount of the inventories carried at NRV.
- The amount of any reversal of any write down that is recognized as the income.
- The circumstances and events that led to the reversal of write down
- The carrying amount of any securities pledged for security.
- If the inventories are recorded using allowed alternative treatment then the difference of inventories under benchmark treatment and allowed alternative treatment is also required to be disclosed.
- The financial statements should also disclose the cost of inventories recognized as expense during the period.

Disclosure - IAS 18

- An entity shall disclose;

  a) The accounting policies adopted for the recognition of revenue, including the methods adopted to determine the stage of completion of transitions involving rendering of services;

  b) The amount of each significant category of revenue recognized during the period including revenue arising from;

     i. The sale of goods;
     ii. The rendering of services;
     iii. Interest;
     iv. Royalties;
     v. Dividend; and

  c) The amount of revenue arising from exchanges of goods or services included in each significant category of revenue.

Recognition of Borrowing Costs

- Under the benchmark treatment of IAS 23 borrowing cost should be treated as expense in the period they are incurred regardless of how the loan is used.

Disclosure Requirements- Borrowing Cost

- If benchmark treatment is used the enterprise is only required to disclose the policy adopted for borrowing costs.

Disclosure of EPS

- Disclosure must still be made where the EPS figures (basic and/or diluted) are negative (i.e. a loss per share)

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- The amounts used as the numerators in calculating basic and diluted EPS, and a reconciliation of those amounts to the net profit or loss for the period.

- The weighted average number of ordinary shares used as the denominator in calculating basic and diluted EPS, and a reconciliation of these denominators to each other.

Disclosures – Cash Flows

- All entities should disclose, together with a commentary by management, any other information likely to be of importance, for example:

  a) Restrictions on the use of or access to any part of cash equivalents.

  b) The amount of un-drawn borrowing facilities which are available.

  c) The separate disclosure of cash flows that represent increases in operating capacity and cash flows that are required to maintain operating capacity is useful in enabling the user to determine whether the entity is investing adequately in the maintenance of its operating capacity. An entity that does not invest adequately in the maintenance of its operating capacity may be prejudicing future profitability for the sake of current liquidity and distributions to owners.

  d) The disclosure of segmental cash flows enables users to obtain a better understanding of the relationship between the cash flows of the business as a whole and those of its components parts and the availability and variability of segmental cash flows.

Retrospective Application – IAS 8

- (Para 22) subject to Para 23, when a change in accounting policy is applied retrospectively in accordance with Para 19, the entity shall adjust the opening balance of each affected component of equity for the earliest period presented and the other comparative amounts disclosed for each prior periods presented as if the new accounting policy has always been applied.

Notes to the accounts

1. Legal status and nature of business

The company is incorporated in Pakistan and is listed on Karachi, Lahore and Islamabad Stock Exchanges. It is principally engaged in the manufacture and sale of paper, paperboard, packaging materials and tissue products.

2. Significant accounting policies

2.1 Basis of preparation

2.1.1 These financial statements have been prepared in accordance with the requirements of the Companies Ordinance, 1984 and International Accounting Standards (IAS) as applicable in Pakistan. Approved Accounting Standards comprise of such IASs as notified under the provisions of the Companies Ordinance, 1984. Wherever, the requirements of the Companies Ordinance, 1984 or directives issued by the Securities and Exchange Commission of Pakistan (SECP) differ with the requirements of these standards, the requirements of the Companies Ordinance, 1984 or the requirements of the said directives take precedence.

2.1.2 During the year, the SECP substituted the Fourth Schedule to the Companies Ordinance, 1984 which is effective from financial year ending on or after July 5, 2004. This has resulted in the change in accounting policy pertaining to the recognition of dividends proposed subsequent to year end (note 11.1) and capitalization of exchange differences (note 2.19).

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2.2 Accounting convention

These financial statements have been prepared under the historical cost convention, except for revaluation of certain financial instruments at fair value and recognition of certain employee retirement benefits at present value.

2.3 Taxation

Provision of current tax is based on the taxable income for the year determined in accordance with the prevailing law for taxation of income. The charge for current tax is calculated using prevailing tax rates or tax rates expected to apply to the profit for the year if enacted. The charge for current tax also includes adjustments, where considered necessary, to provision for tax made in previous years arising from assessments framed during the year for such years.

2.4 Fixed capital expenditure and depreciation/amortization

2.4.1 Property, plant and equipment

Property, plant and equipment except freehold land are stated at cost less accumulated depreciation and any identified impairment loss. Freehold land is stated at cost less any identified impairment loss. Cost in relation to certain plant and machinery signifies historical cost and interest, mark up etc. as referred to in note 2.20. Depreciation on all operating property, plant and equipment is charged to profit on the straight-line method so as to write off the historical cost of an asset over its estimated useful life at the following annual rates:

Plant and machinery	6.25% to 20%
Buildings	2.5% to 10%
Other equipment	10% to 33.33%
Furniture and fixtures	10% to 20%
Vehicles	20%

Depreciation on additions to property, plant and equipment is charged from the month in which an asset is acquired or capitalized while no depreciation is charged for the month in which the asset is disposed off. Impairment loss or its reversal, if any, is also charged to income.

Where an impairment loss is recognized, the depreciation charge is adjusted in the future periods to allocate the asset's revised carrying amount over its estimated useful life.

Major repairs and improvements are capitalized. Minor repairs and renewals are charged to income. The gain or loss on disposal or retirement of an asset represented by the difference between the sale proceeds and the carrying amount of the asset is recognized as an income or expense.

2.4.2 Intangible assets

Expenditure incurred to acquire computer software and Enterprise Resource Planning System (ERP) are capitalized as intangible assets and stated at cost less accumulated amortization and any identified impairment loss. Intangible assets are amortized using the straight line method over a period of three years.

Amortization on additions to intangible assets is charged from the month in which an asset is acquired or capitalized while no amortization is charged for the month in which the asset is disposed off. Impairment loss or its reversal, if any, is also charged to income. Where an impairment loss is recognized, the amortization charge is adjusted in the future periods to allocate the asset's revised carrying amount over its estimated useful life.

2.4.3 Capital work in progress

Capital work in progress is stated at cost less any identified impairment loss.

2.5 Leases

Finance leases

A finance lease is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset. Assets subject to finance lease are stated at the lower of present value of minimum lease payments under the lease agreements and the fair value of the assets.

The related rental obligations, net of finance charges, are included in liabilities against assets subject to finance lease as referred to in note 6. The liabilities are classified as current and long-term depending upon the timing of the payment.

Each lease payment is allocated between the liability and finance charges so as to achieve a constant rate on the balance outstanding. The interest element of the rental is charged to profit over the lease term.

Assets acquired under a finance lease are depreciated over the useful life of the asset on a straight-line method at the rates given in note 2.4.1. Depreciation of leased assets is charged to profit.

Depreciation on additions to leased assets is charged from the month in which an asset is acquired while no depreciation is charged for the month in which the asset is disposed off.

Operating leases

Leases where a significant portion of the risks and rewards of ownership are retained by the lessor are classified as operating leases. Payments made under operating leases (net of any incentives received from the lessor) are charged to profit on a straight line basis over the lease term.

2.6 Investments

Investments in equity instruments of subsidiaries and associated companies Investments are initially measured at cost. Cost in relation to investments made in foreign currency is determined by translating the consideration paid in foreign currency into rupees at exchange rates prevailing on the date of transactions.

Other investments

The other investments made by the company are classified for the purpose of measurement into the following categories: Held to maturity Investments with fixed maturity that the management has the intent and ability to hold to maturity are classified as held to maturity and are initially measured at cost and at subsequent reporting dates measured at amortized cost using the effective yield method.

Available for sale

Investments classified as available for sale are initially measured at cost, being the fair value of consideration given. At subsequent reporting dates, these investments are re-measured at fair value (quoted market price), unless fair value cannot be reliably measured. The investment for which a quoted market price is not available, are measured at cost as it is not possible to apply any other valuation methodology. Realized and un-realized gains and losses arising from changes in fair value are included in the net profit or loss for the period in which these arise.

All purchases and sales of investments are recognized on the trade date which is the date that the company commits to purchase or sell the investment. Cost of purchase includes transaction cost.

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At subsequent reporting dates, the company reviews the carrying amounts of the investments to assess whether there is any indication that such investments have suffered an impairment loss. If any such indication exists, the recoverable amount is estimated in order to determine the extent of the impairment loss if any. Impairment losses are recognized as expense. Where an impairment loss subsequently reverses, the carrying amount of the investment is increased to the revised recoverable amount but limited to the extent of initial cost of the investment. A reversal of the impairment loss is recognized in income.

2.7 Stores and spares

Usable stores and spares are valued principally at moving average cost, while items considered obsolete are carried at nil value. Items in transit are valued at cost comprising invoice value plus other charges paid thereon.

2.8 Stock-in-trade

Stock of raw materials, except for those in transit, work-in-process and finished goods are valued principally at the lower of weighted average cost and net realizable value. Cost of work-in-process and finished goods comprises, cost of direct materials, labour and appropriate manufacturing overheads. Materials in transit are stated at cost comprising invoice value plus other charges paid thereon.

Net realizable value signifies the estimated selling price in the ordinary course of business less costs necessarily to be incurred in order to make a sale.

2.9 Financial instruments

Financial assets and financial liabilities are recognized when the company becomes a party to the contractual provisions of the instrument. The particular measurement methods adopted are disclosed in the individual policy statements associated with each item.

2.10 Trade debts

Trade debts are carried at original invoice amount less an estimate made for doubtful debts based on a review of all outstanding amounts at the year end. Bad debts are written off when identified.

2.11 Cash and cash equivalents

Cash and cash equivalents are carried in the balance sheet at cost. For the purpose of cash flow statement cash and cash equivalents comprise cash in hand, demand deposits, other short-term highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of change in value and finances under mark up arrangements. In the balance sheet, finances under mark up arrangements are included in current liabilities.

2.12 Borrowings

Loans and borrowings are recorded at the proceeds received. In subsequent periods, borrowings are stated at amortized cost using the effective yield method. Finance costs are accounted for on an accrual basis and are included in creditors, accrued and other liabilities to the extent of the amount remaining unpaid.

2.13 Creditors, accrued and other liabilities

Liabilities for trade and other amounts payable are carried at cost which is the fair value of the consideration to be paid in future for goods and services.

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2.14 Provisions

Provisions are recognized when the company has a present obligation as a result of past event which it is probable will result in an outflow of economic benefits and a reliable estimate can be made of the amount of the obligation.

2.15 Revenue recognition

Revenue is recognized on dispatch of goods or on the performance of services except for management fee, which is recognized on receipt.

Return on deposits is accrued on a time proportion basis by reference to the principal outstanding and the applicable rate of return.

Dividend income on equity investments is recognized as income when the right of receipt is established.

2.16 Borrowing costs

Mark up, interest and other charges on long-term borrowings are capitalized up-to the date of commissioning of the related plant and machinery, acquired out of the proceeds of such long-term borrowings. All other mark up, interest and other charges are charged to profit.

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