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ALLAMA IQBAL OPEN UNIVERSITY

FINANCIAL ACCOUNTING

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PREFACE

One of the best features of AIOU academic programs is regular revision of courses. It is a continuous process for enhancing students' learning through latest and updated learning materials. In the process of revising the course, students and tutors feedback as well as new and emerging trends and research generated knowledge is included. It is matter of immense pleasure that the Department of Commerce of Allama Iqbal Open University is offering a revised course **"Financial Accounting"** for Associate Degree/B.Com/BS students.

AIOU books are developed in the mode of self-learning so that students can easily understand the subject and contents related to it. Our faculty put their best efforts in making the materials self-explanatory so that the text speaks to the learner. This book is especially written for non-formal and distance learners but is also helpful for the students of formal education system. This book is recommended as textbook of financial accounting for AD/B.Com/BS students at AIOU.

The present century is the era of knowledge economy that must not be restricted to one book or specified learning materials. The teachers and learners of this course are advised to go beyond the limits of one course book. Sky is the limit when you go in search of knowledge. I wish all the readers of this book an enlightening journey of education ahead.

(Prof. Dr. Zia Ul-Qayyum)
Vice Chancellor, AIOU

INTRODUCTION

In present era of specialization, there are a number of sub-disciplines, which fall under the umbrella of Accountancy. This course of Financial Accounting focus on the recording of financial information in a standard professional format, which allows managers, investors, lenders, stakeholders, and regulators to make appropriate decisions. In this course, students will learn to prepare Income Statement, Balance Sheet, Statement of Cash Flows, and Statement of Shareholders' Equity, to compile and analyze these financial statements, determine the value of a firm, and compare the firm to its competitors.

Department of Commerce introduced this subject of Financial Accounting at the bachelor level for Associate Degree/B.Com and BS students. It describes the basic concepts of using accounting information in decision-making and topics have been discussed in enough depth without sacrificing the emphasis on explanation of the basic concepts. It consists of nine units, including the basic concepts, accounting information system, completion of accounting cycle, accounting for receivables and investments, accounting for corporations, long term liabilities, reporting the statement of cash flows and the analysis of financial statements.

The book is written for Distance Learning Education System, thus making it a self-study material where a student may understand concepts with minimum help of the tutor. But it is equally valuable for the students of AD/B.Com and BS of formal system of education. Practical exercises are given in all units after the theoretical concepts so that student can learn theoretical concepts in better way. At the end of each unit self-assessment questions and structured questions are given for the better understanding of the topic covered in the unit. A comprehensive summary has also been added at the end of each unit, which is very useful for the students for learning and revision of the units during the course of study

Although efforts have been made to ensure error free version of book but still, room for improvement always exist. Comments and suggestions for improving the contents and quality of the book are welcomed and will be gratefully acknowledged.

I owe a great deal and oblige to the efforts of Mr. Muhammad Ashraf Bhutta (FCMA), Retired-Director Finance, PTV, who took the responsibility of writing complete book and put his efforts in completing this marvelous task. Mr.

Muhammad Ashraf Bhutta (FCMA) wrote this book without any remuneration and transferred all rights to the University for Welfare of the society.

I am also grateful to Prof. Dr. Syed Muhammad Amir Shah, Chairman Department of Commerce, whose supervision, support and guidance made possible the completion of this book.

OBJECTIVES

This is an introductory course in financial accounting. Financial accounting focuses on the rules by which firms (and individuals) report the results of their operations to outsiders such as stockholders, potential investors, creditors, suppliers and regulatory agencies.

Course objectives are to understand:

i. The important role accounting plays in society
ii. The accounting concepts, which enable students to recognize and maintain different accounts of business according to the Accounting Standards.
iii. Understand the basic elements of double-entry accounting systems, accounting cycle, entering transactions in journals, posting to ledgers, compiling end-of-period worksheets with adjusting entries and preparation of financial reports.
iv. How to create financial statements such as balance sheets, income statements, and cash flow statements from the underlying transactions.
v. How to perform ratio analysis to know the important role accounting plays in allowing individuals to make informed decisions.

Muhammad Munir Ahmad
Course Development Coordinator

CONTENTS

Unit–1

ACCOUNTING IN BUSINESS

Written by: Muhammad Ashraf Bhutta
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CONTENTS

INTRODUCTION

This unit describes the development of an understanding for accounting which is considered as language of business. The Owners of business require a systematic way of recording the business transactions and reporting the results periodically to evaluate performance of activities. In this respect basic accounting principles for recording, classifying and summarizing the business transactions have been described to ensure uniform reporting in preparing financial statements.

OBJECTIVEES

After study of this unit, the students would become conversant to understand and achieve the following objectives:

1) How the accounting can be defined and what are the spectrum of its field.
2) How the generally accepted accounting principles are applied for recording the business transactions.
3) The way of summarizing process through classification of transactions and preparation of a trail balance.
4) Accounting serves as a source document for internal and external users of accounting information.
5) Drafting the financial statements to report results of business operations periodically.

1.1 DEFINITION OF ACCOUNTING

The Accounting has been defined by different professionals and scholars from time to time according to the necessity and application of accounting information in the business and the needs of the management. However, comprehensive definition has been described in the encyclopedia Britannica which states that "the accounting is a process of recording, classifying, summarizing and interpreting the business transactions which can be measured in financial terms with the objectives to promote financial and administrative discipline in the business organization.

The above definition describes entering the business activities into accounting record in a specified manner so as to compute and report results of operations.

The major focus is over the transactions, which are measured in financial terms i.e. which can be related with monetary consideration. In accounting, no business event can be considered as a transaction until it is related with the prevailing currency because medium of recording the business transaction in accounting record is the currency amount, which has been exchanged or promised to be collected or disbursed in future.

1.2 IMPORTANCE OF ACCOUNTING

The accounting is an information system to which every person related to public or private business activities would like to know intermittent reports about performance. Accounting provides economic information to the society in a uniform manner and in selective format as is considered expedient. There are variety of user of accounting information about an enterprise. These may be classified as external users. These are described as under:-

A) External Users

The external users are not usually directly involved in the affairs of an enterprise. Such people comprise the shareholders, lenders, creditors, analyst, suppliers' customers, and regulatory agencies such as Securities and Exchange Commission of Pakistan, Stock Exchanges, Taxation authorities and other similar institutions. All such external users make their decisions about their dealings with the enterprise on the basis of accounting information provided to them on a uniform standard format of external reporting system.

B) Internal Users

The internal users of accounting information are those people who are directly related to the operating affairs of the organization. These people consist of the top management, middle management and lower management of the enterprise who take business decisions based upon the operating information provided to them from the accounting records. Besides the general employees, trade unions and internal auditors are all interested to use accounting information for their benefits. Such people are provided accounting information in a tailored format.

The external and internal users of accounting information of the enterprise have, therefore placed significant importance to the accounting in view of its contribution in meeting their needs.

1.3 FUNDAMENTALS OF ACCOUNTING

The accounting record is maintained and accounting reports are prepared in most of the business enterprises based upon Professional Ethics, Generally Accepted Accounting Principles, International Accounting Standards and International Financial Reporting Standards so as to ensure presentation of reliable accounting information to all the external and internal users. Such information will be treated as compatible and dependable which would be used without any doubts. The objectives of the forgoing fundamentals of accounting are to prevail upon qualitative reporting characteristics. There are further deliberated as here under: -

A) Professional Ethics

The accountants have obligations to adhere to the high standard of ethical conduct for recording, reporting and analyzing the results of operation of an organization. While adopting these professional ethics the accountants need to adopt honestly, fairness and adequate responsibility in discharging their own responsibilities and shall encourage its colleagues to adhere to such professional ethical standards. This encompasses maintaining confidentiality of internal information, high level of integrity of his character and credibility in communicating information to all users.

B) Generally Accepted Accounting Principles (GAAP)

The Financial Accounting Standard Board (FASB) has described certain guiding principles conventions and concept for implementation while recording the business transactions and dealing with the matters of concern. Some of these GAAP are described as hereunder: -

Business Entity:
The business unit has independent recognition from its owners. The business can purchase in its own name and can own. It can sue and be sued. Accounts are kept for entries, as distinguished/separate from the persons who are owners. The concept of separate entity is applicable to all forms of business Organizations. Thus, the personal affairs of owners are not to be recorded as business transactions.

Going Concern Concept: According to this concept, it is assumed that an entity is a going concern, that it will continue to operate for indefinite period and there is no intention to liquidate the particular business venture in the near future. Therefore, the accountants, on this concept, while valuing the assets, do not take into account the sale value of assets. Moreover, the depreciation on fixed assets is charged on expected life rather than their market value.

Money Measurement Concept:
In financial accounting, a record is maintained only for the transactions which can be expressed in monetary terms. In order words, no accounting is possible for an event or transaction which cannot be measured in money terms.

Cost Principle:
The actual cost paid on acquisition of goods or asset is considered as basis for recording in books of Accounts. Generally, no subsequent market fluctuation is considered for the assets held by the business.

Accounting Period Concept:
The users of financial statements need information that is reasonably current. Therefore, for financial reporting (Income Statement and Balance Sheet), the life of a business is divided into a series of relatively short accounting periods of equal length which is usually of a year, so that income and expenses of a specific period are compared.

Matching Concept:
A significant relationship exists between revenue and expenses. Expenses are incurred for producing income. So, the expenses are offset with income. The concept of taking total periodical expenses for comparing with periodical income is called as matching concept.

Realization Concept:
The revenues should be recognized at the time when goods are sold or services are rendered. Sale is considered to be made at the point when the property of

goods passes on to the buyer and he becomes legally liable to pay. So, the total periodical revenues from sale or services are to be taken for comparing with periodical expenses.

Conservatism:
According to this convention the Accountants follow the principle that anticipate no profit but provide for all possible losses, while recording business transactions. This is a policy of "playing safe".

Full disclosure:
The users of financial statements must be informed about the policies and procedures adopted while preparing these statements so that the users must understand and interpret the statements properly. The disclosure may be made either in the body of financial statements or in the accompanied notes.

Consistency:
This convention states that once an entity has decided to use one method of treatment of a transaction in Accounts, the same method should invariably be followed while recording and preparing the financial statements of the subsequent period until it has a sound reason to change the method. In case of a change in method, the impact in financial terms is to be disclosed. However, such change should not be frequent.

Materiality:
The term materiality refers to the relative importance of an item or an event. An item is material if it influences the performance position during an accounting period and may affect the decision makers and users of financial statements. However, the financial reporting must be cost effective while recording transactions. The convention of materiality allows accounting to ignore other accounting principles with respect to items which are not material.

Dual aspect Concept:
The economic resources of an entity are called assets. The claims and rights of various parties against these assets are called equities. So value of assets is equal to owner's equity and liabilities. Every transaction has thus a dual impact on accounting record. Accounting systems are set up so as to record both aspects of a transaction. This is also called as Accounting Equation which is premised on double Entry accounting system.

Accounting Equation:
The Assets are equal to the rights of assets. Thus the assets are represented by the interest of owner's rights and creditors claim. It is expressed as: -

Assets = Capital + Creditors.

C) International Accounting Standards (IAS)

Basically an International Accounting Standards Committee (IASC) came into existence during June 1973 in London (UK) as a result of an agreement by 13 accountancy bodies of Australia, Canada, France, Germany, Japan, Mexico, Netherlands, United Kingdom, Ireland, United States of America, Korea, South Africa and Italy. The business of IASC is conducted by a Board comprising representatives of the foregoing countries including some organizations having an interest in financial reporting. The objectives of IASC are to formulate and publish in the public interest the accounting standards to be observed in the presentation of financial statements and to promote their worldwide acceptance and observance. Further its objective is to work generally for the improvement and has motivation of regulations, accounting standards and procedures relating to the presentation of financial statements. The member countries agree to ensure that published financial statements comply with the International Accounting Standards (IAS) in all material respect and disclose the fact of such compliance. The IASs prescribe the accounting treatment of various types of business transactions in the books of account by all the business organization so that identical treatment of every transaction in recording and summarizing is carried out to ensure uniformity and compatibility of reports. The statutory auditors have legal responsibility to check whether or not all the relevant IASs have been applied by the accounting staff and management of the business organization. Conversely the auditors would issue qualified respect to the management and shareholders of the company.

D) International Financial Reporting Standards (IFRS)

Another fundamentals of Accounting are the International Financial Reporting Standards (IFRS) which sets out the mission and objectives & scope of the reporting standards. The IFRS is aimed to develop in the public interest, a single set of high quality, understandable and enforceable global accounting reporting standards. The IFRS ensures transparent and comparable information in financial statements to help participants in the world's capital market and other users to make economic decisions based upon reliable information.

1.4 TRANSACTION ANALYSIS AND ACCOUNTING EQUATION

The business transactions and the accounting equation are integrated with each other. Whenever any business event takes place it is called as transaction. This transaction will affect the accounting equation. As already indicated in preceding paragraph that the accounting equation is described that assets are equal with the rights of assets. The rights vest with the owners and creditors. Thus accounting equation is presented as under: -

Assets = Owner's equity + Creditors

During accounting period whenever any transaction takes place it would definitely affect the foregoing accounting equation. The investment by owner will increase the assets and equity. Generation of revenues will enhance the assets and equity. Incurrence of expenses will decrease the assets and equity. Withdrawal by owner from business would decrease the assets and equity. Discharge of liability will reduce the assets and creditors' claims. Thus while conducting any business transaction we shall focus on the accounting equation as to how it is affected for change. However, any transaction and event leaves the accounting equation in balance.

Now few business transactions are conducted to analyses the affective accounting equation as described below: -

Demonstration Problem 1-1
Transaction No. 1 Investment by owner
1-1-a) Mr. Arshad started business of trading merchandise on January, 2020 with a capital investment of Rs. 500,000. This transaction carries the following impact on accounting equation.

Assets	=	Equity	+	Liabilities
Cash Rs. 500,000	=	Capital Rs. 500,000	+	0

The investment of cash by the owner has increased the asset i.e. cash and simultaneously increased the capital of the owner. Thus equation is created through the transaction.

b) Transaction No. 2 Purchase of merchandise
The business purchased merchandise for on 5 January 2020 of Rs. 300,000 on cash of Rs. 200,000 and Rs.100, 000 on credit. The accounting equation is affected as under:

Assets			= Equity +	Liabilities
	Cash	+ Inventory	= Capital	+ Account payable
Opening Balance	Rs. 500,000	+ Rs.0	= Rs.500,000	+ 0
Purchases	Rs. (200,000)	+ Rs.300,000		+ Rs. 100,000
Balances	Rs.300,000	+ Rs. 300,000	= Rs.500,000	+ Rs.100,000
Total	Rs. 600,000		= Rs. 600,000	

The purchase of merchandise has increased the asset of inventory by Rs.300, 000 on assets side and has also decreased another asset – Cash by Rs. 200,000 which was paid to the supplier. On the other hand the unpaid amount of Rs.100, 000 has been shown as liability – Account payable. Thus the accounting equation is matching both sides.

c) Transaction No, 3 Purchase of Computer

On 06 January, 202 the Owner purchased a computer for cash of Rs. 50,000. The new accounting equation will emerge as under:-

	Assets			= Equity	+ Liabilities
	Cash	+ Inventory	+office equipment	= Capital	+ Account payable
Opening Balance	Rs. 300,000	+ Rs.300,000	+Rs.0	= Rs.500,000	+ Rs. 100,000
Purchases of computer	Rs.(50,000)	+ Rs.0	+ Rs.50,000	= Rs.00	+ Rs.0
Balances	Rs.250,000	+Rs. 300,000	+ Rs.50,000	= Rs.100,000	+ Rs. 100,000
Total	Rs. 600,000			= Rs. 600,000	

The purchase of computer at cash of Rs. 50,000 has decreased the asset – cash and simultaneously increased another asset – office equipment by the same amount of Rs.50, 000. Thus the accounting equation is matching both the sides.

d) Transaction No.4, Sale of merchandise on cash

The merchandise of costing Rs.150, 000 was sold on 7 January, 2020 at Rs. 200,000 0n cash. The accounting equation will now look like as under:-

	Assets			= Equity	+ Liabilities
	Cash	+ Inventory	+ office equipment	= Capital	+ Account payable
Opening Balance	Rs. 250,000	+ Rs.300,000	+ Rs.50,000	= Rs.500,000	+ Rs. 100,000
Sale	Rs.200,000	+ Rs. (150,000)	+ Rs.0	= Rs.200,000 (150,000)	+ Rs.0
Closing Balances	Rs.450,000	+ Rs. 150,000	+ Rs.50,000	= Rs.550,000	+ Rs. 100,000
Total	Rs. 550,000			= Rs. 550,000	

This transaction indicates that on assets side the cash has been increased by Rs. 200,000 for sale of merchandise and the inventory has been decreased by Rs. 150,000 which was the cost of goods sold. On the other hand the equity i.e. capital of owner has increased by the sale value of merchandise by Rs. 200,000 and simultaneously the capital is decreased by Rs. 150,000 for the cost of merchandise sold. Therefore, accounting equation has been maintained through this transaction.

e) Transaction No. 5 Payment of expenses by cash

The owner paid on 18 January 2020 an amount of Rs. 15,000 as rent and Rs.5,000 as electricity bill for the month. The impact of this expense on the accounting equation would be as under: -

	Assets			= Equity	+ Liabilities
	Cash	+ Inventory	+Office equipment	= Capital	+Account payable
Opening Balance	Rs. 450,000	+ Rs.150,000	+Rs.50,000	= Rs.550,000	+ Rs. 100,000
Payment of rent & electricity bill	Rs.(20,000)	+ Rs.0	+ Rs.0	= Rs.(20,000)	+ Rs.0
Closing Balance	Rs.430,000	+Rs.150,000	+ Rs.50,000	= Rs.530,000	+ Rs. 100,000
Total	Rs. 630,000			=Rs. 630,000	

The payment of expenses of rent and electricity bill has reduced the asset – cash by Rs. 20,000 and also decreased the capital by the same amount of Rs. 20,000 therefore, the accounting equation has been maintained after recording this transaction.

f) Transaction No.6 Payment of liability by cash

The payment of merchandise purchased on credit basis amounting to Rs. 100,000 has now become due by Rs.50,000. Therefore, this amount is paid on 28 January, 2020 the supplier. The balance amount of Rs.50, 000 from the total liability would be paid when becomes due at some later period.

The accounting equation would be effected as under by this payment.

	Assets			= Equity	+ Liabilities
	Cash	+ Inventory	+office equipment	= Capital	+ Account payable
Opening Balance	Rs. 430,000	+ Rs.150,000	+Rs.50,000	= Rs.530,000	+ Rs. 100,000
Payment of liability	Rs.(50,000)	+ Rs.0	+ Rs.0	= Rs.0	+ Rs.50,000
Closing Balance	Rs.380,000	+ Rs. 150,000	+ Rs.50,000	= Rs.530,000	+ Rs. 50,000
Total	Rs. 580,000			= Rs. 580,000	

The payment of part amount of Accounts Payable which was liability of the company has reduced – Cash by Rs. 50,000 and also decreased the Accounts Payable – liability by Rs.50, 000. As such the accounting equation is maintained after recording this transaction.

g) Transaction No.7. Withdrawal of cash by owner

Mr. Arshad who is owner of the business withdraws cash of Rs. 8,000 on 31 January 2020 from the business for his personal use. The effect of this transaction on accounting equation would be as under: -

	Assets			=Equity	+ Liabilities
	Cash	+Inventory	+Office equipment	= Capital	+ Account Payable
Opening balance	Rs.380,000	Rs. 150,000	+ Rs. 50,000	= Rs. 530,000	+ Rs. 50,000
Drawings	(Rs. 8,000)	-	-	= (Rs. 8,000)	-
Closing balance	Rs. 372,000	+Rs. 150,000	+ Rs. 50,000	= Rs 522,000	+ Rs. 50,000
Total	Rs. 572,000			= Rs. 572,000	

The withdrawals of cash of Rs. 8,000 by the owner from the business has decreased the Asset – Cash by Rs. 8000 and also decreased his Capital by Rs. 8,000. The drawing is not the expense of the business; rather it is drawing of amount against the periodic profit. Therefore, it is decrease in capital as the revenues from sale of merchandise increased the capital.

Summary of Transactions:
The business transaction as described in the preceding pages can now be consolidated and presented in an expanded accounting equation as detailed below which also include Revenues, Expenses and Drawing columns in the Equity Section of the accounting equation:-

(All amounts are in Rupees)

Transaction	Assets			= Equity				+Liabilities
	Cash	+ Inventory	+Office equipment	=Capital	-Drawing	+Revenue	-Expenses	+Account Payable
a)	500,000	-	-	= 500,000	-	-	-	-
b)	(200,000)	+ 300,000	-	-	-	-	-	100,000
Balance	300,000	+ 300,000	-	= 500,000	-	-	-	100,000
c)	(50,000)	-	+ 50,000	= -	-	-	-	-
Balance	250,000	+ 300,000	+ 50,000	= 500,000	-	-	-	100,000
d)	200,000	+(150,000)	-	= 50,000	-	+200,000	-150,000	-
Balance	450,000	+ 150,000	+ 50,000	= 550,000	-	+200,000	-150,000	100,000
e)	(20,000)	-	-	(20,000)	-	-	-20,000	-
Balance	430,000	+ 150,000	+50,000	= 530,000	-	+200,000	-170,000	100,000
f)	(50,000)	-	-	= -	-	-	-	(50,000)
Balance	380,000	+ 150,000	+ 50,000	= 530,000	-	+200,000	-170,000	50,000
g)	(8,000)	-	-	= -	-8,000			
Balance	372,000	+150,000	+ 50,000	= 530,000	-8,000	+200,000	-170,000	50,000
Net balance	572,000			=		572,0000		

The comparison of above expanded presentation of accounting equation indicates similar results of incorporating seven business transactions as detailed in the individual transactions. The overall net result is also matching with the detailed individual transactions of the accounting equation.

1.5 FINANCIAL STATEMENTS

The analysis of business transactions in the preceding pages although indicate the overall impact on the contents of accounting equation yet do not exhibit the performance status and financial condition of the organization. This can be ascertained from the financial statements which comprise the following: -

1) **Income Statement:**
It describes the comparison in detail the revenues and expenses and net performance status for the period.
2) **Statement of Owner's equity:**
It indicates the investment of owner in the business and subsequent changes because of net income/loss for the period including withdrawals during the period.
3) **Balance Sheet:**
It identifies the overall financial position of the organization stating assets, liabilities and owner's equity at the end of business period.
4) **Cash flows Statement:**
It describes the cash inflows and cash outflows during a period of time.

All the above financial statements are now prepared as per demonstration problem at 1-2 in ensuring para ad considered in the accounting equation in the preceding pages.

Demonstration Problem 1-2

ARSHAD TRADING COMPANY

Solution:

A) Income Statement for the month ending 31 January 2020.

Revenues: Sale of Merchandise		Rs. 200,000
Less Cost and Expenses:		
Cost of goods sold		Rs. 150,000
Gross Income		50,000
Rent	15,000	
Electricity	5, 000	Rs. 20,000
Net Income		Rs. 30,000

B) Statement of Owner's Equity as at 31 January, 2020.

Capital in investment	Rs. 500,000
Add Net Income (A)	30,000
	530,000
Less Drawings	8,000
Ending balance of capital	Rs. 522,000

C) Balance sheet as at 31 January, 2020.

(All Amounts are in Rupees)

Assets		Liabilities and Equity	
Cash	372,000	Account Payable	50,000
Inventory	150,000	Owner's Equity	-
Office Equipment	50,000	Capital	522,000
Total	572,000	Total	572,000

ARSHAD TRADING COMPANY

D) Cash Flow Statement for the month ended on 31 January, 2020.

Cash flow from operating activities		
Cash collected from sales	Rs. 200,000	
Cash paid for purchase of merchandise	(Rs. 200,000)	
Cash paid to supplier	(Rs. 50,000)	
Cash paid for rent and electricity bill	(Rs. 20,000)	
Net cash flow from operating activities		**Rs. (70,000)**
Cash flow from investing activities		
Cash paid for purchase of Office equipment		**(Rs. 50,000)**
Cash flow from financing activities		
Cash investment by owner	Rs. 500,000	
Cash withdrawal by owner	(Rs. 8,000)	
Net cash flow from financing activities		**Rs. 492,000**
Net increase in cash		Rs. 372,000
Add opening cash balance on 1 January 2020		-----
Cash balance as on 31 January 2020		Rs. 372,000

The above financial statements have been prepared from the few transactions used in the accounting equations in preceding pages. However, in the business organization multiple transactions are conducted daily which cannot be used in the accounting equation for the purposes of financial statements. Therefore, the transactions need to be recorded in the prescribed general journal and then posted into ledger accounts as preliminary step of maintaining looks of accounts. These steps have been described in the ensuring paragraphs.

1.6 ANALYZING AND RECORDING TRANSACTIONS

The accounting process identifies business transactions and events, carries out analysis of each transaction and then records it in the prescribed books of accounts to summarize overall effects of all transactions. This process is carried out in a chronological order through recording transactions in the general journal and then classification of every transaction for grouping identical transactions in a single ledger account. The posting of transaction from general journal into ledger accounts are maintained to identify significance of each account balance. The accounts are classified broadly into five major categories as appended below:

A) Asset Accounts

The assets accounts represent the existence of economic resources in tangible and intangible condition which are used for conduct of business. These include cash, Account Receivables, Inventories, Building, Plant and Machinery, Furniture, Vehicles and Good Will etc.

B) Liability Accounts

The Liability accounts represent obligations of the enterprise and claims of the creditors against assets of the organization. These include Account Payable, Notes Payable, Salaries Payable, unearned revenues, Bonds Payable and Debentures Payable.

C) Equity Accounts

The equity Accounts denote claims of the owners for investments made by them and the accumulated profits retained by the organization. The equity accounts are reduced by the withdrawals by the owners from the company while these are enhanced by any additional capital invested in the enterprise.

D) Revenue Accounts

The revenue Accounts represent the inflow of resources generated by the organization through sale of merchandise, professional fee earned, Rental income, interest income and commission income. The revenue accounts increase owner's equity.

E) Expense Accounts

The Expense Accounts are the outflow of resources of the organization in order to generate revenues. The expense accounts comprise cost of merchandise sold, salaries, utilities, rent, advertising, office supplies used, insurance and the depreciation expenses of assets.

The business organizations use a Chart of Accounts based upon the above broad classification of accounts. The chart of accounts comprises multiple nomenclatures of accounts which are used in recording day to day transactions and for classification and summarized process. A large organization would maintain comprehensive chart of accounts while a small organization would need moderate quantum of accounts. These accounts are used for recording transactions based upon the rules of debiting and crediting as have been discussed in the ensuing portion.

1.7. ANALYZING AND PROCESSING TRANSACTIONS

The business transaction is analyzed and processed for recording in the books of accounts which are premised upon some rules of debiting and crediting as tabulated below: -

Classification of Accounts			Effect Status
A)	Asset Accounts	Increase	Debited
		Decrease	Credited
B)	Liability Accounts	Increase	Credited
		Decrease	Debited
C)	Equity Accounts	Increase	Credited
		Decrease	Debited
D)	Revenue Accounts	Increase	Credited
		Decrease	Debited
E)	Expense Accounts	Increase	Debited
		Decrease	Credited

The analyzing and process of recording transactions is elucidated by taking some transactions conducted by Ali Trading Company as below: -

Demonstration Problem 1-3

01 January, 2020	Invested Rs. 650,000 in business by Mr. Ali the owner, to start a trading business.
04 February	Purchased merchandise for Rs. 420,000 paying cash of Rs. 250,000 and balance on 30 days' credit. Carriage of Rs. 3,000 was paid.

05 February	Purchased office furniture for Rs. 60,000 and computer for Rs. 70,000 on cash.
06 February	paid rent of office amounting to Rs. 30,000.
07 February	Purchased office supplies on cash of Rs. 8,000.
08 February	Sold merchandise to Mr. Subhan costing Rs. 300,000 at the price of Rs. 380,000 receiving Rs. 280,000 in cash and balance on credit.
10 February	Sold merchandise costing Rs. 50,000 at Rs. 60,000 on cash.
12 February	Paid Rs. 5,000 for advertising in newspaper.
15 February	Paid Rs. 12,000 as salary to an employee for first half of February, 2020.
18 February,	Paid electricity bill amounting to Rs. 4,560.
20 February	sold merchandise costing Rs. 60,000 to Mr. Arshad at the price of Rs. 85,000 on credit.
21 February,	Purchased merchandise at Rs. 150,000 on credit basis from Shayan Corporation.
24 February,	Collected Rs. 50,000 from Mr. Subhan on account of goods sold to him on credit on 8 February, 2020.
28 February,	Withdrew Rs. 30,000 by the Mr. Ali for his personal use.
29 February,	Collected Rs. 10,000 as rent for some space provided to the cafeteria contractor.

The analysis of above transactions would start by identification from the source documents, impact on accounting equation, recording into general journal using the relevant Accounts and applying the debiting and crediting rules, as described earlier and then classification and posting into ledger accounts usually in T format.

These are now demonstrated as under:-

Solution: Ali Trading Company

General Journal

Date	Particular of Accounts	LF	Debit	Credit
01 Feb, 2020	Cash Account Ali's Capital Account		Rs. 650,000	 Rs. 650,000
04 Feb,	Inventory Account Cash Account Accounts Payable		420,000	 250,000 170,000
04 Feb,	Carriage expense Account Cash Account		3,000	 3,000
05 Feb,	Furniture Account Computer Account Cash account		60,000 70,000	 130,000
06 Feb,	Rent Expense Account Cash Account		30,000	 30,000
07 Feb,	Supplies Account Cash Account		8,000	 8,000
08 Feb,	Cash Account Accounts Receivable(Mr. Subhan) Sales Account		280,000 100,000	 380,000
8 Feb,	Cost of Goods Sold Account Inventory Account		300,000	 300,000
10 Feb,	Cash Account Sales Account		60,000	 60,000
10 Feb,	Cost of Goods Sold Account Inventory Account		50,000	 50,000
12 Feb,	Advertising Expense Account Cash Account		5,000	 5,000
15 Feb,	Salary Expense Account Cash Account		12,000	 12,000
18 Feb,	Electricity Expense Account Cash Account		4,560	 4,560
20 Feb,	Account Receivable (Mr. Arshad) Sales Account		85,000	 85,000
20 Feb	Cost of Goods Sold Account Inventory Account		60,000	 60,000
21 Feb	Inventory Account Accounts Payable (Shayan Corporation)		150,000	 150,000
24 Feb,	Cash Account Account Receivable (Mr.Subhan)		50,000	 50,000
28 Feb,	Drawings Account Cash Account		30,000	 30,000
29 Feb	Cash Account Rental Income Account		10,000	 10,000

The second step in accounting is the classification of transactions for posting into the ledger accounts. The transactions recorded in the general journal are now classified and posted into ledger accounts as under: -

LEDGER ACCOUNTS

CASH ACCOUNT							
Date, 2020	**Particulars**	**JF**	**Amount**	**Date, 2020**	**Particulars**	**JF**	**Amount**
01 Feb,	Ali Capital A/C		650,000	4 Feb,	Inventory A/C		50,000
8 Feb,	Sales A/C		280,000	4 Feb,	Carriage Expense A/C		3,000
10 Feb,	Sales Account		60,000	5 Feb,	Furniture A/C		60,000
24 Feb,	A/C Receivable		50,000	5 Feb,	Computer A/C		70,000
29 Feb,	Rental income A/C		10,000	6 Feb,	Rent Expense A/C		30,000
				7 Feb,	Supplies A/C		8,000
				12 Feb,	Advertising Exp A/C		5,000
				15 Feb,	Salary Expense A/c		12,000
				18 Feb,	Electricity A/C		4.560
				28 Feb,	Drawing A/C		30,000
				29 Feb,	Closing balance		577,440
	Total		**Rs. 1,050,000**		**Total**		**Rs. 1,050,000**

Ali's Capital Account

Date	Particular	Amount	Date	Particular	Amount
29 Feb	Closing balance	650,000	1 Feb	Cash Amount	650,000
	Total	**Rs. 650,000**		**Total**	**Rs. 650,000**

Inventory Account

Date	Particular	Amount	Date	Particular	Amount
4 Feb	Cash Account	250,000	8 Feb	Cost of Goods Sold Account	300,000
4 Feb	Account Payable	170,000	10 Feb	Cost of Goods Sold Account	50,000
21 Feb	Account Payable	150,000	20 Feb	Cost of Goods Sold Amount	60,000
			29 Feb	Closing balance	160,000
Total		**Rs. 570,000**		**Total**	**Rs. 570,000**

Accounts Payable

Date	Particular	Amount	Date	Particular	Amount
29 Feb	Closing balance	320,000	4 Feb	Inventory Amount	170,000
			21 Feb	Inventory Account	150,000
Total		**Rs. 320,000**		**Total**	**Rs. 320,000**

Carriage Expense Account

Date	Particular	Amount	Date	Particular	Amount
5 Feb	Cash Account	3,000	29 Feb	Closing balance	3,000
	Total	**Rs. 3,000**		**Total**	**Rs. 3,000**

Furniture Account

Date	Particular	Amount	Date	Particular	Amount
5 Feb	Cash Account	60,000	20 Feb	Closing balance	60,000
	Total	**Rs. 60,000**		**Total**	**Rs. 60,000**

Computer Account

Date	Particular	Amount	Date	Particular	Amount
05 Feb	Cash Account	70,000	29 Feb	Closing	70,000
	Total	**Rs. 70,000**		**Total**	**Rs. 70,000**

Rent Expense Account

Date	Particular	Amount	Date	Particular	Amount
06 Feb	Cash Account	30,000	29 Feb	Closing balance	30,000
	Total	**Rs. 30,000**		**Total**	**Rs. 30,000**

Supplies Account

Date	Particular	Amount	Date	Particular	Amount
07 Feb	Cash Account	8,000	29 Feb	Closing balance	8,000
	Total	**8,000**		**Total**	**Rs. 8,000**

Accounts Receivable

Date	Particular	Amount	Date	Particular	Amount
08 Feb	Sales Account	100,000	24 Feb	Cash Amount	50,000
20 Feb	Sales Account	85,000	29 Feb	Closing balance	135,000
	Total	**Rs. 185,000**		**Total**	**Rs. 185,000**

Sales Account

Date	Particular	Amount	Date	Particular	Amount
29 Feb	Closing balance	525,000	08 Feb	Cash Amount	280,000
			08 Feb	Account Receivable	100,000
			10 Feb	Cash Account	60,000
			20 Feb	Account Receivable	85,000
	Total	**Rs. 525,000**		**Total**	**Rs. 525,000**

Cost of Goods Sold Account

Date	Particular	Amount	Date	Particular	Amount
08 Feb	Inventory Account	300,000	29 Feb	Closing balance	410,000
10 Feb	Inventory Account	50,000			
20 Feb	Inventory Account	60,000			
	Total	**Rs. 410,000**		**Total**	**Rs. 410,000**

Advertising Expense Account

Date	Particular	Amount	Date	Particular	Amount
12 Feb	Cash Account	5,000	29 Feb	Closing balance	5,000
	Total	**5,000**		**Total**	**5,000**

Salary Expense Account

Date	Particular	Amount	Date	Particular	Amount
15 Feb	Cash Account	12,000	29 Feb	Closing balance	12,000
	Total	**12,000**		**Total**	**12,000**

Electricity Expense Account

Date	Particular	Amount	Date	Particular	Amount
18 Feb	Cash Account	4,560	29 Feb	Closing balance	4,560
	Total	**4,560**		**Total**	**4,560**

Drawing Account

Date	Particular	Amount	Date	Particular	Amount
28 Feb	Closing balance	30,000	29 Feb	Closing balance	30,000
	Total	**30,000**		**Total**	**30,000**

Rental Income Account

Date	Particular	Amount	Date	Particular	Amount
29 Feb	Closing balance	10,000	29 Feb	Cash Amount	10,000
	Total	**10,000**		**Total**	**10,000**

After posting of general journal entries into their respective ledger accounts which is a classification process, the next step is to balance the ledger accounts. The assets and expense accounts will have debit balance while all the liabilities, revenue and equity accounts will have credit balance. Therefore, the closing balance of each account will be inserted on the other side in the ledger accounts. This process has duly been completed in the foregoing pages and each ledger account is showing either debit or credit balance according to its nature.

1.8 PREPARING TRIAL BALANCE

The double entry accounting system requires that each transaction would be recorded at least in two accounts, one debit and the other credit so as to maintain equality of every account. After posting the journal entries into ledger accounts the equality of debit balances with the credit balances need to be checked before proceeding to the preparation of financial statements. The trial balance is used to confirm equality and accuracy. Thus the trial balance listed all the accounts available in the ledger accounts with their balances. The account balances are reported in their respective debit or credit columns of the trial balances. The trial balance is now prepared as under from the forgoing ledger accounts of Ali Trading Company.

Ali Trading Company

Trial balance as at 29 February, 2020

Particulars	**LF**	**Debit**	**Credit**
Cash Account		Rs. 577,440	
Ali's Capital Account			Rs. 650,000
Inventory Account		160,000	
Accounts Payable			320,000
Carriage Expenses Account		3,000	
Furniture Account		60,000	
Computer Account		70,000	
Rent Expense Account		30,000	
Supplies Account		8,000	
Rental income Account			10,000
Accounts Receivable		135,000	
Sales Account			525,000
Cost of Goods Sold Account		410,000	
Advertising Expense Account		5,000	
Salary Expense Account		12,000	
Electricity Expense Account		4,560	
Drawings Account		30,000	
Total		**Rs. 1,505,000**	**Rs. 1,505,000**

The aforementioned trial balance ensures equality of total sum of debit balance with the credit balance. This facilitates preparation of financial statements. In case the equality of trial balance is not found then the errors would be located to correct it.

1.9 Preparing Financial Statements

The composition of financial statements has already been described at para 1.5. These financial statements are prepared as per demonstration problem 1-4 from the account balances of Trial Balance as at para. 1.8 As follows: -

Demonstration Problem 1-4

Solution:

Ali Trading Company

A) Income Statement for the month ended 29 Feb, 2020.

	Sales		Rs. 525,000
Less:	Cost of Goods Sold		410,000
	Gross Income		115,000
Less:	***Operating expense:***		
	Carriage expense	3,000	
	Rent expense	30,000	
	Advertising expenses	5,000	
	Salary expenses	12,000	
	Electricity expense	4,560	54,560
	Net Operating income		60,440
Add:	Rental income		10,000
	Net income		**Rs. 70,440**

B) Statement of Owner's Equity as at 29 Feb, 2020.

	Capital investment by owner	Rs. 650,000
Add:	Net income during Feb, 2020	70,440
	Total equity	720,440
Less:	Drawings	30,000
	Closing balance of equity	Rs. 690,440

Ali Trading Company

C) Balance Sheet as at 29 Feb, 2020.

Assets		**Liabilities and Equity**	
Cash	Rs. 577,440	Accounts Payable	Rs. 320,000
Accounts Receivable	135,000	Owner's Equity	690,440
Supplies	8,000		
Inventory	160,000		
Furniture	60,000		
Computer	70,000		
Total	**Rs.1,010,440**	**Total**	**Rs.1,010,440**

Ali Trading Company

D) Cash flow Statement for the month ended 29 Feb, 2020.

Cash Flow from operating activities:		
Cash inflows		
Cash Collected from Sales and Rental income(inflow)		Rs.400,000
Cash outflows		
Purchase of merchandise	Rs. (250,000)	
Purchase of supplies	(8,000)	
Carriage Expenses	(3,000)	
Rent Expenses	(30,000)	
Advertising Expenses	(5,000)	
Salaries Expenses	(12,000)	
Electricity Expenses	(4,560)	(312,560)
Net Cash inflow from operating activities		**87,440**

Cash flow from investing activities:		
Cash outflow for purchase of:		
Furniture	(60,000)	
Computer	(70,000)	
Net Cash outflow from investing activities		**(130,000)**

Cash flow from financing activities:	
Cash inflow from investment by owner	650,000
Less: Cash outflow for drawings by owner	(30,000)
Net cash inflow from financing activities	620,000
Net cash inflow	577,440
Add opening cash balance on 1 Feb,2020	00
Cash balance as on 29 Feb, 2020	**Rs. 577,440**

1.10 SUMMARY

The business activities and functions of accounting are integrated with each other. Accounting provides information to the internal management and external agencies to probe into their matters of interest. The reliable accounting information system is based upon the implementation of fundamentals of accounting comprising Generally Accepted Accounting Principles (GAAP), International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS) and furthermore use of Professional Ethics in reporting.

The double entry accounting system is based upon the concept of accounting equation with the rights of assets. The rights rest with the owners and creditors.

The recording of business transactions into general journal and then posting into ledger accounts is based upon the dual recording aspect. The trial balance is then prepared to check equality of the total sum of debit accounts balance and the credit accounts balance to facilitate preparation of financial statements comprising Income statement, Statement of Changes in Owner's Equity, Balance Sheet and the Cash Flow Statement to ascertain periodic performance and financial condition of the organization at period end.

1.11 THEORETICAL QUESTION

1. Define the Accounting and its purpose including benefits to the organization.
2. Describe the internal and external users of the accounting information.
3. What are the professional ethics of reporting?
4. Describe the term Generally Accepted Accounting Principles (GAAP) and elucidate at least five of them.
5. What do you know about the International Accounting Standards (IAS) and what is their role to facilitate recording of business transaction?
6. What are the objectives for use of International Accounting Standards and their impact on reporting?
7. Describe the International Financial Reporting Standards and their impact on reporting for the results of business organization.
8. The accounting equation is considered as the base of double entry accounting system. Describe the relationship with each other.
9. State five broad categories of classification of Accounts in an accounting system.
10. What are the debiting and crediting rules for the classified accounts for recording transactions in the books of accounts?
11. What is the composition of financial statements? Describe each of them.
12. What are the objectives of preparation of trial balance and how it is prepared?
13. What are the contents of an Income Statement and the ultimate place of closing its balance?
14. Describe the contents of Statement of Owner's Equity and where its closing balance is transferred?
15. State the composition of a Balance Sheet. What information is available in it?
16. Describe the contents of the Statements of Cash Flows.

1.12 PRACTICAL PROBLEMS

P.1-1 Mr. Asif has stated a trading business. The transactions for the month of March, 2020 are as under:-

March

1. Invested Rs. 450,000 cash as capital.
3. Purchased furniture at the cost of Rs. 70,000 on credit.
4. Purchased merchandise at the cost of Rs. 250,000 for sale and paid cash.
6. Paid rent of shop for the month amounting to Rs. 25,000.
8. Sold merchandise costing Rs. 50,000 at the price of Rs. 75,000 and collected cash.
10. Sold merchandise to Mr. Arshad costing Rs. 40,000 at the selling price of Rs. 60,000 and collected cash of Rs. 40,000, the balance due.
13. Paid telephone bill amounting to Rs. 3,000
16. Purchased merchandise costing Rs. 80,000 on credit from Subhan Company.
18. Collected cash of Rs. 10,000 from Mr. Arshad for goods sold to him on credit.
22. Paid electricity bill amounting to Rs. 6,500.
25. Paid Rs. 50,000 for the furniture purchased on credit.
31. Paid Salary of an employee amounting to Rs. 20,000.

Required

Prepare a statement of an accounting equation in detail and record the above transactions indicting the balance of each item of every transaction.

P.1-2 Subhan Law Associates has started the legal consultancy services during March 2020. The following transactions were occurred during the first month: -

March 2020.

04. Mr. Subhan established the firm and invested Rs. 100,000 cash.
05. Purchased office equipment at the cash price of Rs. 50,000.
06. Purchased computer equipment at the cost of Rs. 65,000 on credit basis.
07. Paid rent of Rs. 35,000 for the office for the month of March, 2020.
08. Rendered consultancy services and collected fee of Rs. 15,000 from the client.
10. Paid Rs. 6,000 for purchase of office supplies.
12. Collected consultancy fee of Rs. 30,000 firm another client.
14. Paid telephone bill amounting to Rs. 5,500.

16. Arranged photocopies of some documents and paid Rs. 250 for it.
17. Paid entertainment expenses of Rs. 3,500 to the cafeteria for the clients.
20. Billed a consultancy fee of Rs. 25,000 to a client.
28. Paid electricity bill of Rs. 6,000.

Required

1) Present the above transactions in an accounting equation format with details of each item and indicate the balance after every transaction.
2) Prepare financial statements at the end of March, 2020.

P.1-3 Asghar Trading Corporation was established on 4 January, 2020. The following business transactions were conducted during the month: -

January 2020.

04. Invested Rs. 400,000 cash by the proprietor.
05. Purchased merchandise at the cash price of Rs. 250,000.
06. Paid rent of shop amounting to Rs. 40,000 for the month.
08. Purchased and installed fixture in the shop at the cost of Rs. 15,000.
09. Sold goods worth Rs. 15,000 at cash price of Rs. 22,000.
10. Sold merchandise costing Rs. 40,000 at cash price of Rs. 60,000 to customers.
13. Paid utility bill amounting to Rs. 4,000.
16. Sold merchandise to Mr. Subhan on credit of Rs. 45,000. The cost was amounting to Rs. 30,000.
18. Purchased merchandise on credit from Decent Supplies at Rs. 50,000.
26. Collected Cash of Rs. 30,000 from Mr. Subhan for goods sold to him on credit basis.
30. Paid Salary of Rs. 25,000 to an employee.

Required

1) Prepare a general journal for the above transactions.
2) Post the transactions into ledger accounts and balance it.
3) Prepare a trial balance at the end of the month.

P.1-4 Hussain and Company started medical services enterprise and appointed two doctors. The following transactions took place during April, 2020.

01. Hired a building on rent at monthly rent of Rs. 50,000.

02. Brought cash of Rs. 600,000 by Mr. Hussain for the establishment of professional services business.
03. Paid one month rent of the building.
04. Purchased office furniture costing Rs. 180,000 on 30 days credit.
06. Purchased medical supplies costing Rs. 18,000 in cash.
07. Served patients charging Rs. 18,000 as consultancy fee.
08. Purchased medical supplies costing Rs. 18,000 in cash.
10. Paid utility bills amounting to Rs. 12,000.
12. Collected Rs. 22,000 from patients for the consultancy fee.
15. Medical supplies costing Rs. 8,000 were consumed during first half of the month.
18. Withdraw Rs. 20,000 by the proprietor from the company for personal use.
21. Collected Rs. 30,000 from patients for the consultancy fee.
23. Paid security staff salary amounting to Rs. 25,000.
25. Collected consultancy fee of Rs. 30,000 from patients.
27. Paid electricity bill amounting to Rs. 16,000.
28. Consumed medical supplies costing Rs. 6,000.
30. Paid salary of doctors amounting to Rs. 90,000.
30. Collected consultancy fee of Rs. 45,000 from patients.

Required
1) Prepare a general journal for the above transactions.
2) Prepare ledger accounts from the above transactions and balance it.
3) Prepare a trial balance.
4) Prepare income statement, the statement of owner's equity, balance sheet and the cash flow statement at the end of April, 2020.
5) Was the performance of the business organization profitable or otherwise and should it be continued?

P.1-5 Mr. Ali who is a qualified auto engineer established an auto-workshop for repair of automobiles. He also hired the services of two auto mechanics. Following transactions were conducted during the month of March, 2020:-

02. Brought cash of Rs. 200,000 and auto tools valuing Rs. 150,000 in the workshop.
04. Purchased repair supplies amounting to Rs. 30,000 in cash.
05. Repaired five vehicles in the workshop and consumed supplies amounting to Rs. 3,800.

06. Collected repair changes from the customers amounting to Rs. 26,000.
08. Purchased some more tools for the workshop in cash of Rs. 30,000.
10. Collected repair changes from the customers amounting to Rs. 23,000.
12. Billed institutional customers for repair of vehicles at Rs. 32,000.
14. Collected Rs. 15,000 from the credit customers of two institutions.
17. Consumed repair supplies amounting to Rs. 12,000.
20. Collected repair changes of Rs. 18,000 from clients.
24. Paid electricity bill amounting to Rs. 21,000 for the month.
26. Purchased repair supplies amounting to Rs. 18,000 from Ahmad Company on credit.
30. Paid Salaries of auto mechanics accounting to Rs. 60,000 for the month.
31. The Owner withdrew Rs. 40,000 from the business for his personal use.

Required

1) Record the above transactions in the general journal of the business.
2) Post the transactions in the ledger accounts of the business.
3) Prepare a trial balance.
4) Prepare the following statements: -
   a) Income Statement
   b) Statement of owner's equity
   c) Balance sheet
   d) Cash Flow Statement.
5) Discuss whether the performance of workshop was profitable or otherwise and should it be continued.

P.1-6 Mr. Gulzar started a trading organization with the name and style of Gulzar Trading Enterprise. The transactions during May 2020 were conducted as under: -

01. Mr. Gulzar brought cash of Rs. 1,000,000 in business and furniture valuing Rs. 100,000.
02. Paid repair and maintenance of Rs. 12,000 for the premises hired for the business.
03. Paid rent of Rs. 50,000 for the month of May 2020 to the land lord of premises.
05. Purchased goods worth Rs. 650,000 paying cash of Rs. 500,000 and balance payable after 10 days to Ahsan Company.
08. Sold goods worth Rs. 250,000 at the price of Rs. 300,000 on cash.
10. Sold goods worth Rs. 70,000 to Mr. Afzal on credit basis at Rs. 90,000.
12. Paid entertainment expenses of Rs. 800.
14. Purchased goods worth Rs. 250,000 on cash basis.

16. Paid Rs. 100,000 to Ahsan Company for goods purchased on 05 May, 2020.
18. Sold goods at cash price of Rs. 120,000 which was costing Rs. 75,000.
21. Paid utility bill of Rs. 6,500.
24. Sold goods worth Rs. 20,000 at Rs. 25,000 to Mahmood ul Hassan on credit basis.
26. Mr. Gulzar withdrew Rs.40, 000 for his personal use.
28. Sold goods worth Rs. 30,000 at Rs. 40,000 and collected cash.
30. Paid salary of Rs. 65,000 to employees.

Required

1) Journalize the above transactions in the general journal.
2) Post these transactions in the ledger Accounts maintained by the Accounts Department.
3) Prepare the following financial statements at the end of May, 2020.
    a) Income Statement
    b) Statement of changes in equity
    c) Balance Sheet
    d) Cash flow Statement

1.13 GLOSSARY

Accounting Concepts:
The basic assumptions or procedures on which accounting is based upon.

Accounting conventions
The traditions and customs which provide guidelines to accountants to facilitate their functions.

Transaction
The event or occurrence conducted in the business activity where certain goods, services or cash is exchanged for acquisition of benefits

Accounting
Recording, classification, summarization of business activities which can be measured in financial terms.

Accounting Period
The length of a period during which business activities are assembled and considered in accounting record for measuring performance.

Internal users
The group of persons comprising top management, middle management, employees and trade unions which are interested for accounting information for their specified purposes.

External Users
Different agencies comprising shareholders, creditors, government departments, Stock Exchanges, Lenders, Securities and Exchange Commission, and Courts which are interested in accounting information for their classified objectives.

Accounting Equation
The basic concept of double entry accounting system where the assets are equal with the rights of assets and are according by presented in the accounting records.

Assets
The economic resources held by the organization which facilitates conduct of business activities.

Trial balance
A schedule of verification of equality of sum of debit balances with the sum of credit balances of ledger accounts.

Income Statement
A summarization process where all periodic expenses are offset with the periodic revenues to determine performance position.

Balance Sheet
Comparative presentation of the cost of economic resources (assets) with the rights of assets (liabilities and owner's equity) indicating overall financial condition of the enterprise on a specific date.

Ledger
A book containing different accounts of an entity indicating record of transactions for a specific period.

Unit–2

ADJUSTING ACCOUNTS AND COMPLETION OF ACCOUNTING CYCLE

Written by: Muhammad Ashraf Bhutta
Reviewed by: Muhammad Munir Ahmad

CONTENTS

INTRODUCTION

This unit deals with the functions of reviewing the various account balances appearing in the trial balance and the financial statements prepared in the contents of unit No. 1. Certain adjustments are needed in some accounts to update their balances to ensure reliable reporting of financial and operating results. Further the procedure followed for recording adjustments and preparation of adjusted trail balance through a work sheet is explained in it. After preparation of financial statements, the closing process of accounts is followed and post-closing trial balance would be prepared to transfer account balances to the next accounting period after determining equality of the balances of debit and credit accounts of real and personal nature.

OBJECTIVES

After completion of study of this unit the students would become capable to achieve following objectives: -

1) Conceptual understanding of periodic reporting and time period assumption of business activities.
2) Impact of accrual basis of accounting on the performance and financial condition of the organization after recording accounting adjustments.
3) How the preparation of the work sheet facilitates the job of accountants for compiling financial statements?
4) The understanding for classification of temporary and permanent accounts and their closing.
5) Recording closing entries after preparation of financial statements and preparing post- closing trial balance for the period.

2.1 TIMING AND REPORTING

The business activities are conducted regularly without interruption. Usually such activities are entered into accounting records when these are completed. Thus completion of business activities and maturity of accounting period do not coincide with each other. When cash basis of accounting is being used by an enterprise, the timing of activities and reporting results do not matter for any problem, because the transaction is to be entered only when cash is exchanged. This system does not represent true and fair reporting results for the periodic activities performed. Contrary to it, the alternate reporting system is the accrual basis of accounting which envisages that the transaction should be recorded in the accounting record when it has occurred without regard to the exchange of cash. This accounting system is in line with the generally accepted accounting principles (GAAP and IFRS) as explained in unit No. 1. The accrual basis of accounting therefore, uses the adjusting process to recognize revenues when earned and expenses when incurred. The accounting period concept also specifies that the reporting results should be based upon a consistent identical time period of 12 months each year so as to facilitate fair comparison of results of income with expenses and to gauge efficiency of performance. The matching and realization concepts also specify that only periodic expenses be matched with periodic revenues (realization concept) to ascertain true performance.

2.2 ADJUSTING ACCOUNTS

Some accounting adjustments are needed for the transactions and events that extend over more than one accounting period. The cash received or paid during a period, for certain transactions do not necessarily relate to one reporting period, rather such transactions affect past or future period as well. Therefore, the revenues or expenses received or paid are appropriately need to be related to the relevant period. This is possible through certain accounting adjustments so that true periodic expenses be matched with periodic revenues to report reliable and true results of business operations over a period of time.

The accounting adjustments are classified into four categories as appended below:-

a) Prepaid expenses
b) Accrued expenses
c) Unearned revenues
d) Accrued revenues

The adjusting entries are necessary for each of the above categories so that revenues, expenses, assets and liabilities are correctly reported in the financial statements. Each adjusting entry affects one or more income statement and the balance sheet accounts excluding the Cash Account as tabulated below: -

Adjusting Entries

Category of Adjustment	Income Statement Effect	Balance Sheet Effect
a) Prepaid expenses	Debit Expense A/C	Credit Prepaid (Asset) A/C
b) Accrued expenses	Debit Expense A/C	Credit Liability A/C
c) Unearned expenses	Credit Revenue A/C	Debit Liability A/C
d) Accrued expenses	Credit Revenue A/C	Debit Assets A/C

All types of adjustments in the accounts are categorized in the above four classifications. These adjustments are now explained one by one an under: -

A) Prepaid Expenses

These are several types of expenses which are paid in advance while their benefits (utilization) are taken gradually some later period. The examples of prepaid expenses include rent, supplies, insurance, plant &machinery and tools etc. When payment for acquisition of these items is made the respective asset account is debited and cash account is credited. When this asset is used up the expense account is credited. This is further explained by taking an example that an organization hired a building on 01 September 2019, and paid the rent for two years in advance which amounted to Rs. 240,000. The accounting entry for payment of rent in advance would be as under: -

Date	Particulars	Debit	Credit
01-09-2019	Prepaid Rent A/C	Rs. 240,000	
	Cash A/C		Rs. 240,000

The prepaid rent of Rs. 240,000 has been considered as an asset. The adjustment of the rent at year end on 30 June 2020 for 10 months would be recorded as under: -

Date	Particulars	Debit	Credit
30-06-2020	Rent Expense A/C	Rs. 100,000	
	Prepaid Rent A/C		Rs.100,000

The rent expense at Rs. 100,000 would be charged to the income statement while the balance prepaid rent of Rs. 140,000 (Rs. 240,000 less Rs. 100,000) would be presented in the balance sheet as at 30 June 2020 as current asset and would be expensed during next year with the passage of time upon usage of building.

Similar treatment would be carried out for other prepaid expenses like supplies, insurance, plant &machinery and tools etc. The usage of plant & machinery would be charged as under: -

Dr.	Depreciation Expense Account
Cr.	Accumulated Depreciation Account

The amount of depreciation expense account would be charged to the income statement while the accumulated depreciation would be treated as contra asset and deducted from the plant and machinery while presentation in the Balance Sheet at year end.

B) Accrued Expenses

Accrued expenses include those expenses which have been incurred during the period or benefits for such expenses have been enjoyed by the enterprise but payment of such expenses has not yet been made. For instance the salaries of employees have become due upon expiry of the month of June, but payment would be made during first week of the succeeding month. Similarly certain utilities like telephone, electricity and gas have lean used during a month but payment was not made during the same month. Therefore, the accrued expenses would be recorded during the relevant month through following adjusting entry: -

Date	Particulars	Debit	Credit
30.06.2020	Salaries Expense A/C	Rs. 50,000	
	Accrued Salaries A/C		Rs. 50,000

The Salary expense Account would be charged to the income statement while the accrued Salaries account would be presented in current liabilities of balance sheet as at 30 June 2020.

The accrued Salaries would be carried forward to the next month. The payment of accrued salaries on 2 July 2020 would be accounted for as under: -

Date	Particulars	Debit	Credit
2 July 2020	Accrued Salaries A/C	Rs. 50,000	
	Cash Account		Rs. 50,000

The payment of salaries has been made from the liabilities Account hence it has not affected expenses of July in any manner.

Similarly, other accrued expenses would be debited to the expense account during the month to which these are related and liabilities would be recognized. Next month these expenses would be paid from the liability account (accrued expenses A/C).

C) Unearned Revenues

The unearned revenues refer to the situation where cash is received in advance from clients with an obligation to provide products or services at some later period. Therefore, upon receipt of cash in advance the liability for the obligation is recognized through the following accounting entry.

Date	Particulars	Debit	Credit
30 June 2020	Cash A/C	Rs. 30,000	
	Unearned Revenues A/C		Rs. 30,000

During next month when services valuing Rs. 30,000 are provided to the client the liability account would be adjusted and revenue account would be recognized by this amount. During the first week of July 2020 the services were rendered against which the cash was received in advance on 30 June, 2020. The adjusting entry would be passed on 07 July 2020 as under: -

Date	Particulars	Debit	Credit
07 July 2020	Unearned Revenues A/C	Rs.50,000	
	Earned Revenues A/C		Rs.50,000

After rendering the services during July, 2020 the liability account is squared off and Earned revenue account is recognized.

D) Accrued revenues

The accrued revenues refer to the revenues which have been earned but neither received in cash nor recorded in the accounts. The accrued revenues can be the professional services rendered to a client but payment was not received till end of the month. Therefore, at the close of the monthly accounts, the adjusting accounting entry will have to be recorded to record accrued revenues and simultaneously an asset account. For instance, a law firm contested a case in the court of law on behalf of a client but he did not pay the fee of Rs. 35,000 as agreed upon till end of January, 2020. The adjusting accounting entry in the accounts for the month of January, 2020 would be recorded as under: -

Date	Particulars	Debit	Credit
31 Jan 2020	Professional Fee Receivable A/C	Rs.35,000	
	Professional Fee Earned A/C		Rs.35,000

Through the above adjusting entry the revenues have been recognized and simultaneously an asset for receivable A/C has been recorded. Later during

February 2020 when the client paid the fee, following accounting entry would be passed.

Date	Particulars	Debit	Credit
06 Feb, 2020	Cash A/C	Rs.35,000	
	Professional Fee Receivable A/c		Rs.35,000

The cash collected from the client has been adjusted against the receivable A/C instead of professional fee earned Account because this account has already been credited through adjusting entry on 31 January, 2020.

There are several more example of accrued revenues like interest earned on the funds deposited with a bank rental income accrued on property rented out and the dividend income declared by the other company but the amount of divided not yet received by the investor. All such accrued revenues would be recorded through adjusting entry before close of the monthly or annual accounts to recognize the income and also the receivable account.

2.3 PREPARING FINANCIAL STATEMENTS

All the four categories of adjusting entries in the accounting record are necessitated in all organizations where accrual basis of accounting procedure is adopted so as to update all the assets, liabilities, and income, expense and equity accounts and prepare financial statements which should exhibit true and fair performance and financial position of the enterprise at end of the accounting period. The adjusting entries are then incorporated in the ledger accounts and revised account balance are picked up and a trial balance (updated) is prepared where from the financial statements are prepared. Alternatively, the adjustments are directly entered in the unadjusted trial balance to update the account balances where adjustments were carried out. Thus adjusted trial balance is used for the preparation of financial statements. This process is further deliberated through taking an unadjusted trial balance, as prepared at Para 1.8 of Unit.No.01 making certain adjustments as required at period end and preparing the adjusted trial balance for preparation of financial Statements as per demonstration problem 2-1 that follows: -

Demonstration Problem 2-1

Ali Trading Company
Unadjusted Trial Balance as on 29 February, 2020

Sr.No.	Particulars	Debit	Credit
1	Cash Account	Rs. 577,440	
2	Ali Capital Account		Rs. 650,000
3	Inventory Account	160,000	
4	Accounts Payable		320,000
5	Carriage expense Account	3,000	
6	Furniture Account	60,000	
7	Computer Account	70,000	
8	Rent Expense Account	30,000	
9	Supplies Account	8,000	
10	Rental Income Account		10,000
11	Accounts Receivable	135,000	
12	Sales Account		525,000
13	Cost of Goods Sold Account	410,000	
14	Advertising Expense Account	5,000	
15	Salary Expense Account	12,000	
16	Electricity Expense Account	4,560	
17	Drawing Account	30,000	
	Total	**Rs. 1,505,000**	**Rs. 1,505,000**

The scrutiny of the above trial balance and other source documents indicates that certain accounting adjustment are needed to update the account balances of certain accounts before presentation of financial statements for the month of February, 2020. These adjustments are as under: -

a) The rent of Rs. 30,000 paid to the landlord is for two monthi.e. February and March 2020.

b) The depreciation at 10% per annum on furniture and computer is to be charged for the month of February, 2020.

c) The office supplies available at month end, after physical checking, were found to be worth Rs. 5,000.

d) The interest income of Rs. 8,000 has become due on the cash balance available in the Bank Account.

e) The Salary of Rs. 12,000 of an employee is still payable for the second half of February, 2020.

f) The Rental income of Rs. 10,000 was received in advance as it is related to the months of March and April 2020.

The adjusting accounting entries for the above adjustments are recorded as under:

Sr. No	Particulars	Debit	Credit
a)	Prepaid Rent Account	Rs. 15,000	
	Rent Expense Account		Rs. 15,000
b)	Depreciation Expense Account	1,083	
	Accumulated Depreciation Account		1,083
	Furniture Rs. 60,000x10%x1/12 = Rs. 500		
	Computer Rs. 70,000x10%x1/12 = Rs. 583		
	Total depreciation = Rs. 1,083		
c)	Supplies Expense Account	3,000	
	Supplies Account		3,000
d)	Interest Receivable Account	8,000	
	Interest Income Account		8,000
e)	Salary Expense Account	12,000	
	Accrued Salary Account		12,000
f)	Rental Income Account	10,000	
	Unearned Rental Income Account		10,000

The adjusted trial balance, after incorporating the effect of above six adjusting entries is now prepared. First, the unadjusted trial balance figures will be inserted and secondly two more columns, debit and credit, will be added for the caption of adjustments. After giving effects of the adjustments in relevant accounts, thirdly adjusted trial balance columns will be added which will reflect the adjusted account balances as presented below: -

Ali Trading Company
Adjusted Trial Balance as on 29 February, 2020.

Particulars	Unadjusted Trial Balance		Adjustments		Adjusted Trial Balance	
	Dr	*Cr*	*Dr*	*Cr*	*Dr*	*Cr*
Cash Account	Rs.577,440				Rs.577,440	
Ali Capital Account		Rs.650,000				Rs.650,000
Inventory Account	160,000				160,000	
Accounts Payable		320,000				320,000
Carriage Expense Account	3,000				3,000	
Furniture Account	60,000				60,000	
Computer Account	70,000				70,000	
Rent Expense Account	30,000			(a)15,000	15,000	
Supplies Account	8,000			(c) 3,000	5,000	
Rental Income Account		10,000	(f) 10,000			
Accounts Receivables	135,000				135,000	
Sales Account		525,000				525,000
Cost of Goods Sold Account	410,000				410,000	
Advertising Expense Account	5,000				5,000	
Salary Expense Account	12,000		(e) 12,000		24,000	
Electricity Expense Account	4,560				4,560	
Drawings Account	30,000				30,000	
Prepaid Rent Account			(a)15,000		15,000	
Depreciation Expense Account			(b) 1,083		1,083	
Accumulated Depreciation Account				(b)1,083		1,083
Supplies Expense Account			(c) 3,000		3,000	
Interest Receivable Account			(d) 8,000		8,000	
Interest Income Account				(d) 8,000		8,000
Accrued salary Account				(e) 12,000		12,000
Unearned Rental Income Account				(f) 10,000		10,000
Total	**Rs.1,505,000**	**1,505,000**	**49,083**	**49,083**	**1,526,083**	**1,526,083**

A perusal of the adjusted trial balance as presented above indicates that in the particulars column some more accounts have been added after the Drawing Account. These additional accounts have been involved through six adjusting entries as incorporated from the scrutiny of record. These adjustments have been recorded in the next two columns and have been linked as (a) to (f) of the adjusting entries to create linkage and understand properly. There after the adjusted Trial Balance is prepared after giving effect of the adjustments to the unadjusted trial balance accounts where necessary. Now this adjusted trial balance is available to prepare financial statements with updated figures.

Ali Trading Company
A) Income Statement for the month ended 29 Feb, 2020.

Sales revenues		**Rs. 525,000**
Less: Cost of Goods Sold		410,000
Gross Income		**115,000**
Less: Operating Expenses:		
Carriage expenses	Rs. 3,000	
Rent Expenses	15,000	
Advertising expenses	5,000	
Salary expenses	24,000	
Electricity expenses	4,560	
Supplies expenses	3,000	
Depreciation expenses	1,083	**55,643**
Operating Income		**59,357**
Add: Interest income		8,000
Net Income		**Rs. 67,357**

Ali Trading Company
B) Statement of Owner's Equity as at 29 Feb 2020.

Capital investment by owner		Rs. 650,000
Add: Net income during February 2020		67,357
Total Equity		717,357
Less: Drawing		30,000
Closing balance of equity		**Rs. 687,357**

Ali Trading Company
C) Statement of Owner's Equity as at 29 Feb, 2020.

Assets			**Liabilities and Equity**	
Cash		Rs. 577,440	Accounts Payable	Rs. 320,000
Amounts Receivable		135,000	Accrued Salary	12,000
Supplies		5,000	Unearned Rental Income	10,000
Inventory		160,000	Owner equity	687,357
Prepaid Rent		15,000		
Interest Receivable		8,000		
Furniture	60,000			
Computer	70,000			
Total Cost	130,000			
Less: Accumulated Depreciation	1,083	128,917		
Total		**Rs. 1,029,357**	**Total**	**Rs. 1,029,357**

Ali Trading Company

D) Statement of cash flow for the month ended 29 Feb, 2020.

Cash flows from operating activities:

Cash Inflows:		
Cash Collected from sales	Rs. 390,000	
Cash Collected from rentals	10,000	Rs. 400,000
Cash Outflows:		
Purchase of merchandise	(258,000)	
Carriage expenses	(3,000)	
Rent Expenses	(30,000)	
Advertising expenses	(5,000)	
Salary paid	(12,000)	
Electricity expenses	(4,560)	(312,560)
Net. Cash flow from operating Activities		**Rs. 87,440**

Cash Flow from investing activities

Cash outflow for purchase of:		
Furniture	Rs. (60,000)	
Computer	(70,000)	
Net cash outflow from investing activities		Rs. (130,000)

Cash Flow from financing activities

Cash inflow		
Investment by Owner as capital	Rs. 650,000	
Cash outflow		
Drawings by owner	(30,000)	
Net cash flow from financing activities		Rs. 620,000
Net cash inflows		577,440
Add: opening cash balance on 1 Feb 2020.		00
Cash balance as on 29 February 2020		Rs. 577,440

Upon review of the financial statements as presented above, after corporation of the adjustments needed at the end of accounting period the performance position as evident from the income statement is changed from the previous income statement as presented at Para 1.9 of Unit No.1. Similarly, certain changes in the statement of owner's equity and in the Balance Sheet have also been visible as compared with such statements as available at Para 1.9 of Unit No.1. The current financial statements present more fair, accurate and reliable information as these have been prepared based upon accrual basis of accounting and after incorporating period end necessary adjustments needed upon scrutiny and scanning of the relevant records. Simultaneously the adjusting entries of Demonstration Problem 2-1 are recorded in the general journal and then posted into ledger accounts to update balances of the relevant accounts affected by adjustments.

2.4 WORK SHEET AS A TOOL

Another alternate step in completion of accounting cycle and preparation of financial statements is the preparation of draft document embodying the trial balance figures from the ledger accounts, adding the proposed adjustments at period end and then drafting the financial Statements look from the adjusted trial balance accounts to preview the proposed periodic performance and position. When such results are acceptable, the formal financial statements are prepared accordingly. This draft document is generally named as a work sheet. This work sheet is an informal working of the accountant which is just for internal purposes use. This work sheet can be prepared manually and alternatively on a computer using spreadsheet software as available in the market or tailored software according to the specific requirements of an organization the work sheet provides multiple benefits to the management, comprising an aid to the accountant for preparing the financial statements intermittently, competing prehand information about the profitability for the period, reducing errors while working with several accounts and their adjustments and planning for audit more effectively. When the previewed performance results are agreed upon, the accountants, and then enter the proposed adjustments in the accounting record. The work sheet comprises 10 columns captions.

First two columns are meant for the debit and credit balances of ledger accounts, which is named as unadjusted trial balance. Next two columns are earmarked for the proposed adjustments at period end which require debit and credit columns. The next step is preparation of adjusted trial balance which requires two columns for debit and credit accounts. These will be computed by merging the figures of adjustments in the relevant accounts of the unadjusted trial balance. Afterwards the account balances of the adjusted trial balance will be spread on two columns each for income statement accounts and the balance sheet accounts relevant to each taped as debit and credit columns. The totals of debit and credit columns of unadjusted trial balance, proposed adjustments and the adjusted trial balance will match with each other. However, the totals of debit and credit caption column s of Income Statement accounts will not match with other. The difference is because of periodic net income or loss, which will be inserted in the column of lower balance. This net income or loss will also be entered in the balance sheet account column as addition in the credit column in case of net income or subtraction (negative) in credit column in case of net loss. This work sheet is now tabulated in the ensuring Demonstration Problem 2-2 which is premised upon the accounting data of Demonstration Problem 2-1 of Para 2.3 in the preceding pages.

Demonstration Problem 2-2

Ali Trading Company
Work Sheet for the month ended 29 Feb 2020.

Particulars	Unadjusted Trial Balance		Adjustments		Adjusted Trial Balance		Income Statement		Balance Sheet	
	Dr	*Cr*	*Dr*	*Cr*	*Dr*	*Cr*	*Dr*	*Cr*	*Dr*	*Cr*
Cash Account	577,440				577,440				577,440	
Ali Capital A/C		650,000				650,000				650,000
Inventory A/C	160,000				160,000				160,000	
Accounts Payable		320,000				320,000				320,000
Carriage Exp: A/C	3,000				3,000		3,000			
Furniture A/C	60,000				60,000				60,000	
Computer A/C	70,000				70,000				70,000	
Rent Exp: A/C	30,000			(a)15,000	15,000		15,000			
Supplies A/C	8,000			(c)3,000	5,000				5,000	
Rental Income A/C		10,000	(f)10,000							
Accounts Receivables	135,000				135,000				135,000	
Sales Account						525,000		525,000		
Cost of goods Sold A/C	410,000				410,000		410,000			
Advertising exp A/C	5,000				5,000		5,000			
Salary Exp: A/C	12,000		(e) 12,000		24,000		24,000			
Electricity Exp: A/C	4,560				4,560		4,560			
Drawings A/C	30,000				30,000				30,000	
Prepaid Rent A/C			(a)15,000		15,000				15,000	
Depreciation Exp A/C			(b)1,083		1,083		1,083			
Accumulated Dep: A/C				(b)1,083		1,083				1,083
Supplies Exp: A/C			(c)3,000		3,000		3,000			
Interest Receivable A/C			(d)8,000		8,000				8,000	
Interest Income A/C				(d)8,000		8,000		8,000		
Accrued Salary A/C				(e)12,000		12,000				12,000
Unearned Rental income A/c				(f)10,000		10,000				10,000
Total Rs.	**1,505,000**	**1,505,000**	**49,083**	**49,083**	**1,526,083**	**1,526,083**	**465,643**	**533,000**	**1,060,440**	**993,083**
Net Income							***67,357***	**-**	**-**	***67,357***
Total Rs.							**533,000**	**533,000**	**1,060,440**	**1,060,440**

The journal entries for the adjustments as shown in this work sheet are also simultaneously recorded in the general journal and then posted into ledger accounts to update the balances of these accounts affected by adjustments. The work sheet as presented above classifies the adjusted trial balance accounts in the

Income Statement and Balance Sheet columns according to the available sequence of account balances. These account balances are not presented in the trial balance according to the prescribed format of the Income Statement and the Balance Sheet. Therefore, these are called as proforma financial statements. However, overall performance position and financial condition of the enterprise can be gauged from it. Now preparation of the financial statements according to the prescribed format as per International Accounting Standard No.1 (IAS-1) from this work sheet is facilitated which are prepared as here under: -

Ali Trading Company

A) Income Statement for the month ended 29 February 2020.

Sales Revenues		Rs. 525,000
Less: Cost of Goods Sold		410,000
Gross Income		**115,000**
Less: Operating expenses:		
Carriage expenses	Rs. 3,000	
Rent expenses	15,000	
Advertising expenses	5,000	
Salary expenses	24,000	
Electricity expenses	4,560	
Supplies expenses	3,000	
Depreciation expenses	1,083	55,643
Operating Income		**59,357**
Add: Interest income		8,000
Net Income		**Rs. 67,357**

Ali Trading Company

B) Statement of Owner's Equity as at 29 February, 2020.

Capital investment by owner	Rs. 650,000
Add: Net income during February 2020 (A)	67,357
Total Equity	**717,357**
Less: Drawing	30,000
Closing balance of equity	Rs. 687,357

Ali Trading Company

C) Balance Sheet as at 29 February, 2020.

Assets			**Liabilities and Equity**	
Cash		Rs.577,440	Accounts Payable	Rs. 320,000
Accounts Receivable		135,000	Accrued Salary	12,000
Supplies		5,000	Unearned Rental income	10,000
Inventory		160,000	Owner's equity(B)	687,357
Prepaid rent		15,000		
Interest Receivable		8,000		
Furniture	60,000			
Computer	70,000			
Total cost	130,000			
Less: Accumulated Depreciation	1,083	128,917		
Total		**Rs.1,029,357**		**Rs. 1,029357**

D) Statement of cash flows for the month ended 29 February, 2020.

Cash flow from operating activities

Cash inflow		
Cash collected from Sales	Rs. 390,000	
Cash collected from Rental	10,000	Rs. 400,000
Cash outflows		
Purchase of merchandise	(258,000)	
Carriage expenses	(3,000)	
Rent expenses paid	(30,000)	
Advertising expenses	(5,000)	
Salary paid	(12,000)	
Electricity expenses	(4,560)	(312,560)
Net cash flow from operating activities		Rs. 87,440

Cash flow from investing activities

Cash outflow for purchase of:		
Furniture	Rs. (60,000)	
Computer	(70,000)	
Net cash outflow from investing activities		Rs. (130,000)

Cash flow from financing activities

Cash inflows		
Investment by owner as capital	Rs. 650,000	
Cash outflows		
Drawings by owner	30,000	
Net cash inflow from financing activities		620,000
Net cash inflows		577,440
Add: Opening cash balance on 1 February, 2020.		00
Cash balance as on 29 February, 2020.		Rs. 577,440

It may be noted that the above financial statement prepared from the work sheet are identical to the financial statements prepared from the adjusted trial balance at the demonstration problem No. 2-1 at Para 2.3 of this unit.

2.5 CLOSING PROCESS

The closing process of accounting is carried out at the end of each accounting period when the financial statements are prepared and completed. The closing process is significantly an important function of the accountants in the organization at period end. As the expenses are offset against the revenues through income statement, similarly the accounting entries for closing of all expenses and revenues are passed to close all such accounts in the accounting record. Further the net income or loss determined for the period is also closed to the owner’s equity. The purpose for closing process is to bring the balances of expenses and revenues accounts to zero, so that the expenses and revenues are recorded in these accounts during the succeeding accounting period afresh with zero balance.

2.6 TEMPORARY AND PERMANENT ACCOUNTS

All the accounts used in the ledgers of an enterprise consist of three types, one classification is nominal accounts while the others are real and personal accounts. Those accounts which are presented in the income statement are called as nominal accounts which are opened at beginning of the accounting period and are closed at the end of accounting period through offsetting the expenses accounts against the revenue accounts. Since their life tenure is simply spread over one accounting period, therefore, all these accounts are called as temporary accounts. The real accounts and personal accounts are the balance sheet accounts. The real accounts comprise the assets accounts like building, plant & machinery, furniture, office equipment and motor vehicles etc. The life of these accounts are longer than one accounting period, therefore these are named as permanent accounts. Similarly, the personal accounts comprise Accounts Receivables, Accounts Payable, long term liabilities and capital (equity) accounts which are classified as permanent accounts as their balances are carried to next accounting periods and are usually represented in the accounts perpetually.

The closing process only applies on the nominal accounts while the closing balances of real accounts and personal accounts are transferred to the next accounting period as opening balances.

2.7 RECORDING CLOSING ENTRIES

As explained at Para 2.5, the closing entries are necessitated at period end to bring the balance of all nominal accounts to zero after financial statements are prepared. Usually there are four types of closing entries which are recorded in the periodic accounts as are explained here.

a) Closing of expenses to Income Summary A/C

All the periodic expenses accounts have debit balances. These expenses are credited to off-set against the periodic revenues accounts in the income summary A/C. The accounting entry will be as under: -

Date	Particulars	Dr	Cr
29-02-2020	Income Summary A/C	XXX	
	Cost of Goods Sold A/C		XXX
	Salary expenses A/C		XXX
	Rent Expenses A/C		XXX
	Depreciation Expense A/C		XXX

In the above general journal entry only few expenses accounts have been selected. In fact practically all the expenses accounts as are appearing in the ledger accounts for the accounting period would be closed to income summary account to bring their balance as zero.

b) Closing of revenues to Income Summary

The next step is to close all the revenues accounts having credit balances to the income summary by debiting the revenue accounts to bring their balance as zero at period end. The accounting entry would be incorporated as here under: -

Date	Particulars	Dr	Cr
29-02-2020	Sales Account Rental Income A/C Interest Income A/C Professional Fee A/C Income Summary A/C	XXX XXX XXX XXX	 XXX

In this closing entry all types of revenue accounts which are usually practiced in an enterprise have been taken to close.

c) Closing of Income Summary balance to Capital Account

When all the expenses and revenues are closed to the Income Summary Account, the next step is to close the balance of Income Summary account. If the revenues exceed the expenses, the Income Summary account will represent credit balance, which will show periodic net income. In order to close the Income Summary account the following accounting entry would be incorporated to bring its balance as zero: -

Date	Particulars	Dr	Cr
29-02-2020	Income Summary Account Capital Account	XXX	 XXX

Through the above closing accounting entry the balance of Income Summary Account will stand as zero. Conversely, in case the balance of expenses accounts closed to income summary account exceeds the revenue accounts, it would represent net loss for the accounting period. The debit balance of the Income Summary account which is the net loss would be closed to the capital Account through the following closing entry: -

Date	Particulars	Dr	Cr
29-02-2020	Capital Account Income Summary Account	XXX	 XXX

d) Closing Drawing A/C to Capital Accounts

The cash funds or some merchandise withdrawn by the owner from the business for personal use which is titled as Drawing Account would now be closed to the Capital Account would now be closed to the Capital Account at the period end. Since the Drawings Account has debit balance, therefore, for its closing, the Capital Account would be debited and Drawings Account would be credited as per following closing accounting entry: -

Date	Particulars	Dr	Cr
29-02-2020	Capital Account Drawings Account	XXX	 XXX

It is relevant to add here that the closing of Income Summary Account balance and the Drawings Account balance to the capital Account, as dealt with at item No (c) and (d) of Para 2.7 above, is possible only in case of a sole proprietorship or the partnership organizations. However, in case of a joint stock company, the debit or credit balance of Income Summary Account is closed to the retained earnings Account while the capital A/C is kept intact. Further, no closing accounting entry would be necessitated for the drawings account as drawing account is not involved in the companies' accounts.

The process of recording closing entries is practically explained by taking the data of financial Statements (Income Statement and Owner's equity) as presented at Para 2.4 in preceding pages. The closing entries would be as under: -

Date	Particulars	Dr	Cr
29-02-2020	Income Summary A/C	Rs. 465,643	
	Cost of Goods Sold A/C		Rs. 410,000
	Carriage Expenses A/C		3,000
	Rent Expenses A/C		15,000
	Advertising Expenses A/C		5,000
	Salary Expenses A/C		24,000
	Electricity Expenses A/C		4,560
	Supplies Expenses A/C		3,000
	Depreciation Expenses A/C		1,083
29-02-2020	Sales Revenues A/C	525,000	
	Interest income A/C	8,000	
	Income Summary A/C		533,000
29-02-2020	Income Summary A/C	67,357	
	Capital Account A/C		67,357
29-02-2020	Capital Account A/C	30,000	
	Drawings A/C		30,000

After incorporation of above four closing entries in the respective ledger accounts, the Expenses Accounts, Revenue Accounts and the Drawings Account will indicate zero balances while the impact of these closing entries will be consolidated in the owner's Capital Account which would be updated through the conduct of this closing accounts process.

2.8 POST – CLOSING TRIAL BALANCE

Consequent upon incorporating the closing entries in all nominal accounts including the Drawings Account in the general ledger of Ali Trading Company, their balance would exhibit zero balance. Thus all these accounts stand closed.

These are all income statement accounts. However, the balance sheet accounts which are classified as real accounts and personal accounts will indicate closing balance which would be carried forward to the next accounting period as opening balances. All the ledger accounts after posting of the six adjusting entries of the demonstration Problem 2-1 at Para 2.3 and four closing general journal entries (a) through (d) of Para 2.7 are now presented as under: -

Updated Ledger Accounts

Cash Account **All amounts in Rs.**

Date	Particulars	Amount	Date	Particulars	Amount
01-02-2020	Ali Capital A/C	Rs. 650,000	4-02-20	Inventory A/C	Rs. 250,000
08-02-2020	Sales A/C	280,000	4-02-20	Carriage Expense A/C	3,000
10-02-2020	Sales A/C	60,000	5-02-20	Furniture A/C	60,000
24-02-2020	Accounts Receivable	50,000	5-02-20	Computer A/C	70,000
29-02-2020	Rental Income A/C	10,000	6-02-20	Rent Expense A/C	30,000
			7-02-20	Supplies A/C	8,000
			12-02-20	Advertising Expense A/C	5,000
			15-02-20	Salary Expenses A/C	12,000
			18-02-20	Electricity Expense Account	4,560
			28-02-20	Drawing Account	30,000
			29-02-20	Closing Balance	577,440
Total		**Rs. 1,050,000**		**Total**	**Rs.1,050,000**

Ali Capital Account

Date	Particulars	Amount	Date	Particulars	Amount
29.02.20	Drawings A/C	Rs. 30,000	01.02.20	Cash Amount	Rs. 650,000
	Closing balance	687,357		Income Summary A/C	67,357
	Total	Rs. 717,357		Total	Rs. 717,357

Inventory Account

Date	Particulars	Amount	Date	Particulars	Amount
04-02-20	Cash Account	250,000	08.02.20	Cost of Goods Sold A/C	300,000
04-02-20	Accounts Payable	170,000	10-02-20	Cost of Goods Sold A/C	50,000
21-02-20	Accounts Payable	150,000	20-02-20	Cost of Goods Sold A/C	60,000
			29-02-20	Closing Balance	160,000
	Total	Rs.570,000		Total	Rs.570,000

Accounts Payable

Date	Particulars	Amount	Date	Particulars	Amount
04-02-20	Closing balance	320,000	04.02.20	Inventory A/C	170,000
			21-02-20	Inventory A/C	150,000
	Total	Rs.320,000		Total	Rs.320,000

Carriage Expenses Account

Date	Particulars	Amount	Date	Particulars	Amount
04-02-20	Cash Account	3,000	29-02.20	Income Summary	3,000
	Total	Rs.3,000		Total	Rs.3,000

Furniture Account

Date	Particulars	Amount	Date	Particulars	Amount
05-02-20	Cash Account	60,000	29-02-20	Closing balance	60,000
	Total	Rs.60,000		Total	Rs.60,000

Computer Account

Date	Particulars	Amount	Date	Particulars	Amount
05-02-20	Cash Account	70,000	29-02-20	Closing balance	70,000
	Total	Rs.70,000		Total	Rs.70,000

Rent Expense Account

Date	Particulars	Amount	Date	Particulars	Amount
06-02-20	Cash Account	30,000	29-02.20	Prepaid Rent Account	15,000
			29-02-20	Income Summary	15,000
	Total	Rs.30,000		Total	Rs.30,000

Supplies Account

Date	Particulars	Amount	Date	Particulars	Amount
08-02-20	Cash Account	8,000	29-02.20	Supplies Expense Account	3,000
			29-02-20	Closing balance	5,000
	Total	Rs.8,000		Total	Rs.8,000

Accounts Receivable

Date	Particulars	Amount	Date	Particulars	Amount
08-02-20	Sales Account	100,000	24-02.20	Cash Account	50,000
20-02-20	Sales Account	85,000	29-02-20	Closing balance	135,000
	Total	Rs.185,000		Total	Rs.185,000

Sales Account

Date	Particulars	Amount	Date	Particulars	Amount
29-02-20	Income Summary Account	525,000	08-02.20	Cash Account	280,000
			08-02-20	Accounts Receivable	100,000
			10-02-20	Cash Account	60,000
			20-02-20	Accounts Receivables	85,000
	Total	Rs.525,000		Total	Rs.525,000

Cost of Goods Sold Account

Date	Particulars	Amount	Date	Particulars	Amount
08-02-20	Inventory Account	300,000	29-02.20	Income Summary Account	410,000
10-02-20	Inventory Account	50,000			
20-02-20	Inventory Account	60,000			
	Total	Rs.410,000		Total	Rs.410,000

Advertising Expense Account

Date	Particulars	Amount	Date	Particulars	Amount
12-02-20	Cash Account	5,000	29-02.20	Income Summary Account	5,000
	Total	Rs.5,000		Total	Rs.5,000

Salary Expense Account

Date	Particulars	Amount	Date	Particulars	Amount
15-02-20	Cash Account	12,000	29-02.20	Income Summary Account	24,000
29-02-20	Accrued Salary Account	12,000			
	Total	Rs.24,000		Total	Rs.24,000

Electricity Expense Account

Date	Particulars	Amount	Date	Particulars	Amount
18-02-20	Cash Account	4,560	29-02.20	Income Summary Account	4,560
	Total	Rs.4,560		Total	Rs.4,560

Drawings Account

Date	Particulars	Amount	Date	Particulars	Amount
28-02-20	Cash Account	30,000	29-02.20	Capital Account	30,000
	Total	Rs.30,000		Total	Rs.30,000

Rental Income Account

Date	Particulars	Amount	Date	Particulars	Amount
29-02-20	Unearned Rental Account	10,000	29-02.20	Cash Account	10,000
	Total	Rs.10,000		Total	Rs.10,000

Prepaid Rent Account

Date	Particulars	Amount	Date	Particulars	Amount
29-02-20	Rent Expense Account	15,000	29-02.20	Balance Account	15,000
	Total	Rs.15,000		Total	Rs.15,000

Depreciation Expense Account

Date	Particulars	Amount	Date	Particulars	Amount
29-02-20	Accumulated Depreciation Account	1,083	29-02.20	Income Summary Account	1,083
	Total	Rs.1,083		Total	Rs.1,083

Accumulated Depreciation Account

Date	Particulars	Amount	Date	Particulars	Amount
29-02-20	Balance C/F	1,083	29-02.20	Depreciation Expense Account	1,083
	Total	Rs.1,083		Total	Rs.1,083

Supplies Expense Account

Date	Particulars	Amount	Date	Particulars	Amount
29-02-20	Supplies Account	3,000	29-02.20	Income Summary Account	3,000
	Total	Rs.3,000		Total	Rs.3,000

Interest Receivable Account

Date	Particulars	Amount	Date	Particulars	Amount
28-02-20	Cash Account	8,000	29-02.20	Balance C/F	8,000
	Total	Rs.8,000		Total	Rs.8,000

Interest Income Account

Date	Particulars	Amount	Date	Particulars	Amount
29-02-20	Income Summary Account	8,000	29-02.20	Interest Receivable Account	8,000
	Total	Rs.8,000		Total	Rs.8,000

Accrued Salary Account

Date	Particulars	Amount	Date	Particulars	Amount
29-02-20	Balance C/F	12,000	29-02.20	Salary Expense Account	12,000
	Total	Rs.12,000		Total	Rs.12,000

Unearned Rental Account

Date	Particulars	Amount	Date	Particulars	Amount
29-02-20	Balance C/F	10,000	29-02.20	Rental Income Account	10,000
	Total	Rs.10,000		Total	Rs.10,000

Income Summary Account

Date	Particulars	Amount	Date	Particulars	Amount
29-02-20	Cost of Goods Sold	410,000	29-02.20	Sales Revenue	525,000
	Carriage Expense Account	3,000	29-02-20	Interest Income Account	8,000
	Rent Expense Account	15,000			
	Advertising Expense Account	5,000			
	Salary Expense Account	24,000			
	Electricity Expense Account	4,560			
	Supplies Expense Account	3,000			
	Depreciation Expense Account	1,083			
29-02-20	Capital Account	67,357			
	Total	Rs.533,000		Total	Rs.533,000

In the foregoing ledger accounts, all the temporary accounts (nominal accounts) have been closed while the permanent accounts (real and personal accounts) which are related to the balance sheet are indicating closing balances. In order to verify accuracy of such balances a post closing trial balance is prepared to keep ready the balances of such accounts to transfer them to the next accounting period. The post closing trial balance will be prepared from the ledger accounts which are showing balances. The post closing trial balance is prepared and presented as under:-

Ali Trading Company
Post Closing trial balance as on 29 February, 2020.

Particulars	Dr	Cr
Cash Account	Rs. 577,440	
Ali's Capital Account		Rs. 687,357
Inventory Account	160,000	
Accounts Payable		320,000
Furniture Accounts	60,000	
Computer Account	70,000	
Supplies Account	5,000	
Accounts Receivable	135,000	
Prepaid Rent Account	15,000	
Accumulated Depreciation Account		1,083
Interest Receivable Account	8,000	
Accrued Salary Account		12,000
Unearned Rental Account		10,000
Total	**Rs.1,030,440**	**Rs. 1,030,440**

After preparation and machting the totals of debit and credit colunms accounts of the post closing trial balance, the accounting process stands completed and similar activities are then undertaken during the next accounting period.

2.9 SUMMARY

The reliable periodic reporting in an organization depends upon the appropriate accounting system adopted by it. The accrual basis of accounting meets and ensures accuracy and reliability as the financial statements present true and fair operating results and financial position. In this context, after preparation of trial balance for a specific period, the accounts are reviewed in order to carry out certain adjustments in those accounts where changes are necessitated. These are called as internal entries of adjustments. The adjusting entries are classified into four categories namely, prepaid expenses, accrued expenses, unearned revenues and accrued revenues. These adjusting entries affect the expenses revenues assets and liabilities accounts and ultimately the owner's equity. The financial statements prepared after necessary adjustments will exhibit true information. In order to facilitate accounting work, a ten column work sheet is used to draft financial and operating results. Thereafter, temporary accounts are closed to income summary account and then to the equity account. The post-closing trial balance is then drawn in order to ensure equality of debit and credit balances of the permanent accounts for transferring to the next accounting period.

2.10 THEORETICAL QUESTIONS

1. Describe the accrual basis of accounting and how it is beneficial for reliable reporting of business results.
2. Describe different classification of adjustments needed at period end in the accounts.
3. Explain the procedures for adjustment of prepaid expenses in the accounts?
4. How accrued expenses are recorded in the accounts?
5. What is meant by the unearned revenues? Present accounting entries in this respect.
6. What adjusting accounting entry is required for accrued revenues? Explain it with different two examples.
7. How the adjusting accounting entries will affect the reporting position of financial statements?
8. Describe the classification of financial statements and the information disclosed by each statement.
9. A worksheet is considered as a draft working of an accountant for carrying out the accounting adjustments, their impact on temporary and permanent accounts and facilitation for preparation of financial statements. Explain if you agree with it.
10. Indicate the classification of temporary and permanent accounts maintained in an enterprise.
11. What is meant by closing process of accounts? Tabulate some closing entries needed at end of an accounting period?
12. What is the objective for undertaking a closing process of accounts in an organization?
13. What is meant by the post- closing trial balance and how far it is compared with the balance sheet accounts?
14. How far it is necessary to record and post the adjusting entries in the general journal and then into ledger accounts before post-closing trial balances in drawn?
15. What purpose is served by the Income Summary Account during closing process of accounts?

2.11 PRACTICAL PROBLEMS

P.2-1

The following data is assembled from the accounting records of Subhan Industries, Islamabad.

a) The company borrowed Rs. 500,000 from the bank on November 01, 2019 issuing a Provisory Note which is payable after 03 months with an interest rate of 18% per annum.
b) The company paid Rs. 136,000 for a fire insurance policy of stock covering a period of two years beginning from 01 October 2019. The Payment was recorded in prepaid Insurance Account.
c) A note receivable of Rs. 600,000 dated 01 September 2019 was received from a customer in payment of his account. This note receivable could be collected after 6 months.
d) The company collected an amount of Rs. 27,000 representing rent from the cafeteria contractor alongside the premises for a period of 06 months commencing from 01 August 2019. The amount was credited to the Unearned Rented Revenues.

Required:
Record necessary adjusting journal entries in the accounts which are closed on 31 December each year.

P.2-2
A trial balance of Shayan Trading Company for the year ended 30 June, 2019 was prepared by the Accountant. A scrutiny of the various accounts revealed that the following adjustments are needed:-
a) Salaries amounting to Rs. 135,000 of certain employees for the month of June, 2019 were neither paid nor was any provision made.
b) Depreciation at 20% on computer equipment costing Rs. 250,000 was yet to be recorded for the year.
c) Office supplies were purchased at the cost of Rs. 45,000 while the year ended physical verification indicated that office supplies worth Rs. 22,000 were only available in the stores.
d) Accrued interest for 02 months at 12% per annum on an investment of Rs. 800,000 was neither recorded nor received.
e) The utility bills for June 2019 amounting to Rs. 18,500 were received at the end of month which is due for payment on 05 July 2019.
f) The loan repayment instalment of Rs. 130,000 with interest of Rs. 10,000 till end of June 2019 is due for payment on 01 July 2019.

Required:
1) Prepare adjusting accounting journal entries for the above adjustments.
2) Indicate the overall impacts of above adjustments on net income if these are omitted.

P.2-3

The following trial balance for the year ended 30 June, 2019 was extracted from the accounting record of Ashar Construction Company:

Particular	**Debit**	**Credit**
Cash Account	Rs. 228,000	
Equipment and Machinery	265,600	
Accounts receivable	101,100	
Supplies	10,000	
Accounts Payable		18,000
Capital Account		650,000
Drawings Accounts	25,000	
Construction fee		320,000
Wages expenses	45,000	
Interest expenses	6,000	
Rent expenses	24,000	
Property tax	8,500	
Repair and maintenance expenses	6,500	
Utilities expenses	8,300	
Motor vehicle	260,000	
Total	**Rs. 988,000**	**Rs. 988,000**

The checking of record indicates that following adjustments are required:

a) Depreciation on equipment and machinery and Motor vehicle at 10% annually is to be charged.
b) Supplies worth Rs. 6,400 were available in the stores.
c) The construction fee includes an amount of Rs.20, 000 for which services were not rendered.
d) Wages amounting to Rs. 15,000 are still outstanding to employees.
e) Rent expenses include an amount of Rs. 4,000 which is related to July and August 2019.

Required:

a) Prepare adjusting accounting entries for the above items.
b) Prepare a schedule showing unadjusted trial balance, adjustments and the adjusted trial balance.
c) Prepare following financial statements: -
    1. Income Statement
    2. Statement of change in equity.
    3. Balance Sheet.
    4. Cash flows Statement.

P.2-4

Following account balances were taken from the ledger of Umair Supply Company as on 31 December 2019:-

Accounts Payable	Rs. 27,500	Land	Rs. 550,000
Accounts Receivable	56,000	Note Payable	140,100
Advertising	4,000	Office expenses	13,400
Building	600,000	Purchases	615,000
Capital	905,000	Sales	920,000
Cash	20,000	Selling expenses	41,200
Insurance	12,000	Supplies expenses	5,200
Interest Expense	2,200	Utilities expenses	20,100
Interest income	500		
Opening inventory	54,000		

Adjustments as on 31 December 2019 are required as under:-

a) Inventory on hand is amounting to Rs. 72,850
b) Building is to be depreciation at 10% per annum.
c) Accrued selling expenses are amounting to Rs. 14,000.
d) The unexpired insurance is amounting to Rs. 6000.
e) Utilities bills amounting to Rs. 6,300 are outstanding

Required:

i. Prepare necessary adjusting accounting entries.
ii. Prepare 10 columns work sheet.
iii. Prepare Income Statement.
iv. Prepare Retained Earnings Statement.
v. Prepare Balance Sheet.
vi. Prepare Closing entries
vii. Prepare Post Closing Trial Balance.

P.2-5

Following is the trial balance of Cirose Cinema for the month ended on 31 January 2020.

Particular	**Dr**	**Cr**
Cash	Rs. 45,000	
Prepaid film rentals	325,000	
Projection Equipment	1,520,000	
Accumulated depreciation on equipment		Rs. 152,000
Accounts Payable		100,000
Unearned ticket revenues		10,000
Capital		1,500,000
Ticket revenues		670,000
Utilities expenses	320,000	
Salaries expenses	222,000	
Total	**Rs. 2,432,000**	**Rs.2,432,000**

The following additional information has been extracted from the record:-

i. The accounts are closed on monthly basis to determine performance.
ii. The building is on rent basis and the rent for January is yet unpaid which is amounting to Rs. 140,000.
iii. The film rentals for January amounting to Rs. 150,000 are yet to be adjusted against the prepaid film rentals
iv. The depreciation at 10% per annum on projection equipment is to be accounted for.
v. The unearned ticket revenues amounting to Rs. 6,000 have been earned during end of January 2020.
vi. Salaries of security staff amounting to Rs. 28,000 are still payable.

Required:

a) Prepare month end adjusting accounting entries.
b) Prepare 10 columns work sheet.
c) Prepare following financial statements:-
    1) Income Statement
    2) Statement of changes in equity
    3) Balance sheet
d) Prepare closing entries
e) Prepare post-closing trial balance.

P.2-6

The unadjusted and adjusted trial balance of the work sheet drawn by the Accountant of Shayan Legal Services for the month ended 31 January 2020 is presented below:-

Particulars	**Unadjusted Trial Balance**		**Adjusted Trial Balance**	
	Dr	**Cr**	**Dr**	**Cr**
Cash Amount	Rs. 5,000		Rs. 5,000	
Legal Fee Receivable			40,000	
Office Supplies	15,000		8,000	
Office Equipment	240,000		240,000	
Salaries Payable				10,000
Salaries Expenses	30,000		40,000	
Legal Fee Earned		240,000		280,000
Office Supplies Expenses	4,000		11,000	
Utility Expenses	12,000		16,000	
Utility Expenses Accrued				4,000
Depreciation Expenses			2,000	
Accumulated Depreciation				2,000
Shayan Capital		66,000		66,000
Rent Expenses			25,000	
Accrued Rent				25,000
Total	**Rs. 306,000**	**Rs. 306,000**	**Rs. 387,000**	**Rs. 387,000**

Required:

a) Prepare adjusting accounting entries incorporated in the unadjusted trial balance.
b) Prepare Income Statement.
c) Prepare statement of change in equity.
d) Prepare Balance Sheet.
e) Prepare Closing accounting entries
f) Prepare post-closing trial balance.

2.12 GLOSSARY

Adjusting entries
The internal transactions which are usually necessitated at period end, after analysis of all accounts, to record left over events, to update account balances where needed, so as to determine accurate operating periodic results and the financial condition of an enterprise.

Prepaid expenses
The expenses paid in advance, the benefits of which will be obtained in the succeeding period.

Accrued expenses
Those expenses which have been incurred currently but their payment is not yet released to the concerned parties.

Unearned revenues
The cash received in advance but the goods will be supplied or services will be rendered at some future period.

Accrued revenues
The revenues which have earned for rendering of services or sale of merchandise but the payment is not yet received or recorded.

Adjusted trial balance
The trial balance whose account balances have been updated through giving the effect of all yearend adjustments in accounting record.

Work Sheet
A draft statement/spread sheet usually of 10 columns which is prepared by accountants to present all account balances with proposed adjustments and draft income statement and balance sheet for an accounting period facilitate preparation of formal financial statements of an organization.

Closing Process
A system of accounting work where the expenses are closed and matched with revenues through an income summary account to computer periodic income or loss.

Temporary accounts
Those accounts of income statement which have a life of one accounting period and are closed at the end of period to bring their balance at zero. Such accounts are also called as nominal accounts.

Permanent accounts
Those accounts which are maintained perpetually comprising the real and personal accounts, also classified as balance sheet accounts which indicate overall financial condition of an organization on a specific date.

Post-closing trial balance
A comparative statement of balances of all liabilities, equity and assets accounts usually of balance sheet accounts to check equality at period end for transferring such account balances to the next accounting period.

Financial Statements
A composition of different statements prepared at the end of accounting period to ascertain operating results and financial condition consisting of an income statement, the statement of owner's equity, the balance sheet and the cash flow statement of an organization.

Accrued basis of accounting
A system of accounting for recording all transactions when these have been committed without regard to exchange of cash.

Cash basis of accounting
A system of accounting for recording transactions only when cash has been exchanged for it.

Unit–3

ACCOUNTING INFORMATION SYSTEM

Written by: Muhammad Ashraf Bhutta
Reviewed by: Muhammad Munir Ahmad

CONTENTS

INTRODUCTION

This unit is related to the development and application of some accounting information systems in a business organization for regular inflow of reports for taking timely business decisions. These accounting information system are based upon computer technology for recording and generating reports quickly and be reliable to support management for review of activities. The special journals for recording repetitive transactions instead of using single general journal have also been introduced so as to facilitate accounting work.

OBJECTIVES

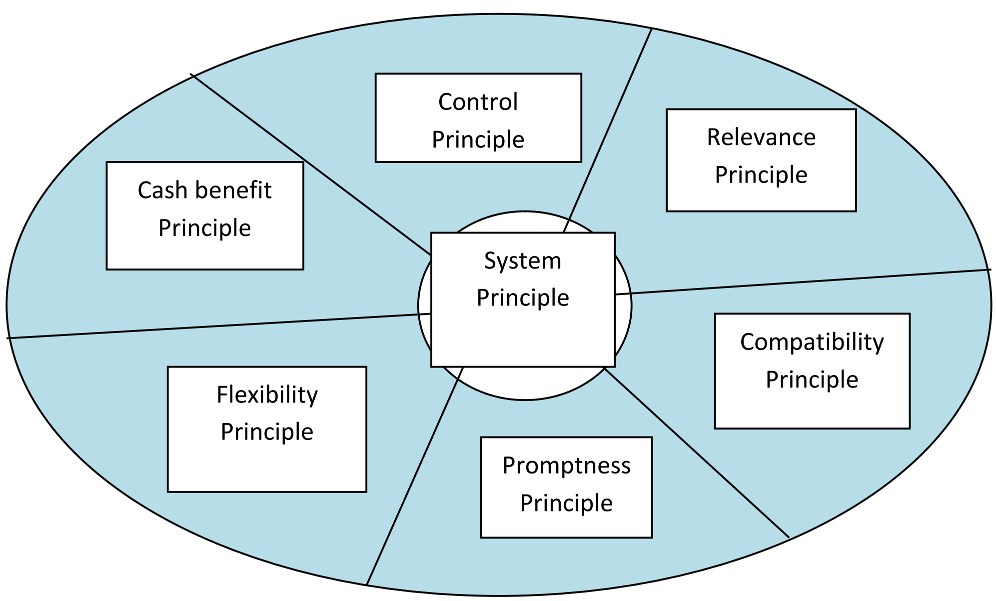
The accounting, apart from a business language, is also viewed as ears and eyes of the management. These requirements are accomplished to some extent, by learning this unit by students which explains the following aspects: -

1) The establishment of an accounting information system in an organization which should be premised upon Six factors of control, relevance, compatibility, informative promptness, flexibility and cost- benefit principles.
2) The computerized accounting system need the hardware and software and data taken from source documents is entered through input devices to the processors for storage and reports generation by the output devices.
3) The maintance of special journals, comprising Sales Journal for recording all credit Sales transactions, cash receipt journal for recording all cash collection from sales, accounts receivables and other sources, Purchase Journals for recording all credit procurement of merchandise, cash payment journal for recording all payments of accounts payables and other expenses and also alternatively a cash book for recording consolidated receipts and payments for all categories of business transactions. This indicates as to how transactions are posted into control leader accounts and subsidiary ledger accounts and their reconciliation at some period end to ensure accuracy.

3.1 FUNDAMENTAL SYSTEM PRINCIPLES

The accounting information system envisages the specific requirements of the management of an organization. This system is evolved by keeping record and developing periodic reports like financial statements and any other detailed selected information in a systematic manner as needed by the management and the regulatory authorities. The legal requirements must be met by a system that is designed in a cost conscious manner. The accounting information system collects the data of transactions, records them and then draws reports to communicate them to the decision makers. A successful rather useful accounting system should be designed in such a manner to give the blend of simplicity and be efficient and economical. However, an integrated information system should provide only that particular information which is needed by each responsible manager. The accumulation of accounting data requires several forms, methods and systems due to varying types and sizes of business activities and the growing need for information, developing some appropriate accounting information system has assumed greater significance during the current century. The decision makers use the information to take more reliable decisions and balance the risks and returns amongst different strategies. The well designed accounting information system comprises Six basic principles as shown in the Pye Graphic Chart at exhibit 3-1 below:-

EXBIT 3-1
Accounting Information System Principles



The above principles of an efficient accounting information system are now deliberated as under: -

A) Control Principle

Control is a systematic effort of the management to achieve objectives by the conduct of business activities at predetermined plans. This is possible through devising internal controls which ensure adherence to the rules, procedures and methods. The regular monitoring of activities through creation of reports under accounting information system leads to remove bottle necks to improve efficiency.

B) Relevance Principle

The management, while taking business decisions, requires reports from the accounting information system which must disclose relevant and reliable details/ information to premise better decisions. Therefore, the accounting information system should be designed to capture data, be understandable, and indicate pertinent information relevant to the need of management to take effective decisions.

C) Compatibility Principle

The accounting information system should be tailored and structured consistently with the operative functions of the company. The compatible principle emphasizes uniformity in designing the accounting information system in line with the nature of workings of the enterprise like professional services, trading or the manufacturing. Every type of enterprise would require the accounting information in harmony with its functions. Thus compatible principle of accounting information system would lead to generate useful reports for the management.

D) Promptness Principle

Sometimes the management needs to take instant decisions in order to face some situations effectively. Thus whether the accounting information system is developed manually or through electronic devices it must flow the information reports instantly, timely and in consonance with the deadline specifically by the management. Usually the prompt flow of information is termed as essence of the accounting information system as delay hampers quick decisions which may be at least beneficial to the enterprise.

E) Flexibility Principle

The flexibility principle of the accounting information system prescribe that it should be able to softly absorb changes in the quantum of activities and nature of transactions. It must conform to the changes in information needs of the management. Besides the flexibility principle also envisages that it must be capable to absorb constantly the technical advancements, consumer's tastes, legal regulations and competitors' pressure conveniently.

F) Cost – Benefit Principle

Every activity in the business is analyzed in the perspective of cost versus its benefits. If the benefits exceed from the cost that particular activity is undertaken. While introducing any type of accounting information system its operation and maintains must conform to the foregoing cost – benefit principle. The preceding all principles at A to E should also be gauged on the cost – benefit principle because and principle whose cost is greater than its benefit, do not support the decision of management for its implementation.

3.2 COMPONENTS OF ACCOUNTING SYSTEMS

The components of accounting information system comprise working staff, records, procedures and methods, software and hardware of computer equipment. The qualified and competent staff of accounting is recruited and trained according to the requirements of accounting information system of the organization. Proper record of accounting is maintained. Procedures and methods are developed in compliance to the discipline determined by the management under uniform reporting system. The tailored software and modern hardware computer equipment at competitive cost is purchased and installed. This system is used to capture relevant information of business activities and generate output reports as are needed by the management including but not limited to the financial accounting, managerial and tax reports. The computerized accounting system exceeds from manual accounting system in several perspectives like reliability, accuracy, speed, flexibility and convenience for operations which is used by all large organizations. The basic components of accounting system are therefore, classified as the source documents (record), information storage and the output devices. These components are described in the succeeding paras.

3.3 SOURCE DOCUMENTS

The source documents are the fundamental evidence of an accounting event. The source documents vary from the nature of business organizations. However, the most common source documents may be identified as purchase and sale bills/invoices, payments and collection vouchers, cash book, bank book, counter folios of cheques, bank statements, receipts, general journal, sales and purchase journals, fixed assets cards, payroll sheets, employees files, utility bills, store ledger cards and many more. Certain source documents can be verified from the electronic device files as gradually the web is playing significant role in the transaction from paper – based documentation to the paperless system in the current scenario of computerization of records. Identification of relevant source documents specifically in the electronic environment of accounting information system is crucial. The input of faulty or incomplete information seriously impairs the reliability and relevance of the accounting information system. Further the setting up of computerized accounting information system necessitates application of control procedures to avoid possibility of entering faulty data in the system which may lead to non-reliable information flow.

3.4 INPUT DEVICES

The input devices refer to the electronic instruments like Key Board, Scanners, modems and mouse of a computer equipment through which the information is captured from source documents and entered into the system processor electronically. These input devices also help to convert data of source documents from written or electronic form to a form useable for the system. Journal entries both manual and electronic are a type of input device. Further, bar code readers capture code numbers and enter them into the computer for processing also fall into the input devices. These input devices are the basic tools of an electronic accounting information system. Therefore, use of these tools by an unauthorized official would defeat the trust of satisfactory information.

3.5 INFORMATION PROCESSERS AND STORAGE

Upon entering relevant information from the source documents through input devices into electronic based accounting system, the said data is processed through software installed in the processer of hardware. Then the processer transforms and summarizes the information for use in the analysis and reporting. The information processers also comprise the journals, ledger accounts, posting procedures and the working papers. Each of these elements help to transform the raw data into desired useful information pattern as preferred by the executives. Currently the computer technology consisting of software and hardware, handled by the information technology professionals, are entering the data in the processers and are retrieving reports for analysis and interpretation for better performance of their jobs.

The information storage is of pivotal importance in any data based electronic system. The software installed and the modern hardware help to store the data for current and future use of comparison and analysis as is needed. The stored data must be accessible only to the authorized users of computers for periodic financial reports generation. In the past, almost all data was stored manually which handicapped longer storage. The modern system of information storage is premised upon electronic storage more detailed data. The greater stored detailed data enables the managers to plan and control business activities with higher efficiency. Such state of affairs has enabled the managers competent enough to deal with the business transactions even under online communications.

3.6 OUTPUT DEVICES

The data retrieved by the users from the electronic processor is the end result of entire electronic based accounting system. This is possible through use of output devices. The output devices include several categories like printers, monitors, projectors, mobile phone screens, and web communications. The output devices easily provide variety of information like simple reports, analytical reports, segmental reports, graphics, bill to customers, cheques to suppliers, employee pay cheques, financial statements and other interval reports. Upon entering the desired request for certain information in the computer containing pre-installed software, the processor starts functioning and after a short time the requisite information appears on the output device. The transfer of funds from one bank account to another through online which is visible on output device is another instance of the system.

3.7 SPECIAL JOURNALS IN ACCOUNTING

As discussed in Unit-2 the general journal is used to record business transactions and then posting into general ledger accounts as a process of classification procedure. This general journal may be used by small or medium organizations where quantum of the transactions is low. However, in large organizations a single general journal does not suffice as a single employee may not be able to record all daily transactions. Further, some repetitive types of transactions, where sale, purchase and cash is involved, may be inordinately time consuming and uneconomical in terms of expenses when repetitively accounts receivable, sales account, purchase account, account payable and cash account are used for sales and purchases or merchandise. Thus logically in order to facilitate working environment in an organization, it would be appropriate to employ some special journals for recording repetitive type of transactions. The broad classification for introduction of special journals may be as under depending upon the nature of activities of an organization: -

	Types of Transaction	Special Journal
1	Sale of merchandise on credit	Sales Journal
2	Receipt of cash from any source	Cash receipt Journal
3	Purchase of merchandise on credit	Purchase Journal
4	Payment of Cash for any purpose	Cash Payment Journal

The above special Journal are now illustrated one by one as under: -

3.7.1 Sales Journal

The Sales journal maintained by the trading organizations is exclusively used for recording all sales of merchandise on credit basis. The sales on cash basis are recorded in the cash receipt journal. Besides the sale/disposal of assets are not recorded in the Sales journal rather these are recorded in the general journal in case these are sold on credit basis while in case of cash basis these are recorded in the cash receipt journal depending upon the terms of sale. The sales journal is illustrated in the demonstration problem 3-2 through some sales transactions of Asad Trading Company which are as follows: -

Demonstration Problem 3-2 Sales Transactions

01-02-2020	Sold merchandise to Asif Company on 30 days credit amounting to Rs. 20,000.
03-02-2020	Sold merchandise to Fareed Sons on 15 days credit amounting to Rs. 15,000
05-02-2020	Sold goods at the price of Rs.12,000 to Azam Sons on 30 days credit.
10-02-2020	Sold goods amounting to Rs. 10,000 to Fareed Sons on 40 days credit.
15-02-2020	Sold merchandise at the price of Rs. 18,000 on credit basis to Azam Sons.
20-02-2020	Sold goods amounting to Rs. 6,800 to Asif & Company on 20 days credit.
28-02-2020	Sold merchandise amounting to Rs. 15,000 on 20 days credit basis to Azam Sons.
29-02-2020	Sold goods at the price of Rs.8,000 on cash to Zia Sons

The above Sales transactions are now recorded in the Sales Journal as under:-

Solution to

Asad Trading Company
SALES JOURNAL

Date 2020	Invoice No.	Account Debited	Posting Reference	Accounts Receivable Dr 2005	Sales Account Cr 5100
01 Feb	320	Asif & Company	√√	Rs. 20,000	
03 Feb	321	Fareed Sons	√√	15,000	
05 Feb	322	Azam Sons	√√	12,000	
10 Feb	323	Fareed Sons	√√	10,000	
15 Feb	324	Azam Sons	√√	18,000	
20 Feb	325	Asif & Company	√√	6,800	
28 Feb	326	Azam Sons	√√	15,000	
		Total	√√	Rs. 96,800	
		Accounts Posted		(2005) Dr	(5100) Cr

All the credit sales transactions have been recorded in the sales Journal of Asad Trading Company except one transaction dated 29 February 2020 which was the cash sales transaction. Since Sales Journal is maintained only for credit sales, therefore, the cash sales will not be recorded in this Sales Journal while this cash sales transaction will be recorded in the cash receipt Journal.

After recording the transactions in Sales Journal, this will now be posted into the respective subsidiary ledger accounts of Receivable from customers on daily basis and a tick mark (√) will be inserted against each credit customer in the posting reference column of the Sales Journal. At the end of each month or on weekly basis, as is considered expedient, the posting of credit sales will also be posted in the Accounts Receivable control account to match the balances of all subsidiary ledger accounts with the control ledger Account.

The subsidiary ledger accounts and the control ledger account for the foregoing sales Journal transactions are presented as here under:-

Subsidiary ledger Accounts of Credit Customers
Asif & Company

01-02-20	Sales Account	Rs. 20,000	29-02-10	Balance c/f	Rs. 26,800
20-02-20	Sales Account	6,800			
	Total	Rs. 26,800			Rs. 26,800

Fareed & Sons

03-02-20	Sales Account	Rs. 15,000	29-02-10	Balance c/f	Rs. 25,000
10-02-20	Sales Account	10,000			
	Total	Rs. 25,000			Rs. 25,000

Azam & Sons

05-02-20	Sales Account	Rs. 12,000	29-02-10	Balance c/f	Rs. 45,000
15-02-20	Sales Account	18,000			
28-02-20	Sales Account	15,000			
	Total	Rs. 45,000			Rs. 45,000

Control ledger Accounts
2005-Accounts Receivable

29-02-20	Sales Account	Rs. 96,800	29-02-10	Balance c/f	Rs. 96,800

5100- Sales Account

29-02-20	Balance c/f	Rs. 96,800	29-02-10	Accounts Receivable	Rs. 96,800

Comparing the total of all the credit customers of the subsidiary ledger accounts as 03 in number) i.e Rs. 26,800 of Asif & Company, Rs. 25,000 of Fareed & Sons and Rs. 45,000 of Azam & Sons as presented above with the total balance of control ledger of Accounts receivable, Rs. 96,800 it is confirmed that these are matching with each other. Hence accuracy is confirmed. Any amount collected from these customers will be recorded on the same day in the subsidiary ledger accounts and the control ledger account to maintain equality after every transaction.

Instead of using the T format traditional ledger accounts, the running balance four column format ledger account is preferably used by all larger organizations where electronic accounting information system is employed.

3.7.2 Cash Receipt Journal

The cash receipt Journal is maintained for recording all transactions wherefrom the cash is collected by the enterprise. This cash can be received from cash sales, collection from credit customers (Accounts Receivables), rent, interest, dividend disposal of certain assets and issuance of capital stock. The Cash Receipt Journal will be divided into two parts, one debit column for recording cash collection and any discount allowed to customers on earlier payment while the credit column will be used for the source from which the cash was collected. The credit column will indicate few major those account sources from which the frequency of transactions is greater while infrequent items will be recorded in Sundry Accounts column. The cash sales, transactions can usually be frequent in a day, therefore, these can first be recorded into a cash sales register and then can be entered into the cash receipt Journal on daily basis through a consolidated one entry.

The Cash Receipt Journal can be illustrated in the demonstration problem 3-3 through some cash transactions of Asad Trading Company which are as follows:-

Demonstration Problem 3-3

Cash collection transactions

02-03-2020	Collected cash of Rs. 20,000 from Asif & Company for credit sales during February 2020.
04-03-2020	Cash sales for the day as per cash register amounting to Rs. 8,650.
06-03-2020	Collected rent of Rs. 12,000 from cafeteria contractor for March 2020.
07-03-2020	Collected Rs. 12,000 from Azam Sons for credit sales on 5 February 2020
10-03-2020	Disposed off an old motor cycle at the cash price of Rs. 13,200 at its cost.
15-03-2020	Received dividend income of Rs. 10,000
18-03-2020	Collected Rs. 15,000 from Azam Sons for credit Sales during February 2020
25-03-2020	Cash sales for the week as per cash register amounting to Rs. 28,500
28-03-2020	Collected Rs. 10,000 from Fareed Sons against credit sales during February 2020
31-03-2020	Cash sales for the week as per cash register amounting to Rs. 25,110

All the above cash transactions are now recorded into the cash receipt journal as under:-

Demonstration Problem 3-3
Solution of Asad Trading Company
Cash Receipt Journal

Date	Particulars of Accounts credited	PR	Cash Debit	Sales Credit	A/R Credit	Sundry Accounts Credit	
March 2020			Rs.	Rs.	Rs.	Rs.	Account No.
02	Asif & Company	√	20,000		20,000		
04	Sales Account	√	8,650	8,650			
06	Rent Income	√	12,000			12,000	5,200
07	Azam Sons	√	12,000		12,000		
10	Motor cycle	√	13,200			13,200	2,300
15	Dividend A/C	√	10,000			10,000	6,100
18	Azam Sons	√	15,000		15,000		
25	Sales Account	√	28,500	28,500			
28	Fareed Sons	√	10,000		10,000		
31	Sales Account	√	25,110	25,110			
	Total		154,460	62,260	57,000	35,200	
	Accounts Posted	√	1,000	5,100	2005	-	

The account codes as used in the Sales Journal and the cash Receipt Journal are those which are usually used by the organizations and are developed by a chart of accounts with numerical codes for recording convenience in the accounting records.

The transactions as recorded in the Cash Receipt Journal will now be posted in the control ledger accounts and the subsidiary ledger accounts. The subsidiary ledger accounts and the control ledger Account for the Accounts Receivable as used in the sales Journal will be adopted for posting of certain transactions conducted during March, 2020 in the cash Receipt Journal apart from the opening of certain additional ledger accounts as involved in the cash Receipt Journal as presented below:-

Subsidiary Ledger Accounts of Credit Customers
Asif & Company

01-02-2020	Sales Account	Rs. 20,000	02-03-20	Cash Account	Rs. 20,000
20-02-2020	Sales Account	6,800	31-03-20	Balance C/F	6,800
	Total	Rs. 26,800			Rs. 26,800

Fareed & Sons

03-02-2020	Sales Account	Rs. 15,000	28-03-20	Cash Account	Rs. 10,000
20-02-2020	Sales Account	10,000	31-03-20	Balance c/f	15,000
	Total	Rs. 25,000		Total	Rs. 25,000

Azam Sons

05-02-2020	Sales Account	Rs. 12,000	07-03-20	Cash Account	Rs. 12,000
15-02-2020	Sales Account	18,000	18-03-20	Cash Account	15,000
28-02-2020	Sales Account	15,000	31-03-20	Balance c/f	18,000
	Total	Rs. 45,000		Total	Rs. 45,000

Control ledger Accounts
2005- Accounts Receivable

29-02-2020	Sales Account	Rs. 96,800	02-03-10	Cash Account	Rs. 20,000
			07-03-20	Cash Account	12,000
			18-03-20	Cash Account	15,000
			28-03-20	Cash Account	10,000
			31-03-20	Balance c/f	39,800
	Total	Rs. 96,800		Total	Rs. 96,800

5100- Sales Account

31-03-20	Balance c/f	Rs. 159,060	29-02-10	Account Receivable	Rs. 96,800
			04-03-20	Cash Account	8,650
			25-03-20	Cash Account	28,500
			31-03-20	Cash Account	25,110
	Total	Rs. 159,060		Total	Rs. 159,060

5200-Rent Income Account

31-03-20	Balance c/f	Rs. 12,000	06-03-20	Cash Account	Rs. 12,000

2300-Motor Cycle Account

01-03-20	Balance b/d	Rs. 13,200	10-03-20	Cash Account	Rs. 13,200

6100-Dividend Account

31-03-20	Balance c/f	Rs. 10,000	15-03-20	Cash Account	Rs. 10,000

The Accounts Receivable control account is now showing a debit balance of Rs. 39,800 based upon the credit sales during February 2020 and collections during March 2020. For simplicity the credit transactions of sales during March, 2020 have not been considered. The balance of accounts Receivable of Rs. 39,800 is now matching with the total balance of subsidiary ledger Accounts of three credit customers namely Asif & Company (Rs.6, 800), Fareed & Sons (Rs.15,000) and Azam Sons (Rs.18,000) which confirms accuracy. Alternately a schedule of credit customers with outstanding balance against them can be prepared at period end to confirm matching with the total amount of Accounts Receivable as tabulated below:-

Schedule of Accounts Receivable as on 31-03-2020

1	Asif & Company	Rs. 6,800
2	Fareed & Sons	15,000
3	Azam Sons	18,000
	Total	Rs. 39,800

3.7.3 Purchase Journal

Likewise the Sales Journal, the Purchase Journal maintained by the trading organization is also used for recording all the purchase of merchandise on credit basis. This is applicable where periodic accounting system is practiced. In case the enterprises are using the perpetual inventory system the nomenclature of purchase will be replaced by Inventory Procurement Journal. The purchase on cash basis will be recorded in the cash disbursement journal. Besides the purchase of some assets on credit basis can also be recorded in the Purchase Journal with some additional columns added in it. Since such assets items are usually infrequent, therefore, these can be recorded in the Purchase Journal. The Purchase Journal is illustrated in the demonstration problem 3-4 through some purchase of merchandise transactions and some other items of Asad Trading Company which are enumerated below:-

Demonstrated Problem 3-4

Purchase transactions

02-02-20	Purchase merchandise from Asghar Sons on 30 days credit amounting to Rs. 12,000.
05-02-20	Purchased merchandise from Baqir Company on 30 days credit amounting to Rs. 14,000.
07-02-20	Procured merchandise from Ahmad Trading Company at the price of Rs. 20,000 on 30 days credit.
12-02-20	Acquired Store supplies at Rs. 4,000 on credit basis for office use from decent supplies.
16-02-20	Purchase Computer equipment for office use at the cost of Rs. 12,500 from Ahsan Technology on credit basis.
22-02-20	Procured merchandise from Asghar Sons on 20 days credit amounting to Rs. 15,000.
28-02-20	Purchased merchandise from Ahmad Trading Company at the price of Rs. 12,000 on 2/10, n/30 credit terms.

The above purchase of merchandise and other assets items will now be recorded in the Purchase Journal as presented below:-

Asad Trading Company
PURCHASE JOURNAL

Date	Account Credited	P/R	Account Payable	Merchandise Purchase	Sundry	Account
February 2020			Credit	Debit	Account	Amount
02	Asghar Sons	√	12,000	12,000		
05	Baqir Company	√	14,000	14,000		
07	Ahmad Trading Company	√	20,000	20,000		
12	Decent Supplies	√	4,000	-	Office Supplies	4,000
16	Ahsan Technologies	√	12,500	-	Office equipment	12,500
22	Asghar Sons	√	15,000	15,000		
28	Ahmad Trading Company	√	12,000	12,000		
	Total		89,500	73,000		16,500
	Accounts posted	√	(3005)	(2010)	(2100)	
					(2200)	

The posting of the above transactions as recorded in the Purchase Journal will now be carried out in the general ledger Accounts and the subsidiary ledger Accounts as presented below:-

Control ledger Accounts
3005- Accounts Payable

29-02-20	Balance c/d	Rs. 89,500	02-03-10	Purchase merchandise	Rs. 73,000
			12-02-20	Office Supplies	4,000
			16-02-20	Office equipment	12,500
	Total	Rs. 89,500		Total	Rs. 89,500

2010 Purchase Account

02-02-20	Asghar Sons	Rs. 12,000	29-02-20	Balance c/f	Rs. 73,000
	Baqir Company	14,000			
	Ahmad Trading Company	20,000			
	Asghar Sons	15,000			
	Ahmad Trading Company	12,000			
	Total	Rs. 73,000		Total	Rs. 73,000

2100-Office Supplies Account

12-02-20	Decent Supplies	Rs. 4,000	29-02-20	Balance c/d	Rs. 4,000
	Total	Rs. 4,000		Total	Rs. 4,000

Subsidiary ledger Accounts of credit Supplies
Asghar Sons

29-02-20	Balance c/d	Rs. 27,000	02-02-20	Purchase Account	Rs. 12,000
			22-02-20	Purchase Account	Rs. 15,000
	Total	Rs. 27,000		Total	Rs. 27,000

Baqir Company

29-02-20	Balance c/d	Rs. 14,000	05-02-20	Purchase Account	Rs. 14,000
	Total	Rs. 14,000		Total	Rs. 14,000

Ahmad Trading Company

29-02-20	Balance c/d	Rs. 32,000	07-02-20	Purchase Account	Rs. 20,000
			28-02-20	Purchase Account	Rs. 12,000
	Total	Rs. 32,000		Total	Rs. 32,000

Decent Supplies

29-02-20	Balance c/d	Rs. 4,000	12-02-20	Office supplies	Rs. 4,000
	Total	Rs. 4,000		Total	Rs. 4,000

Ahsan Technologies

29-02-20	Balance c/d	Rs. 12,500	16-02-20	Office equipment	Rs. 12,500
	Total	Rs. 12,500		Total	Rs. 12,500

The balance of subsidiary ledger accounts of credit suppliers will be matched at the end of each month to confirm accuracy with the balance of control ledger account of Accounts Payable which has a balance of Rs. 89,500. This is confirmed through preparation of schedule of credit suppliers as below:-

Schedule of Accounts Payable as on 29-02-2020

1	Asghar Sons	Rs. 27,000
2	Baqir Company	14,000
3	Ahmad Trading Company	32,000
4	Decent Supplies	4,000
5	Ahsan Technologies	12,500
	Total	Rs. 89,500

The Total figure of Rs. 89,500 is matching with the total balance of Rs. 89,500 of the Accounts Payable Account as on 29 February, 2020 hence the accuracy is satisfied.

Credit Terms and Cash Discounts

In case of cash purchase or cash sales the payment is to be released immediately upon delivery of goods or merchandise. However, in case of credit purchases or sales certain credit terms are agreed upon. These may be 2/10, n/30 or 1/15, n/60 etc. This means that 2% discount will be applicable if the payment is released within 10 days or full amount will be payable within 30 days if discount period for payment is not availed by the purchaser. Similarly, the other term is that 1% discount will be applicable if payment is made within 15 days of purchase/sale and if this discount is not availed, full payment will be due within 60 days. The inspiration of cash discount is practiced by supplier for early collection of funds from the purchasers to meet financial requirements apart from avoiding the chance of bad debts in future. Thus the cash discount an early payment will be treated as expense in the accounts of seller, while it will be treated as income in the accounts of purchaser. However, the trade discount is usually treated separately which is deducted from the purchase price. The 2% discount on payment for the merchandise amounting to Rs. 20,000 purchased from Ahmad Trading Company which words out to Rs. 400 will be treated by Asad Trading Company as cash discount income if payment is released up till 16 February, 2020 to Ahmad Trading Company. This cash discount of Rs. 400 will be treated as cash discount expense by Ahmad Trading Company as it collected the funds earlier than the full credit period. The above credit terms may also be indicated in the Purchase Journal through a separate column so as to keep vigilance on payments becoming due within discount period to avail it and get benefits of cash discount.

3.7.4 Cash Payment Journal

Another special journal is classified the Cash Payment Journal which is used for recording all payment transactions for cash purchases payment for credit purchases (Accounts Payables), salaries, assets purchase, utilities bills and all other payments by the enterprise. The cash payment journal contains columns dependent upon the frequency of transactions while infrequent transactions are entered in the column named as Sundry Accounts. Usually all major payments are released through cheques, therefore a column for a cheque number with its date is also added in the cash Payment Journal. The relevant accounts against which the payment is released, will be marked as debit, while the cash column will be credited for payments and discount availed for early payment will also be marked as credit column.

The cash payment Journal can be illustrated in the demonstrations problem of Asad Trading Company which is as follows:

Demonstration Problem 3-5

Cash Payment transactions

03-03-20	Paid Asghar Sons Rs. 12,000 on account of merchandise purchased on 02 February 2020
07-03-20	Paid the amount of Rs. 20,000 due to Ahmad Trading Company for the merchandise purchased on credit during February, 2020.
08-03-20	Paid amount due to Ahmad Trading Company for purchase of merchandise of Rs. 12,000 on 28-02-2020 within discount of 2/10 period.
10-03-20	Paid electricity bill of Rs. 8,600 for the month of February, 2020.
13-03-20	Paid Ahmad Technology for the computer equipment amounting to Rs. 12,500 purchased on credit basis during February 2020.
15-03-20	Telephone bill amounting to Rs. 1,650 paid.
20-03-20	Paid Rs. 6,800 for repair and maintence of office building.
22-03-20	Paid Rs. 10,000 for cash purchase of merchandise from Rehmat Ali.
26-03-20	Delivery Van got repaired at the payment of Rs. 5,500.
28-03-20	Paid office rent amounting to Rs. 25,000.
31-03-20	Paid staff salary of Rs. 15,000 for March 2020.

All the above Transactions are now recorded in the cash Payment Journal as here under: -

Asad Trading Company

Cash Payment Journal

Date	Cheque No.	Account Debited	Sundry Accounts		A/P	Purchase merchandise	Discount	Cash
March 2020			Dr		Dr	Dr	Cr	Cr
			A/C	Amount				
03	16532	Asghar Sons			12,000			12,000
07	16533	Ahmad Trading Co.			20,000			20,000
08	16534	Ahmad Trading Co.			12,000		240	11,760
10	16535	Utilities expenses	4,010	8,600				8,600
13	16536	Ahsan Trading Co.			12,500			12,500
15	16537	Utilities expense	4,010	1,650				1.650
20	16538	Repair and Maintenance expense	4,100	6,800				6,800
22	16539	Rehmat Ali				10,000		10,000
26	16540	Repair and maintenance expense	4,100	5,500				5,500
28	16541	Rent expense	4,200	25,000				25,000
31	16542	Salary expense	4,300	15,000				15,000
		Total		**62,550**	**56,500**	**10,000**	**240**	**128,810**
		Accounts posted	√		(3005)	(2010)	5200	(1,000)

The transactions as recorded in the Cash Payment Journal will now be posted in the Control ledger accounts and the subsidiary ledger accounts. The control ledger accounts and the subsidiary ledger accounts as used in the Purchase Journal and certain additional accounts as involved during payments will be used for posting of all cash disbursement transactions. These are now prepared as under: -

Control ledger Accounts

3005 – Accounts Payables

03-03-2020	Cash	Rs. 12,000	28-02-2020	Purchase of merchandise	Rs. 73,000
07-03-2020	Cash	20,000	12-02-2020	Office Supplies	4,000
08-03-2020	Cash	12,000	16-02-2020	Office equipment	12,500
13-03-2020	Cash	12,500			
31-03-2020	Balance	33,000			
	Total	Rs. 89,500			Rs. 89,500

2010- Purchase Account

02-02-2020	Asghar Sons	Rs. 12,000	31-03-2020	Balance c/d	Rs. 73,000
05-02-2020	Baqir Company	14,000			
07-02-2020	Ahmad Trading Co.	20,000			
22-02-2020	Asghar Sons	15,000			
28-02-2020	Ahmad Trading Co.	12,000			
22-03-2020	Cash Account	Rs. 10,000			Rs. 89,500
	Total	Rs. 83,000		Total	Rs. 83,000

5200 – Discount Account

31-03-2020	Balance c/d	Rs. 240	08-03-2020	Ahmad Trading Co.	Rs. 240

Utilities Expenses Account

10-03-2020	Cash	Rs. 8,600	31-03-2020	Balance c/d	Rs. 10,250
15-03-2020	Cash	1,650			
	Total	Rs. 10,250		Total	Rs. 10,250

4100 – Repair and Maintenance Expenses Account

20-03-2020	Cash Account	Rs. 6,800	31-03-2020	Balance c/d	Rs. 12,300
26-03-2020	Cash Account	5,500			
	Total	Rs. 12,300		Total	Rs. 12,300

4200 – Rent Expenses Account

28-03-2020	Cash Account	Rs. 25,000	31-03-2020	Balance c/d	Rs. 25,000

4300 – Salary Expenses Account

31-03-2020	Cash Account	Rs. 15,000	31-03-2020	Balance c/d	Rs. 15,000

Subsidiary ledger Accounts

Asghar Sons

03-03-2020	Cash Account	Rs. 12,000	02-02-2020	Purchase Account	Rs. 12,000
15-03-2020	Balance	15,000	22-02-2020	Purchase Account	15,000
	Total	Rs. 27,000		Total	Rs. 27,000

Baqir Company

31-03-20	Balance c/d	Rs. 14,000	05-02-20	Purchase Account	Rs. 14,000

Ahmad Trading Company

07-03-20	Cash Account	Rs. 20,000	0-02-20	Purchase Account	Rs. 20,000
08-03-20	Cash Account	11,760	28-02-20	Purchase Account	12,000
08-03-20	Discount Account	Rs. 240			
	Total	Rs. 32,000		Total	Rs. 32,000

Decent Supplies

31-03-20	Balance c/d	Rs. 4,000	12-02-20	Office Supplies	Rs. 4,000

Ahsan Technologies

13-03-20	Cash Account	Rs. 12,500	16-02-20	Office equipment	Rs. 12,500

The balance of subsidiary ledger accounts of the credit suppliers after making certain payments during the month of March, 2020 will now be matched at the end of the month to confirm accuracy with the balance of control ledger account of Accounts payable which has a balance of Rs. 33,000 as on 31 March 2020.

This is confirmed through preparation of a schedule of credit suppliers as given below:-

Schedule of Accounts Payable as on 31 March, 2020

1.	Asghar Sons	Rs. 15,000
2.	Baqir Company	Rs. 14,000
3.	Decent Supplies	Rs. 4,000
	Total	Rs. 33,000

The total figure of Rs. 33,000 is matching with the total balance of Rs. 33,000 of the Accounts Payable Account as on 31 March, 2020 hence the accuracy is satisfied.

3.7.5 CASH BOOK

The business organizations where the frequency of cash transactions in a day or the week are significantly greater, it would be appropriate to maintain two Cash Journals i.e. cash receipt Journal and the cash payment Journal as discussed and presented in the preceding paragraphs. These separate books can conveniently be entrusted upon two officials for handling independently. However, in some organizations the functions of cash receipts and disbursements are assigned to a single official for the purposes of greater control over cash inflow and cash outflows. Some times when certain amount of cash is available for some period, and in the near future no obligations are maturing, the available cash can be invested with financial institutions or somewhere else to put the cash in productive use and reap certain interest benefits. The cash officer or Treasurer will keep watch over the regularity with which cash from normal business or other operations is being collected. Similarly, he will also keep in view the magnitude of and the regularity with which normal as well as occasional liabilities are to be met with. It will be his responsibility to watch that enough cash, including money in the bank is available to discharge liabilities on due dates. Thus the cash receipt and disbursements functions are handled by a single cash officer to control cash transactions more effectively. In this respect, instead of maintaining two separate cash receipts and cash payment journals, a single cash book will be used for recording receipts and payment transactions to record conveniently.

In order to illustrate the presentations of cash book, we may use the same transactions as dealt with in the cash receipts and cash disbarments journals during the month of March, 2020 as tabulated in the demonstration problems 3-3 and 3-5 at paras 3-7.2 and 3-7.4 respectively. The consolidated transactions of cash receipts and disbursements, in a chronological order of dates, will be recorded in the cash book as per demonstration problem 3-6 that follows. In this Cash Book it is assumed that all cash collected from customers was deposited into Bank Account wherefrom all payments will be made through cheques.

Demonstration Problem 3-6

Asad Trading Company
CASH BOOK

Date March 2020	Cheque No.	Particulars Accounts	P/F	Sales Credit	A/R Credit	Merchandise Purchase Debit	Accounts Payable Debit	Discount Dr/Cr	Sundry Account		Cash		Balance
									Particular Account	***Amount***	***Dr***	***Cr***	***Dr***
1	-	Opening balance	√								30500	-	30500
2	-	Asif & Company	√		20000						20000	-	50500
3	16532	Asghar Sons	√				12000				-	12000	38500
4	-	Sales a/c	√	8650							8650	-	47150
6	-	Rent income	√						Rent Cr. 5200	12000	12000	-	59150
7	-	Azam Sons	√		12000						12000	-	71150
7	16533	Ahmad Trading Co.	√				20000				-	20000	51150
8	16534	Ahmad Trading Co.	√				12000	Cr. 240			-	11760	39390
10	16535	Utilities Expense	√						Utilities exp Dr. 4010	8600	-	8600	30790
10	-	Motor cycle	√						Motor cycle Cr. 2300	13200	13200	-	43990
13	16536	Ahsan Trading Co.	√				12500				-	12500	31490
15	-	Dividend A/C	√						Dividend income Cr. 6100	10000	10000	-	41490
15	16537	utilities Expense	√						Utilities exp.Dr. 4010	1650	-	1650	39840
18	-	Azam Sons	√		15000						15000	-	54840
20	16538	Repairs Maintenance Exp	√						R and M exp Dr. 4100	6800	-	6800	48040
22	16539	Rehmat Ali	√			10000					-	10000	38040
25	-	Sales Account	√	28500							28500	-	66540
26	16540	Repair Maintenance Exp	√						R and M exp. Dr 4100	5500	-	5500	61040
28	16541	Rent Expense a/c	√						Rent Exp DR. 4200	25000	-	25000	36040
28	-	Fareed Sons	√		10000						10000	-	46040
31	16542	Salary Expenses	√						Salary Exp Dr. 4300	15000	-	15000	31040
31	-	Sales A/c	√	25							25110	-	56150
		Total		Rs. 62,260	57000	10000	56500	240.00	Net Dr	27350	184960	128810	56150
		Accounts posted		(5100)	(2005)	(2010)	(3005)	(5200)			(1000)	(1000)	(1000)

The Columns of Cash Book as presented in the demonstration problem 3-6 can be developed according to the particular requirements. These columns can be curtailed or expanded in consonance with the activities and accounting information system. The posting in the control ledger accounts and the subsidiary ledger accounts from the Cash Book as presented on the pre-page will be identical to the postings carried out from the cash receipt journal and the cash payment journal leading to absolutely no change in the account balances.

3.8 TECHNOLOGY – BASED ACCOUNTING SYSTEMS

The accounting information systems based upon computer technology have been explained in the preliminary portion of this unit. However, in order to deliberate further on technology based accounting system we have to look back as early as half century ago. During a decode of 1971 – 1980 phase there was an introduction of simple calculators and afterwards slowly and steadily the computers were introduced and then penetrated in some segmental affairs of the business offices. Gradually the people were inclined to learn professional skills of computer technology and during another next decode phase several professionals were inducted in the digital technology field for working in the business offices most preferably in the accounting profession, apart from application of this technology in the production activities as well.

In the past, most of the accounting record was maintained manually. However, later with the introduction of computer technology, most of the organizations trained their staff on computer systems and gradually converted accounting system during subsequent decade. The manual based accounting information system was time consuming, costly and cumbersome to the extent that physical record in the accounting books and files was kept mandatory. This switched over to the most reliable, fast and non-physical-record-based accounting information system. The ever increasing and modern digital technology based sate of the art computers and software in different categories have facilitated the maintenance of accounting information system and generation of reports and analysis with interpretation most rapidly for trust worthy decision making.

The digital networking has facilitated the accounting professionals on recording business transactions, processing and developing daily, weekly or monthly reports through a simple click on Key board. Besides, presentation of customer's bills communication and transaction online payments and collection of funds electronically has created ease to the business community at large. This has been possible through modern based computer hardware and programming software's tailored according to the specific requirement of the working environment and management demands during the phase of last two decades.

The management of inventory of multiple products being dealt with by organizations has become possible through technology – based accounting system. The manger can monitor the availability of excessive inventory of any products at any warehouse of locality, city or branch and can arrange its movement from one branch to the other, procurement and its disposal online and thus can perform its functions most effectively with lower investment of funds.

The computer technology can dramatically reduce the time and efforts of professionals devoted to the record keeping thus they can concentrate more on analysis and managerial decisions making of business activities.

Several organizations have recruited their own software programmers for continuously updating the software's according to the new features of requirements. Apart from the compilation of inventory as explained earlier, another problem usually confronted by many of the organizations is related to monitoring of its accounts receivables. The credit customers usually do not pay their dues until they are reminded frequently. The technology based system of accounts receivable can extend aid to the management for chasing the customers for timely recovery of dues, through sustained efforts, thus providing adequate financial resources for meeting its own financial obligations.

3.9 SUMMARY

The accounting information system developed in the organization should meet the requirements of the management. The system should be based upon the control, relevance, compatibility, information promptness, flexibility and the cost benefit principles so as to contribute in the function of management. The accounting information system is currently premised upon the technology based accounting system in most of the organizations. The data is extracted from the source documents and is entered through input devices in the system processers for storage. The data is then retrieved in different shapes through output devices as is needed by the executives and top management for external and internal reporting purposes. This is possible through computer hardware and software installed in the enterprise.

The package of accounting information system also comprise the introduction of Special Journals instead of a single general journal with the objectives to distribute the work load over several staff members instead of confining over one person. These special journals include Sales Journal used exclusively for recording credit sales transactions of merchandise, cash receipt journal for recording collection of cash from cash and credit sales, and from any other sources, maintaining purchase Journal for recording procurement of merchandise on credit and the cash payment journal for recording all cash payments for cash and credit purchases and payment for all other expenses of the enterprise. The columns of these special journals can be organized according to the information need of the accounting system. In several organizations a cash book for recording all cash receipts and payments for sales, purchases and other expenses including capital receipts and expenditures is maintained to consolidate all cash transactions. The cash book is maintained in lieu of cash receipt and cash payment journals. Thus greater effective control over funds management is exercised in the enterprise.

3.10 THEORETICAL QUESTIONS

1) Discuss the conceptual frame work of accounting information system in an enterprise.
2) Describe in detail the six basic fundamental principles of accounting system.
3) The promptness principle and cost-benefit-principle of an accounting system are considered as core elements. Explain it.
4) Describe the composition of an electronic accounting information system designed for generating periodic reports.
5) What is meant by Special Journals in accounting?
6) What objectives can be achieved through introduction of special journals in a trading enterprise?
7) Elucidate the contents of a Sales Journal and what types of transactions are recorded in it.
8) Describe the elements of cash Receipt Journal and what types of transactions are entered in it.
9) Discuss the nature of transactions entered in a purchase journal and indicate usual columns maintained in it.
10) Describe the columnar information maintained in a cash payment journal and categories of transactions entered in it.
11) Explain the purpose of maintaining a cash book and explain the different transactions recorded in it.
12) How the cash book facilitates the executives for better funds management instead of maintaining two separate cash Journals of receipts and payments.
13) What do you understand by the technology-based accounting system? Explain in detail.

14) What is the historic development of the technology based accounting system?
15) How the technology-based accounting system helps the executives to achieve objectives in management of billings, accounts receivables and inventories.
16) Describe credit term 1/10, n/30 and how the cash discount on sales will be accounted for in books.

3.11 PRACTICAL PROBLEMS

Problem 3-1.

The following sales transactions were conducted by Ashar Trading Enterprise during the month of April 2020:-

03 Merchandise amounting to Rs. 5,800 were sold on credit to Reliance Traders.

06 Sold goods at invoice price of Rs. 16,700 to Shah Sons on credit of 30 days

10 Sold goods at invoice price of Rs. 13,600 to Zaib Traders on 30 days credit.

15 Merchandise amounting to Rs. 8,500 were sold to Shah Sons on 2/10, n/30 credit terms.

26 Supplied merchandise amounting to Rs. 18,000 to Reliance Traders on 1/15, n/30 credit terms.

28 Sold goods at invoice price of Rs. 15,000 to Good Luck Trading Enterprise at 30 days credit.

Required

a) Record the above transactions in the Sales Journal and allot suitable account numbers of control accounts.
b) Post these transactions in the control ledger accounts
c) Post these transactions in the subsidiary ledger accounts.
d) Prepare a schedule of Accounts receivable indicating the amount due from each credit customer to reconcile at with the balance control account at month end.

Problem 3-2

Following transactions were carried out by Ashar Trading Enterprise during the month of May 2020.

05. Collected the amount of Rs. 16,700 from Shah Sons for merchandise sold to them during April, 2020.

09. Received the amount due from Reliance Traders on account of goods supplied amounting to Rs. 18,000 on 26 April 2020 on credit terms of 1/15, n/30.

10. Received dues from Reliance Traders of Rs. 5,800 for goods sold to them during April, 2020.
14. Collected Rs. 8,400 for cash sales during the week.
16. The canteen contractor deposited an amount of Rs. 12,000 for the rent of May 2020.
20. Received Rs. 560 on disposal of scrap material.
28. Received amount due from Good Luck Trading Enterprise for merchandise sold to it at the invoice price of Rs. 15,000 on 30 days credit terms.

Required

a) Record the above transactions in the cash Receipt Journal and allot suitable account numbers of control accounts.

b) Post these transactions in the control ledger of Accounts Receivable which had the opening balance of Rs. 77,600.

c) Post these transactions also in the subsidiary ledger accounts which had the following opening balances

i.	Reliance Traders	Rs. 23,800
ii.	Shah Sons	25,200
iii.	Zaib Traders	13,600
iv.	Good Luck Trading Enterprise	15,000

d) Prepare a schedule of accounts receivable indicating the amount due from each credit customer to reconcile it with the balance of control account at month end.

Problem 3-3

The purchase transactions as listed below were conducted by Ashan Trading Enterprise during April 2020.

02 Purchased merchandise at the cost of Rs. 8,500 on credit from Decent Supplies.

06 Procured Store supplies valuing Rs. 5,000 on credit from Ahmad Supplies Company.

10 Acquired merchandise amounting to Rs. 22,000 from Decent supplies on 30 days credit.

14 Procured merchandise on credit valuing Rs. 18,500 from Laeeq Sons for sale

20 Purchased Computer equipment from Reliable Technology valuing Rs. 5,500 0n 2/15, n/30 credit terms

25 Purchased merchandise from Laeeq Sons on 20 days credit basis at price of Rs. 10,000

30 Procured Saleable goods worth Rs. 15,000 from Ahmad Supplies Company on 2/10, n/30 credit terms

Required

a) Record the above transactions in the Purchase Journal and allot some suitable account numbers of control accounts
b) Post these transactions in the control ledger accounts
c) Also post these transactions in the subsidiary ledger accounts
d) Draw a schedule of Accounts Payable indicating the amount due to each credit supplies at the end of the month and reconcile it with the control account.

Problem 3-4

The following cash disbursement transactions were arranged by Ahsan Trading Enterprise during May 2020.

03. Released payment of invoice of Rs. 5,500 of Reliable Technology for purchase of computer items within discount period of 2/15, n/30 terms
06. Purchased merchandise amounting to Rs. 8,600 on cash basis
08. The invoice amounting to Rs. 15,000 of Ahmad Supplies Company for purchase of goods on 30 April, 2020 at 2/10, n/30 credit terms was paid within discount period.
15. Paid electricity bill amounting to Rs. 4,800 for the month of May 2020.
18. Paid office rent amounting to Rs. 20,000 for May 2020.
22. Procured merchandise amounting to Rs. 13,500 on cash basis.
26. Paid telephone bill of Rs. 3,200 for the month of April 2020.
31. Paid salary of an employee amounting to Rs. 15,000 for May 2020.

Required

a) Record the above transactions in the cash Payment Journal and allocate suitable account numbers of control accounts.
b) Post these transactions in the control ledger accounts payable which had the balance of Rs. 84,500.
c) Post these transactions in the subsidiary ledger accounts which had the following balances at opening of May 2020:-

Decent Supplies	Rs. 30,500
Ahmad Supplies Company	Rs. 20,000
Laeeq Sons	Rs. 28,500
Reliable Technology	Rs. 5,500

d) Prepare schedule of credit supplies to reconcile the outstanding balance with the control account of Accounts Payable at the end of May, 2020.

Problem 3-5

Undernoted cash collection and cash disbursement transactions were conducted by Asher Trading Enterprise during the month of May 2020:-

01. Opening cash balance was amounting to Rs. 35,800.
03. Released payment of invoice of Rs. 5,500 of Reliable Technology for purchase of computer items within discount period of 2/15, n/30 terms.
05. Collected the amount of Rs. 16,700 from Shah Sons for merchandise sold to them during April 2020.
06. Purchased merchandise amounting to Rs. 8,600 on cash basis.
08. The invoice amounting to Rs. 15,000 of Ahmad Supplies Company for purchase of goods on 30 April 2020 at 2/10, n/30 credit terms was paid within discount period.
09. Received the amount due from Reliable Traders on account of goods supplied amounting to Rs. 18,000 on 26 April 2020 on credit terms of 1/15, n/30
10. The invoice of Rs. 22,000 from Decent Supplies was paid for merchandise purchased on 30 days credit terms.
14. Collected Rs. 8,400 from Cash Sales during the week.
15. Paid electricity bill amounting to Rs. 4,800 for the month of May 2020.
16. The canteen contractor deposited an amount of Rs. 12,000 for the rent of May 2020.
18. Paid office rent of Rs. 20,000 for May, 2020.
20. Received Rs. 560 on disposal of scrap material.
22. Procured merchandise amounting to Rs. 13,500 on cash basis.
26. Paid telephone bill of Rs. 3,200 for the month of April 2020.
28. Received amount due from Good Luck Trading Enterprise for merchandise sold to it at the invoice price of Rs. 15,000 on 30 days credit terms.
31. Paid Salary of an employee amounting to Rs. 15,000 for May, 2020.

Required

Prepare a Cash Book to record all the above cash collection and disbursement transactions and allot suitable account numbers for control accounts.

Problem 3-6

Sherazi Enterprise carried out the following transactions during April 2020:-

01. Purchased goods at the cost of Rs. 25,000 on 1/10, n/30 credit terms from Sohail Sons.
03. Purchased merchandise at the cost of Rs. 18,500 from Shah Enterprises on 60 days credit
05. Sold merchandise at the price of Rs. 8,600 on credit basis to Alam Company.
08. Sold goods at the price of Rs. 16,500 to Hamid Company on 30 days credit.
10. Purchased goods at the cost of Rs. 12,000 on 30 days credit from Nazir Sons.
12. Sold goods to Alam Company at price of Rs. 6,700 on 30 days credit.
15. Purchased merchandise from Alamgir Sons at cash price of Rs. 5,000.
18. Purchased merchandise on credit basis from Zaheer Sons at the cost of Rs. 12,500.
22. Merchandise sold to Hamid Company on credit basis amounting to Rs. 8,300.
27. Merchandise sold to Alam Company on 30 days credit at the price of Rs. 5,500.

Required

a) Record the above transactions in the sales and purchase journals of Sherazi Enterprise and allocate some suitable account numbers of control accounts.
b) Post these transactions in control ledger accounts.
c) Post these transactions in the subsidiary ledger accounts.
d) Prepare schedules of accounts receivable and accounts payable and reconcile it with the balances of control accounts.
e) If any of the transactions was not recorded in any of the Two Journals, explain the reasons for it.

3.12 GLOSSARY

Control principle

The methods and procedures adopted by managers to control and monitor business activities to promote discipline in the enterprise.

Relevance principle

The accounting information system applied in an organization where by the reports produced should be relevant, useful understandable and pertinent to the requirements of management for making decisions.

Compatibility principle

This principle prescribes that the accounting information system should conform with company's basic activities, personnel and structure.

Promptness Principle
The flow of accounting information which must be timely and quickly to facilitate instant decisions by management.

Flexibility principle
The accounting information system which should be capable to adjust changes and alterations as needed by decision makers.

Cost-benefit-principle
It prescribes that the benefit of an activity in the accounting information system should be greater than its cost.

Source documents
The relevant documents which provide basic information about happening of an event of business or a source of an accounting information system

Input Devices
Electronic instruments like key board, scanners, modems and mouse of a computer system through which information is captured from source documents and entered into the system processor electronically.

Information Processors and Storage
The data entered into the system processors for its further processing, storage and generating analysis reports as needed by the users.

Output Devices
The basic electronically operated devices through which the data is generated like printers, monitors, projectors, mobile phone screens, and web communications.

Sales Journal
A specifically designed journal only to record repetitive nature of credit sales transactions of merchandise

Purchase Journal
A specifically designed journal only to record repetitive nature of credit purchase of merchandise transactions

Cash Receipt Journal
A specifically designed journal to record all cash payment transactions of the enterprise

Credit Terms

The time period allowed to credit customer on all Sales and purchase of merchandise transactions for arranging payment like 30 days and 60 days.

Cash Discount

An inspiration offered to credit customer to arrange quick payment say within 5 or 10 days of sale and enjoy certain discount instead of waiting for full credit period of 30 or 60 days for payment.

Cash Book

Another specifically designed journal to record combined transactions of all cash collections and disbursements of any nature to control and exercise intensive managerial skill on funds management.

Unit–4

ACCOUNTING FOR RECEIVABLES AND INVESTMENTS

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CONTENTS

INTRODUCTION

As an aggressive marketing strategy most of the sales are conducted on credit basis by large manufacturing concerns and whole sales. This originates Accounts Receivables and Notes Receivables. Certain discounts are offered for collection of funds before maturity dates. The accounts receivables and manufacturers are conducted on the credit basis, which means that the purchasers are also factored to some agencies and pledged when lump sum funds are needed. These accounts receivables are subject to loss of non-recovery for which some provisions of bad debts are accounted for and Accounts receivables are reported in balance sheet at net realizable value. Sometimes idle funds are invested in short term securities to earn dividend, interest and capital gain on sale, which is also dealt with in this unit.

OBJECTIVES

After studying this unit, the students would be able to understand the following contents.

1) The origination of Accounts Receivables and Notes Receivables when goods are sold on credit basis
2) Collection of funds with interest if any from Accounts and Notes receivables and accounting treatment
3) Factoring and pledging of accounts receivables to different agencies and financial institutions.
4) Valuation of Accounts receivable and creation of allowance for doubtful accounts and presentation in the balance sheet at net realizable value.
5) Investment of funds in short and long term equity and debt securities and accounting for unrealized gain or loss and realized gain or loss on these equity securities and presentation in periodic financial statements of the organization.

4.1 ACCOUNTS RECEIVABLES

The accounts receivable means that some amount is due from the other party. The accounts receivables are usually generated from the credit business activities. Currently most of the business activities, particularly those of wholesalers pays the amount to the seller within a predetermined fixed time after the date of a transaction. Extending credit to customer for sale of merchandise or services is an integral part of marketing strategy as in the market, over 80% of business activities are performed on credit basis. So no one can obviate from this essential element of marketing strategy. The credit business may be conducted on an open account with the customer based upon his proven track of credit worthiness from the past where no written promise as an evidence is obtained by the seller. The accounting record maintained by the seller for the accounts receivable comprise control accounts receivable and separate accounts receivable of each credit customer. The credit accounts of each customer are monitored consistently as an endeavor to realize the dues promptly when they become due upon expiry of the credit period allowed to customers.

4.2 RECOGNIZING ACCOUNTS RECEIVABLE

The accounts receivables emerge from the credit sales to customers. The practice of sales on credit basis has assumed greater momentum during the recent past as a factor of competition in the market to attract customers. When merchandise is sold on credit basis the following accounting entry is incorporated in the books: -

Date	Particulars	Dr	Cr
05 April 2020	Accounts Receivable (AB Co.) Sales Account	Rs. 35,000	 Rs. 35,000

After expiry of the credit period, when the dues are collected, the following accounting entry is passed:-

Date	Particulars	Dr	Cr
04 May 2020	Bank Account Accounts Receivable (AB Co.)	Rs. 35,000	 Rs. 35,000

The company will maintain two types of ledgers in the accounting record. One will be the Accounts Receivable as a Control account in the general ledger while the second will be with the name of individual customers like AB Co. in the subsidiary ledger accounts, meant for all credit customers separate from each other. Periodically, say weekly or monthly, the total sum of all credit customers will be matched with the balance of Accounts Receivable appearing in the general ledger account to ensure accuracy of due amounts.

Maintaining the individual customer's accounts in the subsidiary ledger of accounts receivable will facilitate the enterprise to monitor and watch on the trend of business volume with all credit customers, their behavior of payment of dues and the balance outstanding against each customer to compare it with the credit ceilings allowed to them. In case the credit business is exceeding the ceilings then emphasis should be on instant recovery of dues instead of curtailing business with such customers.

4.3 NOTES RECEIVABLES

Contrary to the credit Sales on an open account as described at Para 4.1, the alternate method of credit sales to some customers is based upon some formal instrument of credit which is called as a promissory note which is secured by Negotiable/Instruments Act, 1881. The negotiable instrument i.e. the promissory note represents evidence about the money or money's worth with a promise to pay the dues within a specified period. From the point of view of a seller, a claim evidenced by the promissory note has some advantages over a claim in the form of an open account. In the case of availability of a promissory note with the seller, the credit customer acknowledges the debt in writing and agrees to pay it in accordance with the terms specified in it. They are, therefore, stronger legal claims in the event of court action. They also are more liquid than open account credit sales because the holder of promissory note can transfer it to one of his creditors in settlement of debt or to a bank in exchange for cash through discounting it.

The credit sales against receipt of the promissory note enables the enterprise to keep such transactions separate from the open account sales. Therefore, Notes Receivable Account will be debited instead of Accounts Receivable and accordingly collection will be from Notes Receivable as per following accounting entries: -

Date	Particulars	Dr	Cr
05 April 2020	Notes Receivables Sales Account	Rs. 35,000	 Rs. 35,000
04 May 2020	Bank Account Notes Receivables	Rs. 35,000	 Rs. 35,000

The Accounts Receivables and Notes Receivables are usually generated through normal trading business activities. These are presented in the balance sheet at period end under current assets classification but the priority presentation is for

Notes Receivables and thereafter the Accounts Receivables after presentation of cash and cash equivalents.

4.3.1 Interest on Notes Receivables

The notes receivables originated from the credit sales may be non-interest bearing and interest bearing. In case the notes receivable is non-interest bearing, it means that the amount indicated on the face of promissory note will only be receivable at its maturity and upon receipt of cash the accounting entry as indicated in Para 4.3 will be passed. However, if the notes receivable is an interest-bearing, then the interest will also be receivable along with the principal account at its maturity. The accounting entry for the accrued interest income will be recognized at close of the accounting period if the maturity date of the notes receivable is beyond the closing date of the accounting period. This is illustrated through the following data.

A note receivable for Rs. 50,000 for sale of merchandise was received from Ahmad Sons, a credit customer, as on 1 May, 2020 having validity of 03 months with interest bearing of 12% per annum. The following accounting entry will be passed:-

Date	Particulars	Dr	Cr
01-05-2020	Notes Receivables (Ahmad Sons) Sales Account	Rs. 50,000	 Rs. 50,000

At financial year ending on 30 June, 2020 the interest accounting to Rs. 1,000 (Rs. 50,000x12%x2/12) for two months period of May and June 2020 was accrued on this note receivable. Therefore, the following adjusting accounting entry will be incorporated:-

Date	Particulars	Dr	Cr
30-06-2020	Interest Receivable on N/R Interest income	Rs. 1,000	 Rs. 1,000

Upon maturity of the foregoing notes receivable as on 01 August 2020, the following accounting entry for receipt of cash along with interest of 03 months will be recorded:-

Date	Particulars	Dr	Cr
01-08-2020	Bank Account Notes Receivable(Ahmad Sons) Interest Receivable on N/R Interest income	Rs. 51,500	 Rs. 50,000 1,000 500

Through this entry the accrued interest of Rs. 1,000 for two months of last financial year and the interest of Rs. 500 for the one month (July 2020) of the succeeding financial year have been adjusted and recorded to the relevant accounts along with the principal amount of the notes receivable received on 01 August, 2020 at its maturity.

4.3.2 Dishonor of Notes Receivable

Occasionally, when the note receivable is presented for payment at its maturity the credit customer might not be capable to arrange its payments, probably due to non-arrangement of adequate funds timely. This is termed as dishonor of the notes receivable. Taking the same data of the preceding illustration of the interest bearing note receivable at Para 4.3-1, on its due data of 01 August 2020 the payment could not be arranged by Ahmad Sons. The following accounting entry for recording dishonor of the notes receivable instead of its collection will be entered in the accounting record.

Date	Particulars	Dr	Cr
01-08-2020	Accounts Receivable(Ahmad Sons)	Rs. 51,500	
	Notes Receivable (Ahmad Sons)		Rs. 50,000
	Interest Receivable on N/R		1,000
	Interest income		500

Thereafter, apart from strenuous efforts for recovery of the amount of accounts receivable from the credit customer identified as Ahmad Sons as stated above, the enterprise would review any further credit business with this firm when its credibility was found doubtful to refrain from any losses of not recovery in future.

4.4 DISPOSAL OF RECEIVABLES

Most of the trading and manufacturing organizations who sell their products to wholesalers on credit basis are usually confronted with the compilation of accounts receivables. This is in fact because of selling the products to all those customers whose credibility was not proven satisfied or the collection policy of the enterprise was not intensive. Thus the credit customers retain the money even after maturity of the credit period. The enterprises are therefore fallen prey of financial crunches and are tightened to discharge their maturing liabilities. Such sort of situation is often faced by several organizations. Therefore, it originates the ways and means to generate sufficient funds to meet its financial requirements. This is possible through the following course of action: -

A. Offering cash discounts for early payment.
B. Factoring accounts receivables, through agencies.
C. Pledging accounts receivables with financial institutions.

These courses are now deliberated in the succeeding paras.

A) Offering cash discounts

As explained in unit No.3 different types of cash discounts are offered to the credit customers for an inspiration of early payment instead of waiting for payment by the customer after a long period of 30 to 90 days or above. The credit terms like 2/10, n/30 or 1/15, n/60 means that 2% discount or 1% discount will be available to customers if the payment is made within 10 days or 15 days of sale respectively. This offer provides a temptation to the customers. Thus the cash is generated from customers promptly and the accounts receivables are squared off.

B) Factoring accounts receivables

Certain dealers or finance companies purchase accounts receivables out right from business concerns on a without recourse basis. This is called as accounts receivable factoring. The buyer of accounts receivable is known as the Factor. Customers are notified that their dues are now payable to the Factor and the Factor assumes the burden of collecting accounts from such credit customers. In many instances factoring may involve more than simply the purchase of accounts receivables and its collection from customers. Factoring frequently involves a continuing agreement whereby a financial institution assumes the credit functions as well as collection functions. Under such an agreement, the Factor grants or denies credit, handles the accounts receivable book keeping, billing the customers and ensures collection timely. The business organization is thus totally relieved of all of these activities. The credit sale of goods and factoring provides immediate cash for business use. Since the Factor absorbs losses from irrecoverable accounts and also assumes credit and collection responsibilities, the charge that he makes usually exceeds the interest charge currently involved in borrowing funds. This charge is classified as factoring expenses. The following accounting entries will usually be entered in the books of Accounts:-

i. Sales of goods on credit basis

Date	Particulars	Dr	Cr
15-04-20	Accounts Receivables	Rs. 100,000	
	Sales Account		Rs. 100,000

ii. Factoring of accounts receivables with 8% charge.

Date	Particulars	Dr	Cr
20-04-20	Bank Account	Rs. 92,000	
	Factoring expenses	Rs. 8,000	
	Accounts Receivable		Rs. 100,000

After factoring the accounts receivables, the Balance Sheet would not indicate any amount for accounts receivables as these have been disposed off to the Factors and cash has been received against it.

C) Pledging accounts receivables

Another way of disposal of accounts receivables is taking loan from banks or other financial institutions on the basis of pledging accounts receivables as collateral security. Usually certain portion or a classified customers' accounts receivables are pledged with the bank and a loan amount is tr5ansferred to the bank account of the enterprise. The loan may be granted up to 70% or 80% of the total amount of pledged accounts receivable with usual interest charge on the loan amount. The amount collected from the credit customers is immediately deposited with the bank for adjustment against the loan. Alternatively, the banks are authorized to collect the funds from pledged accounts receivables and off-set against the loan account. Prompt collection of accounts receivables would reduce the interest expense on the loan. The pledging of accounts receivables is in fact not a disposal as was treated in factoring of accounts receivables. The accounts receivables are presented in the balance sheet of the enterprise with notation of pledging against long or short term loan taken from the bank or financial institution. Similarly, the loan shown in the liability side of the balance sheet will be linked with the pledged accounts receivables. This is usually presented on the face of balance sheet as a disclosure requirement.

4.5 VALUATION OF ACCOUNTS RECEIVABLES

The accounts receivables, which are originated from the credit sales, are usually classified as financial assets in the balance sheet. This is because of the fact that funds flow to the organization from this source during a succeeding period and in accordance with the credit period allowed to the credit customers which may usually spread over from 30 to 90 days and in certain cases longer than it. Therefore, at the end of an accounting period, the value of accounts receivables must be recognized in the balance sheet at its net realizable value so as to reflect the contents of balance sheet at fair value as possible. Some portion of accounts receivables is written off during currency of the accounting period on the basis of some definite efforts which lead that some particular amount of receivables would not be collectible. On the other hand, the past experience of collection of accounts receivable may also guide the management that instead of intensive efforts of recoveries some of the customers fail to pay their dues although the credit sales were allowed to such customers after ascertaining their potential credibility and reputation in the market. As such certain allowance of doubtful for accounts receivables is recognized in the accounting record which is treated as control of accounts receivables for presentation in the balance sheet at net realizable value. Different methods for accounting treatment of valuation of accounts receivables with regard to the uncollectible accounts are deliberated here under:-

A) Direct write off method

In spite of tremendous efforts for collection of certain accounts receivables, when it is concluded that there is no chance of collection, such accounts receivables are excluded from the accounting record by charging the amount to the expense account through incorporation of the following accounting journal entry.

Date	Particulars	Dr	Cr
20-04-2020	Bad Debts expense Account Accounts Receivable (AB Co.)	Rs. 3,500	 Rs. 3,500

This accounting entry reduces the amount of accounts receivables (from AB Company) and simultaneously increases the periodic expense. This system of treatment is known as direct write-off because the accounts receivable has directly been written-off and the amount is charged to the expense account.

Further, later on in case the circumstances are favoring to the organization, whereby the credit customer somehow pays his dues, then his account, which was previously written off and abstracted from the accounting record, will first have to be reinstated and then will be collected. In this respect the reinstatement of accounts receivable will be carried out through the following journal entry: -

Date	Particulars	Dr	Cr
05-05-2020	Accounts Receivables (AB Co.) Bad Debts expense Account	Rs. 3,500	 Rs. 3,500

Afterwards, the recovery of Accounts Receivable will be recorded through the following accounting entry:-

Date	Particulars	Dr	Cr
05-05-2020	Cash Account Accounts Receivable (AB Co.	Rs. 3,500	 Rs. 3,500

When the direct write-off method is used in the organization, the amount of accounts receivable will be presented in the balance sheet at gross amount as no valuation allowance will be used. Therefore, the receivables are not presented at the net realizable value.

The direct write-off method is normally used by those organizations whose major sales are on cash basis and small sales are on credit. The bad debts directly written-off will, therefore be small and will have no material effect on the reported net income. Besides the direct write – 0ff method works satisfactorily in a company that sells most of its output to a few large companies which are financially strong for which no need arises for valuation of accounts receivables and creation of allowance for bad debts in advance.

Under direct write-off method the bad debts expense it usually recorded when the receivables finally cannot be collected. Thus such bad debts expenses are recorded quite later than the credit sales period. Usually the expenses should be recorded under matching principle when revenues are being recorded under realization principle. The direct write-off method is, therefore, a departure from the matching principle. However, the materiality principle states that an amount can be ignored if its impact on the financial statements is negligible and unimportant. The materiality constraint permits the use of direct write-off method when bad debt expenses are small in relation to the volume of sales and other expenses.

B) The allowance for doubtful Accounts Method

The alternate to the direct write-off method is the allowance method for computation of doubtful amount of accounts receivables to charge it as periodic expense. The allowance for doubtful accounts created at the end of accounting period is shown as deduction from the gross amount of accounts receivables to present the accounts receivables at net realizable value in the balance sheet. The allowance for doubtful accounts is created and charged as bad debt expense during the same period when sales were conducted and revenues were recognized. Thus the allowance method adequately is in consonance with the concept of matching and realization principles as the expenses are recorded during the same period when sales revenues were recognized.

The amount of allowance for doubtful Accounts is computed on some logical basis which may be premised upon the past experience or of the current scenario of collections or irrecoverable behavior. There are traditionally two approaches for computation of the amount of allowance for doubtful accounts against accounts receivables. These are deliberated as here under:-

1) Income Statement Approach

The income statement approach refers to the determination of allowance for doubtful accounts on the basis of certain percentage of the periodic credit sales. Premised upon the past experience the management has decided that 2% of the credit sales amounting to Rs. 1,550,000 might be uncollectible during the tenure of collection in future. Therefore, the enterprise would create an allowance for doubtful accounts amounting to Rs. 31,000 (Rs. 1,550,000 x 2%) and the following adjusting accounting entry would be incorporated: -

Date	Particulars	Dr	Cr
30-06-2020	Bad Debts Expense Account	Rs. 31,000	
	Allowance for doubtful Accounts		Rs. 31,000

The accounts receivable will be presented in the Balance sheet at its net realizable value as under:-

Balance Sheet as at 30-06-2020

Current Assets

Cash		Xxx
Marketable Securities		Xxx
Accounts Receivable	1,550,000	
Less: Allowance for doubtful accounts	31,000	1,519,000

The Bad debts expense Accounts of Rs. 31,000 will be closed in the income statement along with other expenses for the period.

The lump sum allowance for doubtful accounts of Rs. 31,000 was created against the total accounts receivables of Rs. 1,550,000 originated against the credit sales. The amount of estimated loss of bad debts was computed because when sales occurred, the management did not know which credit customer will not pay his dues. This means that at end of each period the allowance method requires an estimate of the total bad debts expected to result from that period's sales.

Subsequently when certain accounts receivables are not recoverable inspite of all efforts of recovery the amount is written off against the allowance for doubtful accounts created in the past. Assume that Ahmad Company to whom credit sales were allowed during April, 2020, did not pay his dues amounting to Rs. 8,500. The write-off entry for these irrecoverable accounts receivables would be recorded as under:-

Date	Particulars	Dr	Cr
20-07-202	Allowance for doubtful Accounts	Rs. 8,500	
	Accounts Receivable (Ahmad Company)		Rs. 8,500

In the balance sheet to be prepared at the end of subsequent period, the amount of Rs. 8,500 will be reduced both from the allowance for doubtful accounts and the Accounts Receivables. Thus there would be no impact on the net realizable amount of Accounts Receivables.

Subsequently in case the recovery of accounts receivables from Ahmad Company becomes possible due to efforts of the management, first the written-off Accounts receivable would be reinstated through the accounting entry and then accounting entry would be recorded for collection of cash as below:-

Date	Particulars	Dr	Cr
15-08-2020	Accounts Receivable (Ahmad Company)	Rs. 8,500	
	Allowance for doubtful Accounts		Rs. 8,500
15-08-2020	Cash Account	Rs. 8,500	
	Accounts Receivable (Ahmad Company)		Rs. 8,500

2) Balance Sheet Approach

The balance sheet approach of creation of the allowance for doubtful accounts is widely used for computation of the amount probably uncollectible through aging the accounts receivables or through application of a predetermined percentage rate of the total amount of accounts receivable. The former system of aging the accounts receivable is more preferable for computation of the amount of uncollectible accounts as it is worked out on some logic that older the accounts receivable have greater chance of not recovery while the fresh accounts receivables have lower chance of not recovery. Therefore, higher rate of bad debt expense is applied on the longer old accounts receivables while lower rate of bad debt is applied on fresh accounts receivables to determine the total amount of allowance for doubtful accounts. Usually different rates of probable bad debts are applied on the different age groups of accounts receivables for computing the total amount of doubtful accounts. Therefore, the estimates of uncollectible amounts are made assuming that the longer past due are likely to be uncollectible while current past due are likely to be lower chance of not recovery. These different percentages are applied to the amounts of each class of age group and then totaled to compute the estimated balance of allowance for doubtful account. The computation of the allowance for doubtful accounts based on the aging of accounts receivables is carried out as per Exhibit 4-1 below: -

Exhibit 4-1
Schedule of accounts receivables by age and Estimated uncollectible

	Total	Net yet due	1-30 days past due	31-60 days past due	61-90 days past due	Over 90 days past due
Zahid Company	Rs. 150,000	Rs. 35,000	100,000	Rs. 15,000	-	-
Suleman Sons	Rs. 820,000	-	350,000	Rs. 420,000	Rs. 50,000	-
Decent Company	Rs. 315,000	Rs. 15,000	200,000	Rs. 100,000	-	-
Zeenat Bros	Rs. 205,000	-	100,000	Rs. 100,000	-	Rs. 5,000
Ahmad Company	Rs. 60,000	-	-	-	Rs. 51,500	Rs. 8,500
Total	**Rs. 1,550,000**	**Rs. 50,000**	**Rs. 750,000**	**Rs. 635,000**	**Rs. 101,500**	**Rs. 13,500**
Percent uncollectible	-	1%	2%	3%	6%	10%
Estimated uncollectible	**Rs. 41,090**	**Rs. 500**	**Rs. 15,000**	**Rs. 19,050**	**Rs. 6,090**	**Rs. 1,350**

The total amount of estimated uncollectible works out to Rs. 41,090 against the total accounts receivables of Rs. 1,550,000 at end of the accounting period based on aging schedule as per exhibit 4-1 above. The accounting entry for incorporation of probable bad debt expense will be passed by considering any debit or credit balance already available in the allowance for doubtful accounts. Suppose that a credit balance of Rs. 10,000 is already available in the allowance for doubtful accounts which was brought forward from the previous accounting period, this amount will be adjusted from the amount of Rs. 41,090 as computed in the aging schedule at exhibit 4-1 and the accounting entry for the balance amount of Rs. 31,090 will be passed as under:-

Date	Particulars	Dr	Cr
30-06-20	Bad debts expense account Allowance for doubtful account	Rs. 31,090	 Rs. 31,090

The bad debts expense account of Rs. 31,090 will be closed to the income statement for the current accounting period while the allowance for doubtful account will show the following total credit balance at year end.

Allowance for Doubtful Account

30-06-20	Balance c/f	Rs. 41,090	01-06-20	Opening balance	Rs. 10,000
			30-06-20	Bad debts expense	Rs. 31,090
	Total	Rs. 41,090		Total	Rs. 41,090

In the balance sheet at the end of accounting period the accounts receivables will be presented at net realizable value after deduction of the total amount of allowance for doubtful accounts from the gross amount of accounts receivable as under:-

Balance Sheet as at 30-06-2020

Current Assets		
Cash		Xxx
Marketable Securities		Xxx
Accounts Receivables	Rs. 1,550,000	
Less allowance for doubtful accounts	Rs. 41,090	Rs. 1,508,910

Later on during the succeeding year when instead of intensive efforts for recovery of Rs. 8,500 from Ahmad Company proved to be futile this amount will be struck off from the accounts receivables through passing of the following accounting entry:-

Date	Particulars	Dr	Cr
20-07-20	Allowance for doubtful account Accounts Receivable (Ahmad Company)	Rs. 8,500	 Rs. 8,500

It may be noted that the irrecoverable accounts receivables of Rs. 8,500 from Ahmad Company will be adjusted against the total allowance for doubtful accounts of Rs. 41,090 available in the accounts instead of confining to the specific allowance of Rs.850 which was created on 30 June, 2020 at 10% of Rs. 8,500 receivable from Ahmad Company. In case the chances of recovery of written-off accounts receivables are materialized, the similar accounting entry for first reinstatement of written-off accounts receivables and then collection of cash entries will be passed as described at the end of the procedure of Income Statement approach as was explained at para graph B-1 of para 4.5 in the preceding pages.

4.6 BASICS OF INVESTMENTS

The investment means and includes the deposit of certain funds outside the business to earn some gain instead of keeping funds idle in the organization or in the current accounts with Bank. Apart from it, the companies have motives to invest its short term liquid funds in the profitable securities long term funds of gratuity and pension in mutual funds and other long term securities for earning profit and yet another objective is to acquire controlling interest in other organizations for achieving specific business relationships on strategic grounds. The basic intent of investment leads the accounting treatment. The intent of short term and for temporary purposes, the investment will be presented under current assets while for the long term intent it will be presented in the non-current investment headings after current assets heading of the balance sheet. The purchase, retention, and disposal of these short and long term securities are now deliberated as here under: -

A) Short term investments

The purchase of short term securities is normally recorded at cost which also includes any brokerage commission etc. These short term securities are classified as marketable securities and are considered as cash equivalent as these can be encased any time of wish. Similarly, certain securities have some tenure ranging from 3 to 12 months. Such securities like bonds and debentures which have now left over maturity lesser than one year are also categorized as short term investments or temporary investments.

B) Long Term Securities

Those securities which cannot instantly be encased or are not intended to be converted into cash in short term period are categorized as non-current or long term securities. Normally such securities comprise the Debentures and Bonds which have longer maturity of one to ten years. Similarly, the shares of other companies which have been purchased for holding them for a longer period for earning dividends and for strategic purposes are also classified as long term securities. These securities will be presented in the balance sheet under the headings of Long Term Investments at the cost price including any incidental charges like brokerage fee etc. paid at the time of acquisition.

C) Classification and Reporting

The accounting for investment in securities of other companies depends on three factors namely (1) type of securities whether debts (Bonds and Debentures) or equity (Preferred and Common Shares), (2) the intent of the company for holding them either for short period or for longer period and (3) the percentage of ownership in the other company's equity securities for holding control etc in its affairs. The reporting of each type of such securities will be carried out in the following manner: -

i) Securities held for trading:

These include equity securities (Shares) held for trading purposes which will be reported at fair market value and any increase or decrease from the cost will be reported as unrealized gain or unrealized loss on income statement of the accounting period of acquisition.

ii) Securities held to maturity

These include debt securities like Bonds and Debenture having definite period of maturity and will be reported at amortized cost.

iii) Available for sale Securities

Such Securities are like equity and debt securities and are treated in the accounts at fair value as discussed at serial number (i) and (ii) above

iv) Securities for significant influence

Such securities of equity shares which have been acquired at 10 to 20% or more but lesser than 50% of the total securities of the investee company are held for significant influence in the other company for business relations and are reported at equity method in the accounts.

v) Controlling influence

These equity securities of other company are procured by the company which may be greater than 50% of the other company for exercising all the time controlling influence and are reported in accounts through consolidation including non-controlling interest (NCI) as well.

The accounting treatment of equity securities (Shares of Companies) and the Debt Securities (Bonds and Debentures) are now explained here under: -

1) Accounting treatment of equity securities.

The equity securities which comprise shares of other companies are purchased for investment of funds either for short period of time or for longer period.

When equity securities are purchased these are recorded at cost. Assume Adil company has purchased 1,000 shares of Decent Company on 10 June, 2020 at the price of Rs. 150 per share along with agency fee of Rs. 1,000 the following accounting entry will be recorded.

Date	Particulars	Dr	Cr
10-06-2020	Investment in Marketable Securities(Decent Company)	Rs. 151,000	
	Cash Account		Rs. 151,000

Later on 30 June 2020 the Decent Company declared a dividend of Rs. 15 per share. The receipt of dividend will be recorded as under:-

Date	Particulars	Dr	Cr
30-06-2020	Cash Account Dividends revenues	Rs. 15,000	 Rs. 15,000

The Dividend revenues will be closed in the Income Statement for the year ended 30 June, 2020. Later, when these marketable securities are sold assume on 15 July, 2020 at Rs. 165 each share, the following entry will be passed:-

Date	Particulars	Dr	Cr
15-07-2020	Cash Account Investment in Marketable Securities(Decent Company) Gain on Sale of Marketable Securities	Rs. 165,000	 Rs. 151,000 Rs. 14,000

The gain of Rs. 14,000 on sale of marketable securities will be closed in the Income Statement for the year commencing from 01 July, 2020 onward.

2) Accounting treatment of Debt Securities

The debt securities include the short or long term bonds and debentures purchased with the intents of short period or long period holding. In any case, the purchase of these securities will be recorded at cost. Assume that Adil Company has purchased two years 12% debentures of Rs. 100,000 from Decent Company on 31 January 2020. The interest is receivable after every 6 months. The purchase of these debentures on 31 January 2020 and recognition of accrued interest for 05 month on 30 June, 2020 will be recorded as under:-

Date	Particulars	Dr	Cr
31-01-2020	Investment in Debentures (Decent Co.) Cash Account	Rs. 100,000	 Rs. 100,000
30-06-2020	Accrued Interest on Debentures Interest Income on Debentures	Rs. 5,000	 Rs. 5000

The interest income of Rs. 5,000 will be closed in the Income Statement for the year ended on 30 June, 2020. While the 2 years' investment will be reported as long term investment in the Balance Sheet as at 30 June, 2020.

Subsequently when the interest for 06 months is received on 31 July 2020 the following accounting entry will be passed: -

Date	Particulars	Dr	Cr
31-07-2020	Cash Account Accrued interest on Debentures Interest income on Debentures	Rs. 6,000	 Rs. 5,000 Rs. 1,000

The receipt of interest for another 6 months on 31 January 2021 will be recorded as pee following.

Date	Particulars	Dr	Cr
31-01-2021	Cash Account Interest income on Debentures	Rs. 6,000	 Rs. 6,000

Similarly, the collection of interest income in the subsequent period will be recorded in the accounting record. However, after maturity of 02 years, the collection of principal amount of Debentures with its accrued interest on 31-01-2022 will be recorded as per following: -

Date	Particulars	Dr	Cr
31-01-2022	Cash Account Investment Debentures (Decent Company) Interest income on Debentures	Rs. 106,000	 Rs. 100,000 Rs. 6,000

4.7 REPORTING OF NON-INFLUENTIAL INVESTMENTS

The non-influential investments are those marketable equity securities which have purely been purchased just for earning certain gain and are quite meager in volume and in monetary terms in reference to holding influential impact of administrative control of the other subsidiary company. Such equity securities may be even lesser than 10% of the total equity securities of the investee company.

The marketable equity securities will be valued at market price on the reporting date of the balance sheet as at 30 June, 2020. Considering the same data of the marketable equity securities of Decent Company as purchased and recorded at sub para 1 of main para 4.6 in the preceding portion of this unit, we may assume that the market value of such equity shares was amounting to Rs. 170 each as on 30 June, 2020. The increase in the market price by Rs. 19 per share is in fact still unrealized gain because securities are not yet sold. Therefore, any unrealized gain or loss (loss in case of decline in the market price of such securities) on marketable securities will not be accounted for in the periodic income statement. However, the unrealized gain or loss will be reported separately in the equity section of Balance Sheet. The value of securities well be reported in the current assets at market price with notation of cost-price as well. This treatment is called as mark to market concept of valuation of securities which is a departure from the cost concept of Generally Accepted Accounting Principles.

The following accounting entry will be passed for enhancement in the market value of securities as on 30 June, 2020 along with simultaneous recognition of unrealized gain on the marketable securities.

Date	Particulars	Dr	Cr
30-06-2020	Investment in Marketable Securities(Decent Company)	Rs.19,000	
	Unrealized gain on Marketable Securities		Rs.19,000

Through this accounting entry the value of marketable securities is enhanced and the increase is recognized as unrealized gain for Balance Sheet reporting purposes. The marketable securities in the Balance Sheet are presented as under: -

Adil Company
Balance Sheet as at 30 June, 2020

Current Liabilities		**Current Assets**	
Accounts Payable	xxx	Cash	xxx
Equity		Marketable securities(1,000 shares of decent company purchased at cost of Rs. 151,000)	Rs.170,000
Capital	xxx	Fixed Asset	
Retained Earnings		Building	xxx
Unrealized gain on marketable securities of Decent Company	Rs. 19,000		

Further later during July, 2020 when these securities are sold at Rs. 165 each certain portion of the unrealized gain is now realized which will be accounted for, upon sale, through the following accounting entry:-

Date	Particulars	Dr	Cr
15-07-2020	Cash Account	Rs. 165,000	
	Unrealized gain on marketable Securities	Rs. 19,000	
	Realized gain on marketable securities		Rs. 14,000
	Investment in Marketable Securities		Rs. 170,000

The realized gain of Rs. 14,000 on marketable equity securities will now be treated as other income in the Income Statement for the year 2020-21. Further the non-influential securities are usually valued at fair market value based upon the intent of management and nature of portfolio (Composition of variety of securities of different companies) which may be classified in three categories as (1) Trading, (2) Held to maturity and (3) available for sale. These classifications are now deliberated in the ensuing paragraphs.

4.8 TRADING SECURITIES

The trading securities include those investments in the shape of equity securities (shares) and debt securities (Bonds and Debentures) as explained at para 4.6 vide sub paras 1 and 2 which have been purchased on temporary basis for the purposes of frequent trading to earn some financial benefits upon sale through increase in the market price of such securities. The securities held on balance sheet date are always reported as current assets at the market value as explained at paras 4.6 and 4.7 of preceding pages. Besides, the unrealized gain/loss and realized gain/loss is also accounted for on purchase and sale of these trading securities in the same pattern as explained at paras 4.6 and 4.7 of preceding pages.

4.9 HELD-TO-MATURITY SECURITIES

The held-to-maturity securities are usually debt securities which comprise bonds, debentures and redeemable preference shares which have explicit time of maturity and thereafter are to be redeemed without default. The accounting treatments of such held-to-maturity securities are two-fold. In case, any of such debt securities are falling due for payment within next one year, then these will be classified as current asset in the balance sheet of the investor along with any interest which has accrued till the balance sheet date as explained at para 4.6 (1) in preceding pages. However, if the maturity date of such debt securities is longer than one year from the balance sheet date of current year, then such debt securities will be classified as long term investment in the balance sheet of the investor while the amount of interest accrued on it for the expired period will be reported as current asset in the balance sheet and other income in the income statement.

4.10 AVAILABLE-FOR-SALE SECURITIES

The equity securities (Shares) and debt securities (Bonds, Debentures and redeemable Preferred Shares) which have been purchased with the instant to sell them at any time when the market prices are favorable i.e. greater than cost, then such securities are categorized as available-for-sale securities. Such types of securities usually do not fall in the category of trading or held-to-maturity securities. The objectives of available-for-sale securities are manifold. The first purpose is to earn interest or dividend during the period of its holding and second purpose is to capture the benefit of price escalation of such securities. The available-for-sale securities are not actively managed like trading securities. However, time to time review and evaluation of their market values are inevitable to secure benefits of enhancement of market value upon disposal.

The reporting of available-for-sale securities is similar to the other types of securities. In case the intent is to dispose of within one operating cycle or next year then these will be classified as current assets and in case these are to be retained for more than one operating cycle then these will be classified as long term investment. The unrealized gain or loss at the end of accounting period will be reported in the balance sheet as described in the trading securities and held-to-maturity equity securities as demonstrated in the preceding paragraphs. Similarly, the realized gain or loss will be recognized in the income statement as identical to the treatment of trading securities and held to maturity equity securities.

4.11 DEMONSTRATION PROBLEMS

PROBLEM NO. 1

Shahid Trading Company is applying the balance sheet approach for valuation of its accounts receivables at year end. Besides during the year, it has written of Rs. 4,500 accounts receivable from an insolvent customer by debiting it to the allowance for doubtful accounts. At the end of year on 30 June, 2020 the ageing of accounts receivables was computed as under: -

	Age group	Accounts of Accounts Receivables
1.	Not yet-due	Rs. 350,000
2.	1-30 days past due	Rs.580,500
3.	31-60 days past due	Rs. 432,000
4.	61-90 days past due	Rs. 218,000
5.	91-180 days past due	Rs. 125,000
6.	181-365 days past due	Rs. 60,000
	Total	Rs. 1,765,500

Based upon the past experience, the company has estimated the percentages of probable uncollectible for the above age groups to be as follow: Group 1 at 0.5%, Group2 at 2%, Group3 at 4%, Group4 at 5%, and Group5 at 8% and Group6 at 10%.

Required:

A) Based upon the above information, compute the amount of uncollectible accounts.

B) Prepare necessary adjusting entry at the yearend of bring the allowance for doubtful accounts to the proper amount.

C) Suppose that on 25 July, 2020 a customer namely Usman Brothers owing Rs. 8,400 whose receivable were past due by 150 days died and nothing was collectible from his property. Prepare necessary journal entry required on 25 July, 2020 to adjust this account.

SOLUTION

Based upon the data of accounts receivables by age groups and the estimate of percentage of probable uncollectible the amount of estimated uncollectible is worked out as under:-

A) Schedule of uncollectible accounts

Age group		Percentage uncollectible	Uncollectible amount
1.	Rs. 350,000	0,50%	Rs. 1,750
2.	Rs. 580,500	2%	Rs. 11,610
3.	Rs. 432.000	4%	Rs. 17,280
4.	Rs. 218,000	5%	Rs. 10,900
5.	Rs. 125,000	8%	Rs. 10,000
6.	Rs. 60,000	10%	Rs. 6,000
Total	Rs. 1,765,500		Rs. 57,540

B)

Amount of adjusting entry:	
Uncollectible amount as per (A)	Rs. 57,540
Add existing debit balance of Allowance for doubtful Account	Rs. 4,500
Total Amount of adjusting entry	Rs. 62,040

Date	Particulars	Dr	Cr
30-06-20	Bad debt expenses	Rs. 62,040	
	Allowance for doubtful accounts		Rs. 62,040

C) Writing off Journal entry.

Date	Particulars	Dr	Cr
25-07-20	Allowance for doubtful accounts	Rs. 8,400	
	Accounts Receivables (Usman Brothers)		Rs. 8,400

PROBLEM NO. 02

Akbar Enterprises was owning the following short term equity investments in the shares of joint stock companies listed on Islamabad Stock Exchange:-

1) 4,000 shares of Rs. 1,000 each par value purchased at Rs. 130 each of Kohat Cement Company which have market value of Rs. 150 each as on 30 June, 2020.
2) 2,500 shares of Rs. 50 each par value purchased at Rs. 60 each of Shahid Steel Company which have market value of Rs. 65 each as on 30 June, 2020.

During September, 2020 Akbar Enterprises conducted the following transactions:-

1) On 18 September, 2020 all shares of Kohat Cement Company were sold at Rs. 160 each.
2) On 30 September, 2020 all shares of Shahid Steel were sold at Rs. 55 each.

Required In compliance with mark to market concept:

A) Pass necessary accounting entries to purchase and update the values of short terms investment the end of 30 June, 2020.
B) Present the short terms investments in the financial statements in the financial statements as at 30 June, 2020
C) Incorporate the sale of short term equity securities in the accounting record.

D) Present the income from sale of equity securities and the remaining investment in the financial statements as at 30 September 2020.

SOLUTION

A) Accounting entry during June, 2020

Date	Particulars	Dr	Cr
30-06-20	Investment in Marketable Securities (Kohat Cement Co.)	Rs. 520,000	
	Bank Account		Rs. 520,000

Date	Particulars	Dr	Cr
30-06-20	Investment in Marketable Securities (Kohat Cement Co.)	Rs. 80,000	
	Unrealized Gain on marketable securities (Kohan Cement Co.)		Rs. 80,000

Date	Particulars	Dr	Cr
30-06-20	Investment in Marketable Securities (Shahid Steel Co.)	Rs. 150,000	
	Bank Account		Rs. 150,000

Date	Particulars	Dr	Cr
30-06-20	Investment in Marketable Securities (Shahid Steel Co.)	Rs. 12,500	
	Unrealized Gain on Marketable Securities (Shahid Steel Co.)		Rs. 12,500

B) Akbar Enterprises
Balance Sheet as at 30 June, 2020

Current Liabilities		**Current Assets**	
	xxx	Cash at Bank	Xxx
Equity Authorized and Issued capital Unrealized gain on marketable equity securities of:	Xxx	Investment Marketable equity securities of Kohat Cement Co. 4,000 Shares purchased at Rs. 130 each and market value of Rs. 150 each Marketable equity securities of Shahid Steel Co. 2,500 shares purchased at Rs. 60 each and market value of Rs. 65 each.	Rs. 600,000 Rs. 162,500
Kohat Cement Co.	Rs. 80,000		
Shahid Steel Co.	Rs. 12,500		

C) Accounting entries during September, 2020.

Date	Particulars	Dr	Cr
18-09-20	Bank Account	Rs. 80,000	
	Unrealized Gain on Marketable Securities (Kohat Cement Co.)	Rs. 30,000	
	Investment in Marketable Securities (Kohat Cement Co).		Rs. 225,000
	Realized gain on Marketable Securities (Kohat Cement Co.)		Rs. 45,000

Date	Particulars	Dr	Cr
30-09-20	Bank Account	Rs137,500	
	Unrealized Gain on Marketable Securities (Shahid Steel Co.)	Rs. 12,500	
	Realized loss on Marketable Securities (Shahid Steel Co).	Rs. 12,500	
	Investment in Marketable Securities (Shahid Cement Co.)		Rs. 162,500

D) Akbar Enterprises

Income Statement for the quarter year ended on 30-09-2020

Operating income		xxx
Other income		
Realized gain on Marketable Securities (Kohat Cement Co.)	Rs. 45,000	
Less Realized loss on Marketable Securities (Shahid Steel Co.)	Rs. 12,500	Rs. 32,500

Akbar Enterprises
Balance Sheet as at 30-09-2020.

Current Liabilities		Current Assets	
		Cash at Bank	xxx
Equity		Investment in Marketable Equity Securities of Kohat Cement Co.	
Authorized and Issued Capital	Xxx		
Unrealized gain on marketable equity securities of Kohat Cement Co.	Rs. 50,000	2,500 Shares purchased at Rs. 130 each and market value of Rs. 150 each	Rs. 375,000

4.12 SUMMARY

As a marketing strategy most of the business activities, for sale of merchandise and securities, are conducted on credit basis by manufacturers and wholesalers. These can be on an open account or through promissory notes. The accounting entries debiting Accounts Receivables and Notes Receivables and crediting sale of merchandise are recorded. Upon collection, the Bank Account is debited and Accounts Receivables or Notes Receivables are credited. Sometimes Interest on notes receivables is also involved which is also collected and treated as other income.

When the organizations feel certain liquidity problems, some incentives of cash discounts are offered to credit customers for early payment of their obligations instead of waiting for maturity of credit period. Besides if considerable funds are required instantly then the accounts receivables are entrusted upon for the collection by certain agencies at due times which is called as Factoring of accounts receivables. This involves certain factoring expenses. Apart from it, the funds can be borrowed from banks by pledging accounts receivables.

The valuation and presentation of the accounts receivables in the Balance Sheet at year end requires certain adequate procedures consistently to be followed in the organizations. The credit sales are usually confronted with the risk of irrecovery sometimes. There are two methods generally applied for accounting for such risks. First is the direct write off method which entails that the irrecoverable accounts may be written off. Secondly some allowance for doubtful accounts created periodically by charging periodic expense and presentation of accounts receivables at net realizable value in the balance sheet. The amount of allowance for doubtful accounts may be computed as a percentage of annual credit Sale or on the basis of aging of accounts receivables. These are called as Income Statement approach and Balance Sheet approach and Balance Sheet approach respectively.

Occasionally the business organizations possess certain liquid funds beyond their routine requirements of working capital. These funds are used in productive manner so as to reap certain financial benefits instead of keeping idle. Such funds are therefore, usually used for short term equity and debt securities which are instantly cashable and are presented in the Balance Sheet as current assets. When some funds are available, long term securities of equity and debt are also purchased usually from the pension, gratuity and depreciation funds which are presented as long term investment in the balance sheet. These equity securities are valued at year end at market prices and any increase or decrease from Cost are adjusted and reciprocal unrealized gain or loss on such marketable equity securities are recognized in balance sheet through mark to market concept of Generally Accepted Accounting Principles. The gain or loss is reported in the income statement only when it is actually realized upon disposal of such marketable securities.

4.13 THEORETICAL QUESTIONS

1) Describe as to how accounts receivables and notes receivables are originated in a trading business organization
2) Distinguish between the accounts receivables and notes receivables.
3) What are the sources available for collection of funds quickly from the accounts receivables?
4) What do you understand by factoring of accounts receivables by an organization?
5) What is meant by pledging of accounts receivables when the enterprise is in need of funds instantly?
6) Explain the objectives of valuation of accounts receivables.
7) What are the methods available for accounts receivables?
8) Describe the income statement approach and balance sheet approach for valuation of accounts receivables.
9) Elucidate the procedure for computation of allowance for doubtful accounts through ageing of accounts receivables.
10) What do you understand by short term and long term equity and debt investments?

11) Describe the procedure adopted for valuation and presentation of short term equity securities in the financial statements at year end under mark to market concept.
12) Describe as to how the unrealized gain/loss and realized gain/loss is reported in the financial statements for short term equity securities by an enterprise.

4.14 PRACTICAL PROBLEMS

P.4-1

Shan Trading Company conducted the following transactions during May, 2020:-

a) Sold merchandise to Rehmat Brothers at Rs. 50,000 on 05 May 2020 terms 30 days credit.
b) On 06 June 2020 Rehmat Brothers could not pay his dues and signed a two months Promissory Note with 12% per annum interest.
c) On 30 June the accrued interest was accounted for.
d) On 06 August 2020 the payment of promissory note with interest was collected.

Required

1) Record the above transactions in the books of accounts of Shan Trading Company.
2) Indicate the interest income on the promissory note at year end of 30 June 2020.
3) Compute the total interest income on the promissory note at maturity

P.4-2

Reliance Traders are involved in the supply of office Furniture on credit basis to different private and public sector organizations. Due to lose control over collection procedure of its dues, the company is facing financial crises as the collection is not matching with disbursement schedules of funds. Presently the accounts receivables from different organizations have accumulated at Rs. 15500 million. With a view to facilitate meeting its maturing obligations in time, the enterprise has two options available with it which are as under:-

a) Factoring its accounts receivable to the extent of 80% at factoring fee of 6% to an agency.
b) Pledging its accounts receivables to the extent of 80% at the flat interest of 7% with a Bank for taking loan.

Required

1) Pass necessary accounting entries separately for both the options.
2) Which of the two options is more appropriate for implementation?

P.4-3

Liaqat Trading Company is a wholesaler of domestic appliances to retailers in the territory. The company's accounts receivables from different retailing customers have accounted to Rs. 875,000 as on 30 April 2020. The company is using direct write-off method for charging bad debt expenses and valuation of its accounts receivables. During May, 2020 it was learnt that a customer namely Sadiq Electronics has died and the accounts receivables amounting to Rs. 50,000 from this customer are no more receivable. However, late during June, 2020 upon disposal of his property, 45% of the due were recovered.

Required

1) Record necessary accounting entry for writing off the accounts receivable from the expired customer.
2) Record collection of the dues from the disposal proceeds of the property of expired customer.
3) Present the amount of accounts receivables in the balance sheet as at 30 June, 2020.

P.4-4

Citizen Appliances Company is using income statement approach for creating allowance for doubtful accounts during the period of sales. During 2019-20 the status of Accounts Receivables was as under:-

Accounts Receivables	Rs. 1,850,000
Less allowance for doubtful Accounts	Rs. 20,000
Net Accounts Receivables	Rs. 1,830,000

During July, 2020 the accounts receivables amounting to Rs. 8,500 from Azad Company were written off. However, during September 2020, this customer paid Rs. 5,000. During the year 2020-21 credit Sales amounted to Rs. 1,580,000. The company has a policy to create 1% for allowance for doubtful accounts on the basis of credit sales for the year. Up till 30 June 2021 the accounts receivables amounting to Rs. 1,530,000 were also collected from different credit customers.

Required

1) Record adjusting accounting entry for writing off the accounts receivables from Azad Company.
2) Record Collection of amount from Azad Company who later paid some dues.
3) Record the creation of additional allowance for doubtful accounts during 2020-21.
4) Present the accounts receivables in the balance sheet as at 30 June, 2021.

P.4-5

So-Soft Garments Industries has started business of fabrication of men, women and Kids dresses. These dresses are directly sold to retailers to avoid profit of wholesaler and reduce prices. The merchandise is usually sold on 30 to 60 days credit terms. During its first half year of operations, the credit sales amounted to Rs. 1,360,000. During efforts of collection it was found that the credit sales amounting to Rs. 6,500 were not traceable. Therefore, these receivables were collectible as the customer has shifted to some other city and was not written off. The company is using allowance method for charging bad debt expenses. During second half of the year the credit sales amounting to Rs. 1,240,000 were achieved. Total collections during the year amounted to Rs. 2,000,000. The management is wishing to create an allowance for doubtful accounts equal to 2% of the balance accounts receivables at year end.

Required

1) Pass necessary accounting entries for writing off the accounts receivables.
2) Create necessary allowance for the doubtful accounts at the end of accounting period.
3) Present the accounts receivables in the balance sheet at end of the year.

P.4-6

Safe Pharmaceutical Company is engaged in manufacturing of life saving medicines. In order to avoid multiple panels of wholesale dealers for distribution of its medicines, the company has registered few wholesale dealers for sale of its products. The Company is using balance sheet approach for valuation of its accounts receivables and creating allowance for doubtful accounts based upon ageing of its year end accounts receivable. Normal credit terms of sale are 30 to 60 days period but some of the dealers do not pay their dues within the prescribed credit period. The aging of accounts receivables as on 30 June, 2020 was conducted as under:-

Ageing of Accounts Receivables

	Not yet Due	30days past due	90days past due	180 days past due	Over one year past due
	Rs.	Rs.	Rs.	Rs.	Rs.
A Agency	50,000	—	100,000		—
B Agency	70,000	80,000	250,000		70,000
C Agency	30,000	120,000	520,000	60,000	50,000
D Agency	50,000	70,000	100,000	80,000	30,000
E Agency	—	100,000	50,000	100,000	20,000

The Recovery Staff has suggested the following percentages of likelihood for non recovery of the accounts receivables to which management is inclined.

Net yet due	1%
30 days past due	2%
60 days past due	3%
90 days past due	5%
Over one year past due	10%

The existing balance of allowance for doubtful accounts brought forward from the previous year is amounting to Rs. 22,500.

Required

1) Compute the amount of estimated bad debts required to be accounted for.
2) Pass necessary adjusting accounting entry for the allowance for doubtful accounts.
3) Present the net amount of accounts receivables in the balance sheet at year end.
4) During July, 2020 the amount of Rs. 20,000 receivable from E Agency which was over one year past due was considered to be bad debts. Pass necessary accounting entry for writing off this amount of accounts receivables.

P.4-7

Season Master Trading Company is dealing is consumable merchandise. The goods are sold on 60 days credit terms. The debit balance in the allowance for doubtful accounts was amounting to Rs. 8,300 for the accounts receivables written off during the first half of the year. The sales during the year and the estimated percentage of doubtful accounts on the basis of ageing of the accounts receivables are as under:-

Ageing of Receivables		Classified Expected Amount of Percent of Accounts Receivables Uncollectible	
1.	Not yet due	Rs. 85,000	0.5%
2.	60 days past due	Rs. 530,000	1%
3.	180 days past due	Rs. 650,000	2%
4.	One year past due	Rs. 320,000	5%
5.	Two years past due	Rs. 110,000	20%

The accounts receivables amounting to Rs. 25,000 which were over two years past due were found to be irrecoverable during July 2020.

Required:

1. Compute the amount of expected bad debts on the basis of ageing of accounts receivables
2. Record necessary accounting entry for adjustment of the allowance for doubtful accounts receivables.
3. Present the accounts receivable in the balance sheet as at 30 June, 2020.
4. Pass necessary accounting entry for writing off the accounts receivables during July, 2020 which were found to be irrecoverable?

P.4-8

Subhan Trading Corporation through its intensive efforts for collection of its accounts receivables during the recent past period has some surplus funds in its working capital. The management wishes to generate some financial benefits from these available funds through investment in equity shares. According by the corporation availed some opportunities and invested funds in the marketable securities as under:-

1) Purchased 1,500 shares of Kohinoor Mills Ltd of Rs. 100 each par value, at Rs. 250 each as on 28 September 2020 which have the market value of Rs. 300 each as on 30 June 2021.
2) Acquired 2,000 shares of Saif Group of Industries Ltd of Rs. 50 each par value at Rs. 85 each on 15 March, 2021 which have the market value of Rs. 100 each as at 30 June, 2021.

Required

1) Record the purchase of marketable securities of both the companies in the accounting books.
2) Record the increase in the market price of investment in the accounts.
3) Present the marketable securities in the financial statements in compliance to mark to market concept of securities.

P.4-9

Three Stars Chemical Company has accumulated funds in its Depreciation Fund Account. These funds would be required for replacement of machinery after few years. Therefore, the company has decided to invest these funds in 12% Bonds have maturity of 5 years and were purchased at Rs. 1,000,000 as on 1 April 2020. The interest is payable semiannually.

Required

1) Record the purchase of Bonds in the books of accounts as on 1 April, 2020.
2) Record accrued interest on Bonds in the books of accounts as on 30 June, 2020.
3) Record the collection of interest on bonds as on 30 September, 2020 and as on 31 March 2021.

P.4-10

Shadman Enterprises Ltd is a trading company of industrial goods. The company has sufficient surplus funds available to invest outside the enterprise. Accordingly, the treasurer managed to purchase the following short and long term equity and debt securities as per approval of the chief Executive officers: -

A) 5000 ordinary shares of Rs. 100 par value at Rs. 180, each as on 12 March, 2020 of Reliance Manufacturing Company Ltd. Agents commission was Rs. 5 each share.

B) 6,500 ordinary shares of Rs. 50 par value at Rs. 75 each as on 08 April 2020 of Beauty Cosmetics Industries Ltd. Agent's Commission was Rs. 5 each share.

C) 15% Bonds 1,000 of Rs. 1,000 each of United Commercial Bank on 01 May 2020, interest payable semi annually, having maturity of 5 years.

The market value of equity securities as on 30 June, 2020 was as under: -

1. Reliance Manufacturing Co. Ltd Rs. 200 each.
2. Beauty Cosmetics Industries Ltd Rs. 70 each.

The Company was in need of funds to supplement its working capital, therefore it sold Rs. 2,000 ordinary shares of Reliance Manufacturing Company Ltd at Rs. 190 each on 20 July 2020. Further the 2,000 ordinary shares of Beauty Cosmetics Industries were also sold on 31 July 2020 at Rs. 60 each.

Required

1) Record purchase of equity shares of each Company.
2) Record purchase of Bonds.
3) Record the interest due on 30 June, 2020 on Bonds
4) Record the increase or decrease in the market value of equity shares of each company in terms of mark to market valuation concept of securities.
5) Present the marketable securities and the 15% Bonds in the balance sheet of the enterprise as at 30 June, 2020.
6) Record the receipt of interest on Bonds after 06-month period.
7) Record the sale of equity securities during July 2020.

4.15 GLOSSARY

Accounts Receivables

The debt due from customers on account of goods or services supplied to them on credit basis.

Notes Receivables

The note receivable means written evidence supported by the Negotiable Instrument Act, 1881 regarding due amount for goods services or the funds provided in the past to customer which is receivable within specific period with or without interest.

Dishonors of Notes Receivable

Refusal of the credit customer to pay the amount at due date of the notes receivable because of certain reasons

Factoring Accounts Receivables

Selling of rights of accounts receivable to a third party for collection and in lieu thereof receipt of funds on lump sum basis after certain reduction

Pledging of Accounts Receivable

Use of accounts receivable rights as collateral security for borrowing money from bank or financial institutions

Bad debt

The amount of irrecoverable portion of account receivable from credit customers. This is treated as periodic business expense/loss.

Allowance for Doubtful Accounts

The provision created, usually at the end of accounting period, for expected loss from non-recovery of accounts receivables in future.

Aging of Accounts Receivables

A method for estimation of doubtful accounts receivables based on greater chance for non-recovery of older accounts receivable and lower chance for non-recovery of current accounts receivables. Thus all accounts receivables are phased into different age groups to create allowance for doubtful accounts at different rates at year end.

Short Term Investment

Investment of funds outside the business with the intent to cash it after some short period, within few months, to gain certain benefits from the funds available which are currently surplus.

Unrealized gain/loss

The increase or decrease in the market value of equity securities of other companies, at the yearend reporting period than the purchase cost. This increase or decrease in market value is capitalized in Balance Sheet instead of in the Income Statement of reporting period.

Realized gain/loss

The gain or loss actually realized on disposal of equity securities of other companies. This gain or loss is presented in the income statement of the disposal period.

Trading Securities

The equity or debt securities which have exclusively been purchased on temporary basis and which are to be sold immediately to earn some gain

Available for Sale Securities

The equity or debt securities like shares, bonds and debentures which can be sold out at any time when market prices are favorable.

Mark to Market

A concept of valuation of marketable securities at market value ate the end of accounting period and recognition of any gain or loss for increase or decrease in the market value as compared with cost, as unrealized gain or loss in the balance sheet. This is a departure from the cost concept of GAAP.

Add to Maturity Securities

The long term securities which are retained till its maturity like bonds and debentures and earn interest on it.

Long term Investment

Investment of funds outside the business with the intent to keep it for comparatively longer period than one year with the objectives to earn potential benefits of dividend, interest and hold control in the other company.

Unit–5

ACCOUNTING FOR CORPORATIONS ISSUANCE OF STOCKS

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CONTENTS

INTRODUCTION

This unit deals with variety of sources for collection of funds to be used as capital for conduct of a business as a joint stock Company. The corporate form of business has certain advantages and disadvantages. The Capital Stock is usually generated from Common and Preferred Stocks. The Stock is issued at par at premium and at discount. The preferred Stocks has specified rate of dividend payable on it. The preferred stock may be cumulative; non-cumulative participating, non-participating, redeemable and convertible. The capital stock may be distributed the profit as cash dividend, interim dividend and stock dividend as decided by Board of directors. The stock split may also be decided when the market prices of shares are substantially growing up.

OBJECTIVES

After study of this unit, the students would become conversant to understand the following contents:-

1) Formation of a joint Stock Company, classification of capital stock into common and preferred and its accounting treatment upon issuance.
2) Accounting treatment of issuance of capital stock at par, at premium and at discount and its presentation in the equity section of the balance sheet of the company.
3) Accounting treatment of payment of cash dividend, interim dividend and stock dividend and stock splits.
4) Accounting treatment and distribution of profit in the shape of dividends to cumulative, non-cumulative, participating, non-participating preferred stockholders and common stockholders.
5) Presentation of redeemable Preferred Stocks in long term liabilities instead of equity section of balance sheet.
6) The presentation of stock splits into accounting record only as memorandum information instead of accounting entries.

5.1 CORPORATE FORM OF ORGANIZATION

The gradual growth of trade, commerce and industry during twentieth century, the size of business activities had grown up, and the sole proprietorship and the partnership forms of organizations did not supply all the capital needed. Therefore, a new form of business organization came into existence where in the public was invited to contribute capital. Such an organization is known as a Joint Stock Company or simply a company or alternatively named as a corporation. Such joint stock companies are established in Pakistan under Companies Act, 2017.

A Joint Stock Company or Corporation is a fictitious or artificial legal person existing in the eyes of law. This legal person (Company) once created is distinct from its owners, stockholders, shareholders or members. The Company can own property, sue and be sued and generally carry on activities by its own name and title through its officers and agents. Being a creature of statute, the scope of its activities is dependent upon its memorandum of association and any activity beyond its scope would be judged as invalid and ultra vires. The Companies are thus governed by its relevant law under which it was constituted and registered.

There are two major classifications of joint stock companies. One is a private company whose members are limited and cannot offer its shares to public for sale. The second type is a public company whose members are unlimited and can offer its shares to public for sale. Such shares/stocks once issued are usually traded on the stock exchanges of the country.

Characteristics of a Company

A Joint Stock Company represents an important type of business organization as it has unique characteristics, having pivotal role in the building of economy in the country. It may offer certain advantages and disadvantages as enumerated below:-

A) Advantages

1) Adequate capital: The joint stock company can collect and accumulate sufficient funds in the shape of issuance of shares/stocks to public and also issuance of debentures and bonds apart from taking loans from financial institutions. The corporate structure attracts the public for purchase of shares owing to limited liability, trading facility of such shares and perpetual nature of the company.
2) Separate legal entity of the company facilitates it to conduct business at its own responsibility without involving its owners.
3) The stockholders have limited legal liability to the debts of the company.
4) Perpetual life of the company enables it to continue its operations without interruption upon death of any shareholder.

5) The shares of the company can easily be traded and transferred to others.
6) The shareholders have no rights of mutual agency like in partnership.
7) The business of the company is conducted by a professional group of persons including board of directors.

B) Disadvantages

1) The corporate organizations are mandatory required to follow the regulations and controls imposed by the Companies Act 2017 and other instructions issued by the agencies from time to time.
2) The taxation structure comprising general sales tax and income tax is strictly implemented on the joint stock companies. Thus draining out its profit over by 30% to the government in the shape of income tax and around 15 to 17% on the sales prices of merchandise. Further the tax on dividend ranging from 10 to 20% leads to double taxation on the income of the company.
3) Sometimes the employees of the company take least care in the conduct of transactions of the organization due to their non-involvement in the profitability.

In spite of certain disadvantages of the joint stock form of business organization the overwhelming advantages are greater. Thus the corporate structure is progressing day by day as no other form of business organization can execute mega projects and gigantic/complex manufacturing and trading activities.

General administrative Structure of the Company

The management of the joint stock company rests with the board of directors who is responsible for framing policies, taking decisions and arranging resources for conduct of business activities. The board of directors is elected by the shareholders of the company. The Managing Director, as authorized by the Board of Director, is the Chief Executive Officer of the company who is responsible to conduct all business transactions of the organization. The corporate affairs are looked after by the Company Secretary for holding meetings of the Board of Directors, maintaining minutes of the board meetings, issuance of share certificates to shareholders, arranging approval of the board for transfer of shares from one person to the other and meeting regulatory requirements of the Securities and Exchange Commission of Pakistan in terms of Companies Act, 2017.

The administrative and functional set up of the corporation is entrusted upon the General Managers or Controllers of different Divisions of the organization who all report to the Managing Director for performance in their departments like Administration, Human Resource, Accounting & Finance, Production, Procurement and Marketing etc. There departmental heads are supported by their functional staff.

5.2 BASICS OF CAPITAL STOCK

The Capital stock denotes the contribution of funds made by shareholders/ stockholders in the company through purchase of shares/stocks of the joint stock company. This is the main source of the company through which funds are collected for conduct of business. The capital stock of a company is classified into accounting record with different nomenclatures as deliberated below:

a) Authorized Capital

This is the total amount of capital divided into different classifications, duly approved by the Controller of Capital Issue of Securities and Exchange Commission of Pakistan, on the request of the Company after depositing necessary fee. This also matches with the amount of capital authorized and indicated in the memorandum of association of the company. The company has the power to issue shares up to this authorized amount of capital. The authorized capital is divided into shares of fixed amount like Rs. 10, Rs. 50 or Rs. 100 each share or. The amount of authorized capital with classifications is indicated in the equity section of the balance sheet as memorandum information. No accounting entry is passed for the authorized capital.

b) Issued Capital

This represents the number of shares which have been offered to public through issuance of prospectus or otherwise in the shape of cash or some other considerations of assets or services rendered. The issuance of shares can also be arranged through brokerage houses i.e. underwriters also acquire all or major portion of shares and then sell such shares taking all gains or losses from its resale.

c) Subscribed Capital

It is that part of issued capital which was subscribed by the potential purchasers through their requests expressing intention of purchase to which the company agreed. The subscription may be over or under. In case of over subscription some modality is developed to maintain some rationale for selection of issuance of shares. In case of under subscription usually the shares are issued as requested by purchasers in all.

d) Called up Capital

The amount of money which was called up from the subscribers of shares for making payment to the company.

e) Paid up Capital
The paid up capital is the amount of called up capital that has actually been paid up by the subscribers/stockholders to the company.

f) Par Value of Stock
The par value of Stock denotes the amount as indicated on the face of the share certificate and has been issued at that particular amount to the stockholders. For instance, the share of Rs. 100 issued at Rs. 100 each is its par value.

g) Market Value of Stock
The market value of the stock is the price at which the shares can be purchased and sold each time. This value fluctuates from time to time in the market at stock exchanges. The market value of stock depends upon the amount of dividends growth and other economic factors in the country which have influence over the corporate affairs.

h) No – par Value Stock
No par value stock is not assigned any par value by the company and its memorandum of association. Such shares can be issued at any price without the possibility of a minimum legal capital deficiency (discount factor).

i) Stated Value Stock
The stated value stock is no-par Stock to which the directors assign a "stated" value per share. The stated value per share becomes the minimum legal capital per share.

The shares of the company may be classified into ordinary (common) and Preferred stocks to which Companies Act 2017 permits. These classifications are further dealt with in the succeeding portion.

5.3 COMMON STOCK

The Common Stock of a joint stock company in reference to its rights and privilege shall be governed by its memorandum and articles of association. However, the common stock has the right to profit (dividend) distribution, voting and other benefits like share in residual assets at the time of liquidation of the company after all obligations including preference stocks have been satisfied. The issuance of common stock shall affect the asset amounts and capital accounts. The common shares may be issued by a joint stock company at different prices which are deliberated below along with accounting treatment.

5.3.1 Issuing Par Value Stock at Par

When the common stock of Rs. 100 each denomination is issued at Rs. 100 each it represents issuance of stock at par. When the applications for stock are received by the company and shares are issued after approval of the Board of Directors, following two accounting entries are recorded:

Date	Particulars	Dr	Cr
15-03-20	Bank Account	Rs. 500,000	
	Common Stock Application Account		Rs. 500,000
31-03-20	Common Stock Application Account	Rs. 500,000	
	Common Stock Capital Account		Rs. 500,000

The above accounting entries indicate that the applications for 5000 shares of Rs. 100 each were received which were accepted and after approval the shares were issued. In case of over subscription, the amount will be refunded to the applicants. The common stock capital account is a controlling account. It is necessary to maintain member's record of the name and address of each stockholder and the number of shares hold in order to issue dividend cheques, proxy forms and annual reports. This will be applicable in any type or classifications as enumerated in the succeeding sections. The stockholders equity section in the balance sheet of the company, at the end of its first year of operation, when net income of Rs. 100,000 was earned and no dividend declared, would present as under:-

Stockholders' Equity

Common Stock 100,000 shares of Rs. 100 each authorized and issued 5,000 shares at par Rs. 100 each.	Rs. 500,000
Retained Earnings	Rs. 100,000
Total stockholders' equity	Rs. 600,000

5.3.2 Issuing Par Value Stock at Premium

Sometimes when the shares are issued by a joint stock company at the value greater than its par value, it is termed as at premium. If the common stock of Rs. 100 each par value is issued at Rs. 120 each the excessive amount of Rs. 20 (Rs. 120-Rs. 100) would be termed as premium. The shares of a company are issued at premium when the company is earning higher profits and has potentials of distributing greater amount of dividend than the rate of interest or the dividend rates of other competing companies. Taking the similar data as at para 5.3.1 for issuance of shares, but at premium, the accounting entries will be incorporated as under:-

Date	Particulars	Dr	Cr
15-03-20	Bank Account Common Stock Application Account	Rs. 600,000	 Rs. 600,000
31-03-20	Common Stock Application Account Common Stock Capital Account Premium on Common Stock Capital Account	Rs. 600,000	 Rs. 500,000 Rs. 100,000

The Premium on Common Stock is not a periodic revenue rather it is capitalized in owner's equity. The presentation of owner's equity in the balance sheet at year end would be as under:-

Stockholders' equity

Common Stock 100,000 shares of Rs. 100 each authorized and issued 5,000 shares of Rs. 100 at Rs. 110 each.	Rs. 500,000
Premium on Common Stock Capital	Rs. 100,000
Retained Earnings	Rs. 100,000
Total stockholders' equity	Rs. 700,000

5.3.3 Issuing Par Value Stock at Discount

When the stock of a Joint Stock Company is sold to public at the price which is lessor than its par (face) value, it is called as issuance of stock at discount. A newly established company is not allowed to issue its stock at discount. However, it can later issue the stock at discount with the prior approval of its board of directors and the Exchange Commission of Pakistan with cogent reasons. Suppose the 5000 shares of Rs. 100 par value are issued at Rs. 90 each during second year of its operations, the accounting entries would be recorded as under:-

Date	Particulars	Dr	Cr
10-04-21	Bank Account Common Stock Application Account	Rs. 450,000	 Rs. 450,000
31-04-21	Common Stock Application Account Discount on Common Stock Capital Account Common Stock Capital Account	Rs. 450,000 Rs. 50,000	 Rs. 500,000

The discount on Common Stock is not treated as periodic expense rather it is capitalized in the balance sheet and can be adjustable against the Premium on similar Common Stock Capital. The presentation of owner's equity in the balance sheet at year end when the capital stock is sold at discount would appear as under:-

Owner's equity

Common Stock 100,000 shares of Rs. 100 each authorized and issued 5,000 shares of Rs. 100 each at Rs. 90 each.	Rs. 500,000
Discount on Common Stock	(Rs. 50,000)
Retained Earnings	Rs. 100,000
Total stockholders' equity	**Rs. 550,000**

In case, earlier when some Common Stocks were issued at premium as at para 5.3.2 and later some Common Stocks were sold at discount as per para 5.3.3 the amount of discount of Rs. 50,000 would be adjusted from the premium of Rs. 100,000 on common stock in the internal column and net balance of premium of Rs. 50,000 on Common Stock would be reported in the stockholders' equity apart from the other contents.

5.3.4 Issuing No-Par Value Stock

When the shares are issued, without its denomination of par or face value, the entire proceeds collected on sale are credited to the common stock capital without recognition of any discount or premium. The Companies Act, 2017 does not contain any provision for issuance of no par value stock in Pakistan. However, no-par shares were first authorized by the New York State during 1912 and at present are authorized in nearly all of the States as well as in Canada. The objectives of no-par shares was to combat abuses of the investing public at the hands of exploiting and unethical practices by some promoters and to eliminate complicated accounting for discount on issue of shares. To illustrate, a company records the issuance of 1,000 Common Stock of no-par for Rs. 80 each at cash, the following accounting entry will be recorded:-

Date	Particulars	Dr	Cr
10-03-20	Bank Account	Rs. 80,000	
	Common Stock(No-Par Value)		Rs. 80,000

5.3.5 Issuing Stated Value Stock

In case no-par stock is issued and assigned a stated value, its stated value becomes legal capital which is credited to the stated value Stock Account. Assume that the stated value stock is issued at an amount in excess of stated value; the excess is credited to the Paid-in Capital in Excess of Stated Value Common Stock, which is reported in the Stockholders' equity section. To illustrate, a company that issued 2,000 shares of no-par Common Stock having a stated value of Rs. 100 each at Rs. 110 cash per share, the accounting entry would be recorded as per following.

Date	Particulars	Dr	Cr
12-03-20	Bank Account	Rs. 220,000	
	Common Stock(Rs. 100 Stated Value)		Rs. 200,000
	Paid-in Capital in Excess of Stated Value Common Stock		Rs. 20,000

5.3.6 Issuing Stock for Non cach Assets

When Common Stocks are issued by a joint stock company in exchange for assets other than cash, such as land, building and equipment etc, the assets so received would be recorded at their fair market value. As an illustration, assume that on 15 May 2020, a company acquired land, Building and Equipment with a fair market value of Rs. 8,000,000, Rs. 12,000,000 and Rs. 5,000,000 respectively in exchange of 200,000 Common Stock with a par value of Rs. 100 each, the transaction would be recorded as under:-

Date	Particulars	Dr	Cr
15-05-20	Land	Rs. 8,000,000	
	Building	Rs. 12,000,000	
	Equipment	Rs. 5,000,000	
	Common Stock Capital		Rs. 20,000,000
	Premium Common Stock		Rs. 5,000,000

It may be stated that determination of the fair market value of the assets so acquired is the responsibility of the Board of Directors of the Company. It is not always possible to make an objective determination, but if shares are also being issued for cash at about the same time, the cash price of the shares may provide an indication of the proper valuation of the assets so acquired. The shares so issued would be stated in the balance sheet as having been issued for consideration other than cash as a full disclosure requirement.

A Company can sometimes also issue its Common Stock to promoters in exchange for their services and expenses incurred in the establishment of the Company. Such costs are capitalized in the accounting record as organization expenses and amortized over a period of three to five years gradually. Assume the promoters claim that they have incurred an amount of Rs. 280,000 on the registration of the company and its related documentation, the Common Stock of 2,800 of Rs. 100 each issued to the Promoters would be recorded as under:-

Date	Particulars	Dr	Cr
20-05-20	Organization Expense	Rs. 280,000	
	Common Stock Capital		Rs. 280,000

The issuance of above Common Stock would require prior approval of the Board of Directors of the Company. Such Organization Expenses are termed as Preliminary Expenses and are also called as Deferred Costs of the Company.

5.4 DIVIDENDS

The profitable earnings which are distributed to the Stockholders is called as dividends. The Companies Act, 2017 provides that the dividends shall be paid only from profits. This means that is case of loss there would be no payment of dividend. The authority to distribute earnings to the stockholder's rests with the Board of Directors. Usually in its meeting, the Board of Directors, based upon the periodic earnings; recommend payment of a specific amount or percentage of dividend on Share Capital. This is finally approved by the shareholders in its annual general meeting (AGM). The stockholders have the right to reduce the amount of dividend but cannot increase the dividend as recommended by the Board of Directors. A Company can make no guarantee that its business activities would definitely be profitable. Hence it cannot guarantee dividends to its common stockholders. Further, the directors have wide range of discretionary powers in determining the extent to which earnings should be retained by the company to provide for expansion, to offset possible future losses or to provide for other contingencies.

5.5 CLASSIFICATION OF DIVIDENDS

There are different types of dividends which a Company can distribute to its stockholders which are deliberated as under:-

5.5.1 Cash Dividend

Based upon the recommendations of the Board of Directors of a Company, the cash dividend may be paid to the stockholders on the list of members on a specific date. The Cash Dividend shall depend upon the availability of liquid resources with the company. These cash dividends provide a return to investors and almost affect the market value of shares. The declaration date of Cash Dividend is when it was approved by the Board of Directors. The date of record means the future date specified by the directors for identifying those stockholders listed in the record of the company who would be entitled for the cash dividend. The payment date is within forty-five days of the declaration in case of a listed company and within thirty days in case of any other company. The accounting entries for the cash Dividend would be recorded as under: -

Date of Declaration	**Dr**	**Cr**
Retained Earnings Account	**XXX**	
Dividend Payable Account		**XXX**
Date of Payment		
Dividend Payable Account	**XXX**	
Bank Account		**XXX**

5.5.2 Interim Dividend

Depending upon the anticipated performance and projected profit of a company, the Board of Directors can announce more than one interim dividends on the equity shares. The directors can also revoke the decision to pay interim dividend before it is paid. The interim dividend is paid within forty-five days of the declaration approval. This interim dividend shall be adjustable from the final dividend when approved by the stockholders in its annual general meeting. The accounting entries for the interim dividend shall be identical to what has been stated at Para 5.5.1.

5.5.3 Stock Dividend

The Cash dividend is purely dependent upon the availability of profits and liquid fund resources. In case the Board of Directors finds it suitable that payment of cash dividend would tantamount to financial crises in future for the company, then it may be considered appropriate to issue additional own common stocks to the existing stockholders without receipt of payment in return at a certain proportion in lieu of the cash dividend. Such distribution of additional Common stock is called as stock dividend. Thus overall ownership proportion of the stockholders in a company is maintained. The stock dividends and cash dividends are different from each other. The cash dividend reduces the assets and equity while the stock dividend transfers some portion from retained earnings to the Capital Stock within Owners' equity section of the balance sheet. This is termed as Capitalization of retained earnings. Apart from the anticipated cash crunches in future from the cash dividends and in lieu, there of issuance of stock dividends, there are some other administrative and economic reasons as well. One consideration may be to keep the market price of the shares at affordable level. For example, if a company continues to earn profit but does not distribute cash dividend, the market price of its Common Stock is likely to grow. Thus the market price of such a stock may become so high that it would discourage some potential investors to buy the stocks of such companies. Contrary to it when the stock dividend is distributed by a company, the number of outstanding stocks is increased which reduces the per share market price and book value. Another aspect of issuance of stock dividend is to provide an evidence by the management that the performance of the company is going well and is expected to continue similar better results in future as well.

The issuance of stock dividends requires accounting treatment within its owners' equity section. In the context of explaining the treatment of stock dividend, assume the following status of the owners' equity section of a company at year end on 30 June 2020 which hand some earnings as well: -

Stockholders' Equity as on 30 June 2020

Common Stock 100,000 shares of Rs. 100 each authorized and issued 5,000 shares of Rs. 100 each.	Rs. 500,000
Premium on Common Stock Capital	Rs. 100,000
Retained Earnings	Rs. 100,000
Total stockholders' equity	Rs. 700,000

The Board of Directors decided on 15 August 2020 to issue stock dividend at 12% of the outstanding Capital Stock. The market price of the shares of this Company was at Rs. 140 each. The issuance of 600 stock dividend (5000x12%) would be accounted for in the accounting record through the following entry: -

Date	Particulars	Dr	Cr
15-08-20	Retained Earnings	Rs. 84,000	
	Common Stock Capital		Rs. 60,000
	Paid in Capital in excess of par value		Rs. 24,000

The position of stockholder's equity after 15-08-2020 would now appear as under: -

Stockholders' Equity

Common Stock 100,000 shares of Rs. 100 each authorized and issued 5,600 shares of Rs. 100 each.	Rs. 560,000
Premium on Common Stock Capital	Rs. 100,000
Additional paid in Capital in excess of par value	Rs. 24,000
Retained Earnings	Rs. 16,000
Total stockholders' equity	Rs. 700,000

A comparison of the stockholders' equity before distribution of stock dividends and after distribution of stock dividends indicates that total amount of stockholders' equity remained constant while its elements have changed. After issuance of stock dividends, the quantity of common stock is increased from 5,000 issued shares to 5,600 issued shares. The additional paid in capital in excess of par value at Rs. 24,000 has been added up. This amount can also be merged with the amount of premium on Common Stock Capital and in the accounting entry passed on 15 August, 2020 the nomenclature of the Paid in Capital in excess of par value will have to be changed and used as Premium on Common Stock Capital as both these nomenclatures represent similar purposes. The balance of Retained Earnings Account has also been decreased from Rs. 100,000 to Rs. 16,000 as an amount of Rs. 84,000 (600 shares x Rs. 140) has been converted and capitalized in the Common Stock and additional paid in capital from the Retained Earnings. After issuance of the stock dividends the market value and book value of the shares of this company would reduce from Rs. 140 each (Rs. 700,000/5,000 shares) to Rs. 125 each (Rs. 700,000/5600 shares). This would facilitate the potential investors to purchase shares of the company at lower investment amount.

5.5.4 Stock Splits

Another way of reducing the market value of shares on the Stock Exchanges and enhancing potential trading of a Company's Stocks is through stock splits. Stock split refers to a device whereby the face/par value of the shares is reduced by certain proportion. For instance, a company may decide through its Board of Directors a 2 for 1 stock split. When this stock split is occurred, the Company calls for the outstanding shares from members and in lieu thereof new shares in double quantity (in case of 2 for 1 split) are issued to them afresh. The stock split can be arranged in any proportion like 4 for 1 or 5 for 1 etc, but the par/ face/stated value of shares should be divisible without any fraction. The Stock splits thus reduces the par or stated value per share but does not change the overall ownership of the stockholders in the Company. We may conclude that the objectives of stock split are grossly identical to the stock dividends.

When a Company decides stock splits and conducts as well, no accounting entries for calling back the earlier stocks and issuance of fresh are needed because there is no change in the owners' equity. Only the face/stated value of shares is changed which is usually carried through memorandum entry in the ledgers, members register and in the balance sheet. The stock splits would need only change in the quantity of shares and their denomination of par/stated value in the relevant records. A stock split merely increases the number of shares. It does not usually change retained earnings or paid in capital.

5.6 PREERRED STOCK AND ITS CLASSIFICATION

Apart from the Common Stock issuance by a corporate organization as explained at para 5.3, the other type of stock issuance is the Preferred Stock. The Preferred Stock issued has some attachments with regard to priority of dividend and also payment of principal amount of Preferred stock upon liquidation of the company after other obligations of liabilities are satisfied but before payment to the Common Stockholders. The preferred stock has different descriptions like 15% Preferred Stock or Rs. 14 Preferred Stock. The 15% Preferred Stock ensures that if the preferred stock has par value of Rs. 100 each, then Rs. 15 (Rs.100 x 15%) would be the amount of annual dividend payable to the preferred stockholders on each share.

In case of Rs. 14 Preferred Stock the dividend of Rs. 14 on each preferred stock would be payable each year irrespective of the par or stated value of each such preferred stock. Similarly some other characteristics and conditions may frequently be added to the preferred stock in the extension of certain advantages or in the limitations of certain rights. These privileges and restrictions are deliberated in the classifications of preferred stock which follow.

5.6.1 Cumulative and Non-Cumulative Preferred Stocks

The cumulative preferred stock carries privilege of dividend accumulation from one year to the other. Since the dividend can only be paid out of profits, so in case of no profit or sustaining loss, the dividend on cumulative preferred stock would go in arrears to the next year when in case of sufficient profit, the priority shall be given for payment of arrears of dividend on the cumulative preference Stock and then current year's dividend would be paid on preferred stock if resources of profit can so accommodate. This facility would not be applicable on the non-cumulative preferred stock as the specified amount or rate of dividend would be payable to the non-cumulative preferred stock only when current year's profit an accommodates such obligation. If current year's profit is insufficient only the available amount at lower rates would be paid and any deficiency would not be carried forward to the next accounting period. Further if the company has sustained loss during current year, then neither any payment of dividend to the non-cumulative preferred stock would be made nor such dues would be carried forward to the next accounting period for payment of dividend of the last year. It is relevant to add here that the dividend on common stock would become due, out of any leftover profit, if it is so decided by the board of directors.

Following data is considered for dividend on cumulative, non-cumulative Preferred Stock and Common Stock of a Company: -

-10% Preferred Stock cumulative 10,000 shares of Rs. 100 each.	
-12% Preferred Stock non-cumulative 8,000 shares of Rs. 100 each.	
-Common Stock 5,000 shares of Rs. 100 each.	
Profit of year 01	Rs. 90,000
Profit of year 02	Rs. 150,000

Distribution of Profit

Year-1:- 10% Preferred Stock cumulative 10,000 x Rs. 100 = Rs. 1,000,000
Due Dividend = Rs. 1,000,000 x 10% = Rs. 100,000

The available profit of Rs. 90,000 would be paid to the 10% Preferred Stock Cumulative and balance of Rs. 10,000 (Rs. 100,000 – Rs. 90,000) would be shown as arrear dividend on the cumulative preferred stock in the balance sheet of year 1. Further no dividend on the non-cumulative 12% preferred stock would be payable as no balance profit was available after payment of dividends on 10% Cumulative Preferred Stock.

No Dividend would be paid to Common Stockholders as no profit was available after payment of dividend to the 10% cumulative stockholders.

Year-2:- Profit-of Rs. 150,000

A) Dividend on 10% Cumulative Preferred Stock:

Arrear of dividend of year 1	Rs. 10,000
Dividend of year 2 Rs. 1,000,000 x 10%	Rs. 100,000
Total dividend to be paid	Rs. 110,000

B) Dividend on 12% non-cumulative Preferred Stock

Dividend of year 1 arrear	Nil
Dividend of year 2 8,000 x Rs. 100 = Rs. 800,000 x 12% =	Rs. 96,000

The dividend of year 2 works out to Rs. 96,000 but the balance profit available is amounting to Rs. 40,000 (Rs. 150,000 – Rs. 110,000). Therefore, the amount of Rs. 40,000 only would be paid as dividend to the 12% non-cumulative Preferred Stock while the difference of Rs. 56,000 (Rs. 96,000 – Rs. 40,000) would not be considered as arrear liability on it.

No dividend shall be payable on the common stock during year 2 as no profit was available after payment of dividend to the cumulative and non-cumulative Preferred Stocks.

It would be observed from above tabulations that although the rate of dividends on the cumulative and non-cumulative Preferred Stock was specified yet dividend payment was not guaranteed as the dividend payment was dependent upon availability of the profits.

5.6.2 Participating and non-participating 10% Preferred Stocks

The participating characteristics of the Preferred Stocks mean that in case of excessive profits, the preferred stockholders will also share in the balance profits after payment of dividend equal to the stated amount or percentage on the preferred stocks and also the common stocks. This sharing of balance profit would be based on the amount of capital contribution of the preferred and common stockholders. The non-participating Preferred Stockholders would not be entitled for sharing in any excessive profit and entire balance profit would go to the common stockholders. This is further explained through the following data.

- Participating 10% Preferred Stocks	10,000 shares of Rs. 100 each
-Common Stocks	8,000 shares of Rs.100 each
-Profit for the year	Rs. 270,000

Distribution of Profit as dividend 10% Preferred Stocks 10,000xRs. 100 = Rs. 1,000,000 x 10% =	Rs. 100,000
Common Stock 8000 x Rs. 100 = Rs. 800,000 x 10% =	Rs. 80,000
Total dividend	Rs. 180,000

Balance profit is available at Rs. 90,000 (Rs. 270,000 – Rs. 180,000). The balance profit of Rs. 90,000 to be distributed amongst Preferred Stocks and Common Stock on the basis of their Capital Contribution as under:-

-Preferred Stock Capital	Rs. 1,000,000
-Common Stock Capital	Rs. 800,000
Total Capital	Rs. 1,800,000

Ratio Computation of balance profit

$$\frac{\text{Balance Profit}}{\text{Total Capital}} \quad \frac{\text{Rs. } 90{,}000}{\text{Rs. } 1{,}800{,}000} \times 100 = 5\%$$

Distribution of balance profit as additional Dividend

-Preferred Stock:	Rs. 1,000,000 x 5% = Rs. 50,000
-Common Stock:	Rs. 800,000 x 5% = Rs. 40,000

Total Dividend payable to each category of stockholders.
10% Preferred Stock Participating

Basic dividend	Rs. 100,000
Additional dividend	Rs. 50,000
Total dividend	Rs. 150,000

Common Stock

Basic dividend	Rs. 80,000
Additional dividend	Rs. 40,000
Total dividend	Rs. 120,000

In case the 10% Preferred Stocks have the feature of non-participating, then these stockholders would not be entitled to any additional dividend except that 10% specified rate. The entire balance profit would go to the Common Stockholders. Taking the same data, the profit is distributed as under:-

Dividend to 10% Preferred Stockholders 10,000 x Rs. 100 x 10%	= Rs. 100,000
Dividend to Common Stockholders(Entire balance profit)	= Rs. 170,000
Total dividend/ profit	= Rs. 270,000

It would be noticed from above workings that the Common Stockholders are virtually benefitted for sharing entire balance profit after dividend distribution at specified rate to the non-participating Preferred Stockholders was made by the Company. Sometimes such greater amount of dividends provides an edge to the Common Stockholder for their sharing the risk of no dividend or at lower rate dividend after the dividend to the Preferred Stockholders was disbursed at specified rate.

5.6.3 Convertible Preferred Stocks

The Preferred Stocks have priority of dividend payment over others like common stock. In case the preferred stocks are non-participating then only a specified amount of dividend is payable on it. The preferred stocks generally do not have the voting rights like common stocks. When the company is prospering and significant profit is being earned then the dividends to the common stock would definitely be higher than the specified amount or rate on the preferred stocks. Therefore, under such circumstances, the preferred stockholders would like to exercise the option of converting their preferred stocks into common stocks, if such option is available, so that they could share greater amount of dividends and also exercise voting powers and play their roles in the affairs of the company. Once the preferred stocks are converted into common stock, they would not be allowed to revert back into preferred stocks.

5.6.4 Redeemable Preferred Stocks

Sometimes when the Company requires funds for a specific period say for five years or so, for execution of some specific projects, the Company may issue redeemable preferred stock. Such stocks may be called back and retired by paying the principal amount as stated on the face of such stocks, thus assuming no liability for ever. The call price apart from the face value may also include some dividends in arrears and any premium as specified at the time of issuing such redeemable preferred stocks. The redeemable preferred stocks would be presented in the balance sheet of the Company as long term liability instead of making part of the equity capital.

5.7 ISSUANCE OF PREFERRED STOCK

The preferred stock may be issued by a corporate organization simultaneous to the issuance of Common Stocks. These preferred stocks attract the investors to the extent that such stocks carry privilege of the dividends at specified rate or amount and also priority on payment of principal amount on liquidation of the company over the common stockholders. These preferred stocks contain par or face value. The preferred stocks may be issued at par at premium or at discount likewise common stocks. However, the capital stock structure in the balance sheet would indicate the preferred stock with its specified privileges separately from the common stock. In order to illustrate the accounting entries for issuance of Preferred Stock, assume the following data.

A) Issued 4,000 15% Preferred Stocks of Rs. 100 each at par value.
B) Issued 4,000 15% Preferred Stocks of Rs. 100 each at 5% Premium
C) Issued 4,000 15% Preferred Stocks of Rs. 100 each at 8% Discount.

The accounting entries for issuance of Preferred Stocks for each alternative would be as under: -

A)	Bank Account	Rs. 400,000	
	15% Preferred stock capital		Rs. 400,000
B)	Bank Account	Rs. 420,000	
	15% Preferred Stock Capital		Rs. 400,000
	Premium on Preferred Stock Capital		Rs. 20,000

C)	Bank Account	Rs. 368,000	
	Discount on 15% Preferred Stock	Rs. 32,000	
	15% Preferred Stock Capital		Rs. 400,000

The equity section of the yearend balance sheet of the company indicating the issuance of Common and Preferred stocks (para 5.3-1 and para 5.7-A) at par value would be as under: -

Stockholders' Equity

-Common Stock 100,000 shares of Rs. 100 each authorized and issued 5,000 shares at par Rs. 100 each.	Rs. 500,000
-15% Preferred Stock 50,000 shares of Rs. 100 each authorized and issued 4,000 shares at par Rs. 100 each.	Rs. 400,000
-Retained Earnings	Rs. 100,000
Total Equity of Stockholders	Rs. 1,000,000

The equity section of the year end balance sheet of the company indicating the issuance of Common and Preferred Stocks at Premium (Para 5.3.2 and Para 5.7.B) would be as under:-

Stockholders' Equity

-Common Stock 100,000 shares of Rs. 100 each authorized and issued 5,000 shares of Rs.100 at Rs.110 each.	Rs. 500,000
-15% Preferred Stock 50,000 shares of Rs. 100 each authorized and issued 4,000 shares of Rs. 100 at Rs.105 each.	Rs. 400,000
-Premium on Common Stock	Rs. 100,000
-Premium on 15% Preferred Stock	Rs. 20,000
-Retained Earnings	Rs. 100,000
Total Equity of Stockholders	Rs. 1,120,000

The equity section of the year end balance sheet of the company indicating the issuance of Common and Preferred Stock at discount (para 5.3-3 and para 5.7-C) would be as under:-

Stockholders Equity:

-Common Stock 100,000 shares of Rs. 100 each authorized and issued 5,000 shares of Rs. 100 each at Rs. 90 each.		Rs. 500,000
-15% Preferred Stock 50,000 shares of Rs. 100 each authorized and issued 4,000 shares of Rs. 100 at Rs. 92 each.		Rs. 400,000
-Discount on Common Stock	Rs. 50,000	
-Discount on 15% Preferred Stock	Rs. 32,000	(Rs. 82,800)
-Retained Earnings		Rs. 100,000
Total Equity Stockholders		Rs. 918,000

5-8 DEMONSTRATION PROBLEMS

P.5-1

Modern Technology Company was established during August, 2018 with the following authorized capital:-

-Common Stock of Rs. 10 each	500,000 shares
10% Preferred Stock of Rs. 50 each	200,000 shares

The Company issued shares as under:-

10-09-2018	50,000 Common Stock at Rs. 10 each
20-12-2018	40,000 Common Stock at Rs. 12 each
15-09-2019	20,000 Common Stock at Rs. 9 each
10-10-2019	40,000 10% Preferred Stock at Rs. 60 each
12-10-2019	100,000 10% Preferred Stock for Plant and Equipment valuing Rs. 6,000,000
30-06-2020	Earned a profit of Rs. 900,000 during the year 2019-2020 The closing balance of Accounts Receivable amounted to Rs. 600,000 and Inventories amounted to Rs. 400,000
30-06-2020	Declared 10% dividend on Preferred and 8% dividend on Common Stock. The Accounts Payable at year end amounted to Rs. 100,000
25-07-2020	Paid dividend to 10% Preferred and Common Stockholders

Required:

A) Pass necessary journal entries until 30 June 2020.

B) Prepare balance sheet as at 30 June 2020

C) Pass necessary accounting entries for payment of Dividends on 10% Preferred and Common Stocks on 25 July 2020.

SOLUTION

A) Journal Entries

Date	Particulars	Dr	Cr
10-09-2018	Bank Account	Rs. 500,000	
	Common Stock Capital		Rs. 500,000
20-12-2018	Bank Account	Rs. 480,000	
	Common Stock Capital		Rs. 400,000
	Premium on Common Stock Capital		Rs. 80,000
15-09-2019	Bank Account	180,000	
	Discount on Common Stock Capital	20,000	
	Common Stock Capital		Rs. 200,000
10-10-2019	Bank Account	Rs. 2,400,000	
	10% Preferred Stock Capital		Rs. 2,000,000
	Premium on 10% Preferred Stock		Rs. 400,000
12-10-2019	Plant & Equipment Account	Rs. 6,000,000	
	10% Preferred Stock Capital		Rs. 5,000,000
	Premium on 10% Preferred Stock		Rs. 1,000,000
30-06-2020	Profit & Loss Account	Rs. 900,000	
	Retained Earnings Account		Rs. 900,000
30-06-2020	Retained Earnings Account	Rs.788,000	
	Dividend Payable on Preferred Stock		Rs. 700,000
	Dividend Payable on Common Stock		Rs. 88,000

Workings

Dividend on Preferred Stock: 40,000 + 100,000 = 140,000 x Rs. 50 = Rs. 7,000,000

Rs. 7,000,000 x 10% = Rs. 700,000

Dividend on Common Stock: 50,000 + 40,000 + 20,000 = 110,000

110,000 x Rs. 10 = Rs. 1,100,000 x 8% = Rs. 88,000

B) Modern Technology Company

Balance Sheet as at 30-06-2020

Current Liabilities		**Current Assets**	
Accounts Payable	Rs. 100,000	Cash	Rs. 3,560,000
Dividend payable on 10% Preferred and Common Stocks	Rs. 788,000	Accounts Receivables	Rs. 600,000
Stockholders' Equity			
-Common Stock 500,000 Shares of Rs. 10 each authorized and issued 50,000 shares of Rs. 10 each at par 40,000 shares of Rs. 10 each at Rs. 12 each and 20,000 shares of Rs. 10 each at Rs. 9 each	Rs. 1,100,000	Inventories	Rs. 400,000
		Fixed Assets	
-10% Preferred Stock 200,000 shares of Rs. 50 each authorized and issued 40,000 shares of Rs. 50 each at Rs. 60 each and 100,000 shares of Rs. 50 each at Rs. 60 each in consideration of Plant & Equipment.	Rs. 7,000,000	Plant & Equipment	Rs. 6,000,000
Premium on Common Stock **Less:** Discount on Common Stock	Rs. 60,000		
Premium on 10% Preferred Stock	Rs. 1,400,000		
Retained Earnings	Rs. 112,000		
Total	**Rs. 10,560,000**	**Total**	**Rs. 10,560,000**

C) Accounting Entries for Payment of Dividends

Date	Particulars	Dr	Cr
25-07-20	Dividend Payable on Preferred Stock	Rs. 700,000	
	Dividend Payable on Common Stock	Rs. 88,000	
	Bank Account		Rs. 788,000

P.5-2

Shadman Trading Company had 10,000 shares of 10% Preferred Stock of Rs. 100 each and 80,000 shares of Rs. 10 par value outstanding for last several years. During 2019 and 2020 the profits earned totaled Rs. 60,000 and Rs. 216,000 for each year respectively.

Required

Compute the amount of dividends that must have been paid to the Preferred and Common Stockholders each year based upon the following independent assumptions:-

A) Preferred Stock is cumulative and non- participating.

B) Preferred Stock is non-cumulative and participating.

SOLUTION

A) Dividend distribution on Preferred Stock cumulative and non-participating

1) Year 2019 Profit = Rs. 60,000

10% Preferred Stock 10,000 x Rs. 100 = Rs. 1,000,000 x 10% = 100,000
Profit available Rs. 60,000 distributed to Preferred, Stockholders Arrear dividend Rs. 40,000 Stockholders.

2) Year 2020 Profit Rs. 216,000

10% Preferred Stock Arrear of 2019	Rs. 40,000
Current year 2020	Rs. 100,000
Total dividend	Rs. 140,000
Common Stock = entire balance profit as dividend	Rs. 76,000

B) Dividend distribution on Preferred Stock non-cumulative and participating

1) Year 2019: Profit Rs. 60,000

-10% Preferred Stock 10,000 x Rs. 100 = Rs. 1,000,000 x 10% = Rs. 100,000 Available profit of Rs. 60,000 to be paid as dividend to Preferred Stockholders	No dividend as arrear because Preferred Stock is non-cumulative
-Common Stockholders	No dividend because on profit is available

2) Year 2020: Profit Rs. 216,000

-10% Preferred Stock (no arrear of year 2019)	Rs. 100,000
Participating share of dividend Rs. 1,000,000 x 2% =	Rs. 20,000
Total dividend to Preferred Stock	Rs. 120,000

-Common Stock at 10% equal to Preferred Stock Rs. 800,000 x 20%	Rs. 80,000
Participating share of dividend Rs. 800,000 x 2% =	Rs. 16,000
Total dividend to Common Stock	Rs. 96,000

Balance profit available Rs. 216,000 – Rs. 100,000 – Rs. 80,000 =Rs. 36,000 Rs. 36,000 to be distributed amongst Preferred and Common Stockholders on the basis of their Capital ratio.

Ratio

Preferred Rs. 1000,000 Rs. 36,000 x 100 = 2%
Common Rs. 800,000 Rs. 1,800,000
Total Rs. 1,800,000

5.9 SUMMARY

Larger growth in business activities specifically undertaking mega projects originated development of corporate form of business organizations through which capital was contributed by public at large. Such corporate organizations are governed under Companies Act, 2017. Their affairs are regulated to safeguard interest of investors and owners of such companies by the Securities and Exchange Commission of every country.

According to the memorandum of association the authorized Capital with different classification of shares of the Company is issued from time to time upon receipt of payment. Usual Classification of Stock comprise Common Shares and Preference shares. Some specific privileges and priorities of dividend and payment of principal amount, upon liquidation of Company, are attached to the Preferred Stock. The shares can be issued at Par, at Discount and at Premium. These shares can also be issued against initial services and expenses of promoters for establishment of the company and also in lieu of certain assets acquired by the company for use in the business against which no cash payment was made.

The dividends are paid by the Company out of the profit earned by Company for which first priority is given to the Preferred Stockholders and then to the Common Stockholders. The dividend can be paid in cash or in additional stocks as decided by the Board of Directors of the company. Sometimes when the prices of shares are considered to be greater and it is curtailing the potential investors to trade, the stocks splits are allowed by the Board of Directors. The stock split means reducing the par value of shares in certain proportion for example stock split may be 2: 1 which indicates that as against one share of Rs.100, the Company will issue two shares of Rs.50 each, against surrender of the one share of Rs.100. No accounting entries are needed upon stock split rather memorandum record is amended to give effect of stock split and quantity of issued shares is enhanced in record.

5.10 THEORETICAL QUESTIONS

1. Describe the nature of a corporate form of Organization, its functions and advantages and disadvantages.
2. Explain the authorized capital, subscribed and issued Capital of a Company.
3. What do you understand by par value, no par value, market value and stated value of Common Stocks?
4. What is the basic distinction between the Common Stock and Preferred Stock?
5. Describe the issuance of Stock at par, at premium and at discount with accounting entries on presumptive values in each case.
6. Can the shares be issued by a Company other than cash? If so, describe the situations and considerations suited in each case.
7. Explain the various alternatives available with the management of a company to distribute profit in the shape of dividends and accounting entries involved in each case.
8. Describe the objectives and procedure adopted for Stock Splits and accounting entries needed in it.
9. Describe the various classifications of Preferred Stocks in the context of dividends and payment of principal amount on liquidation of a Company.
10. Explain comprehensively about the redeemable and redeemable Preferred Stocks and how each category is presented in the balance sheet of the organization.

5.11 PRACTICAL PROBLEMS

P.5-1

Shehzor Energy Ltd was established some time back with an authorized capital of 100,000 Common Stocks of Rs. 100 each. The company invited applications for issuance of 50,000 shares through its prospectus. The applications accompanied 50% advance payment. The Company received subscriptions for 60,000 shares on 15 March 2020. The Board of Directors decided to accept the applications for 50,000 shares and return the money to the applicants of over subscription on 31

March 2020. On 15 April, 2020 the balance 50% payment was received from the successful applicants.
The shares were allotted on 30 April, 2020.

Required

A) Prepare accounting entries to record the above events.
B) Present Balance Sheet of the Company as it would appear on 30 April, 2020.

P.5-2

Fresh Poultry Ltd was organized on 05 July, 2019 with the following authorized capital:-

a) Common Stock 50,000 of Rs. 100 each.
b) 12% Cumulative Preferred Stock 50,000 of Rs. 50 each.

The Company issued 50% of each category of shares upon receipt of Cash on 15 August, 2019 at par value. The 20% shares of each category were issued upon receipt of cash with premium of 15% on each share on 20 December, 2019. The Company also issued 10,000 Common Stock against the acquisition of some machinery valuing Rs. 1,200,000.

Required

A) Pass necessary accounting entries
B) Prepare a Balance Sheet as at 30 June, 2020.

P.5-3

Sunshine Company was established some year back with an authorized capital of 500,000 Common Stocks of Rs. 50 each.

Required

1. Prepare journal entries in each of the following assumptions:-
   A) 300,000 Common Stocks are issued at par value.
   B) 300,000 Common Stocks are issued at 10% premium.
   C) 300,000 Common Stocks are issued at 5% discount.
2. Present equity section of the stockholders in Balance Sheet under each of the above assumptions.

P.5-4

The stockholders equity section of the Balance Sheet of Mahnoor Products Company appeared as under at the close of its third year of trading activities as on 30 June, 2020:-

Common Stock 50,000 shares of Rs. 100 each authorized and issued 30,000 shares of Rs. 100 at Rs. 120 each.	Rs. 3,000,000
10% Preferred Stock 20,000 shares of Rs. 100 each authorized and issued 10,000 shares at Rs. 100 each	Rs. 1,000,000
Premium on Common Stock	Rs. 600,000
Retained Earnings	Rs. 600,000
Total equity	Rs. 5,100,000

The following transactions were completed during 2020 -21:

1) Declared 10% Stock dividend on 15 July 2020 to the Common Stockholders and issued accordingly on 12 August 2020.
2) Declared cash dividend on 15 July, 2020 to the Preferred Stockholders and paid it on 15 August 2020.
3) Issued 5,000 additional Common Shares on 18 August 2020 at discount of 5% on payment.

Required

a) Pass necessary accounting entries for the above transactions.
b) Stock split 2 : 1 of Common Stocks was approved and completed on 30 August 2020.
c) Prepare stockholders, equity section of the balance sheet as at 31 August 2020.

P. 5-5

Shahzeb Manufacturing Company had issued 50,000 12% Preferred Stocks of Rs. 50 each and 20,000 Common Stocks of Rs. 50 each. The Company earned a profit of Rs. 595,000 and Rs. 250,000 during first year and second year of operation respectively.

Required

Based upon the above data, compute the amount of dividends to be paid to the 12% Preferred Stockholders and the Common Stockholders under each of the following independent assumptions:-

A) The 12% Preferred Stock is cumulative and participating
B) The 12% Preferred Stock is non-cumulative and non participating
C) The 12% Preferred Stock is cumulative and participating up to 15%

P.5-6

The draft equity sections of the Balance Sheet of Decent Trading Company at the years ended on 30 June 2019 and 2020 were as under:-

A) Stockholders' equity 30-06-2019

-Common Stock Rs. 10 par value, 50,000 shares authorized and 20,000 shares issued.	Rs. 200,000
-Premium on Common Stock	Rs. 100,000
-Retained Earnings	Rs. 150,000
Total	Rs. 450,000

B) Stockholders' equity 30-06-2020

-Common Stock Rs. 10 par value, 50,000 shares authorized and 30,000 shares issued.	Rs. 300,000
-Premium on Common Stock	Rs. 120,000
-Retained Earnings	Rs. 200,000
Total	Rs. 620,000

Following Transactions were conducted

1) On 20 July, 2019 the company declared a dividend of Rs. 2 to each of the common stockholders.
2) On 10 August 2019, the dividend declared on 20 July 2019 was paid to Common Stockholders.
3) During January 2020 the Company issued some more Common Stocks to the public.
4) On 10 July, 2020 the Company declared a dividend of Rs. 3 per Common Stock.
5) On 05 August 2020 the dividend declared was paid to the Common Stockholders.

Required

a) Compute the total amount of dividend declared for the common stockholders as on 20 July 2019.
b) Determine the total amount of dividend paid on 10 August 2019 to the Common Stockholders.
c) Compute the amount of premium per share of the Common Stocks issued during January 2020.
d) Calculate the amount of profit earned by the Company during 2019-20.
e) Compute the total amount of dividend declared for the Common Stockholders on 10 July, 2020.
f) Determine the total amount of dividend paid on 05 August, 2020 to the Common Stockholders.
g) Present the stockholders' equity section of the balance sheet as on 31 August 2020 of the Company.

P.5-7

Smart Trading Company was established during July 2019. The following equity transactions were occurred during its first year of operations apart from other business activities:-

15 July, 2021	Common Stock of 100,000 shares of Rs. 10 par value and 50,000 shares of 15% Preferred Stocks at Rs. 50 each were authorized.
20 August 2019	Issued 40,000 Common Stocks at Rs. 15 each and 30,000 shares of 15% Preferred Stocks at Rs. 60 each.
15 September 2019	Issued 30,000 Common Stock to the vender for supply of Motor vehicle having the market value of Rs. 420,000.
10 December 2019	Declared and paid an interim dividend of Rs. 02 each to the Common Stockholders on record of 31 November.
31 December 2019	The Stock split of 2 : 1 of Common Stock was approved and new shares were issued.
30 June 2020	The accounting profit for the year ended amounted to Rs. 800,000.
30 June 2020	The board of directors approved stock dividend of one Common Stock for every two Common Stocks held by the shareholders' which were issued accordingly.
30 June 2020	The Board of Directors also approved the cash dividend to the Preferred Stockholders.
20 July 2020	The Cash dividend to the Preferred Stockholders was paid.

Required

a) Record the above transactions in the accounting record of the Company.

b) Present equity section of the balance sheet of the Company as at 31 July 2020.

P.5-8

Shaheen International Hospital was established with the following authorized capital during 2016:-

- Common Stock 1,000,000 shares of Rs. 100 each
- 12% Preferred Stock 2,000,000 Shares of Rs. 50 each.

During 2016 the Hospital management had issued the stocks as under:-

- Common Stock 500,000 shares at Rs. 120 each
- Preferred Stock 1,000,000 shares at Rs. 70 each.

The Preferred Stock was non-cumulative. The Hospital Operated successfully and declared and paid the following amounts of dividend during four years to its stockholders.

2017	Rs. 4,000,000
2018	Rs. 5,500,000
2019	Rs. 10,000,000
2020	Rs. 12,000,000

Required

A) Compute the amount of dividend paid to each class of stockholders during each year of operation.

B) Determine the total amount of dividend paid to the Preferred Stockholders for all the four years.

P.5-9

The equity sections of balance sheets of Decent Manufacturing Company for the years ended on 30 June 2019 and 30 June 2020 were as under:-

Stockholders' equity 30-06-2019

Common Stock Rs. 10 par value 100,000 shares authorized, 40,000 shares issued.	Rs. 400,000
Premium on Common Stock	Rs. 80,000
Retained Earnings	Rs. 420,000
Total Equity	Rs. 900,000

Stockholders' Equity 30-06-2020

Common Stock Rs. 10 par value 100,000 shares authorized, 60,000 shares issued.	Rs. 600,000
Premium on Common Stock	Rs. 148,000
Retained Earnings	Rs. 650,000
Total Equity	Rs. 1,398,000

The undernoted transactions and events affected equity sections during 2019-2020:-

15-07-2019	Declared Rs. 2.00 per share cash dividend to Stockholders of record date 30-06-2019.
10-08-2019	Paid Cash dividend declared on 15-07-2019
20-08-2019	Declared Stock dividend of one common stock for every five Common Stocks of record date 30-06-2019. The market value of Common Stock on this date was Rs. 14 per share.
10-05-2020	Declared interim cash dividend of Rs. 1.00 per share of record date of 30-04-2020.
10-06-2020	Paid interim cash dividend declared on 10-05-2020.
15-06-2020	Issued additional 12,000 shares of Rs. 10 each at some premium.

Required

1) How many Common Stocks were outstanding on each cash dividend declaration dates.
2) Compute the cash amount paid as dividends to the common stockholders.
3) Calculate the amount of capitalization of retained earnings for the stock dividends.
4) Compute the net income earned during 2019-20.
5) Compute the premium per stock on additional shares issued on 15 -06-2020.
6) Pass necessary accounting entries for the above transactions.

P.5-10

The Common Stock of Rs. 60 par value of Boss Furniture Manufacturing Company was being traded on Stock Exchange at Rs. 90 per share during December 2018.

After one year, the stock was being traded at Rs. 120 per share. Considering the market price hike per share the board of Directors decided stock split of the Common Stock in either of the following proportions:-

a) If the Stock split is decided in the proportion of 2 for 1, at what price would you expect the stock to trade immediately after Stock Split is arranged as per forgoing ratio.
b) If the stock split is decided in the proportion of 3 for 1, at what price would you expect the stock to trade immediately after this stock split is carried out.
c) What were the objectives under consideration of the board of directors of the company for stock splits and which alternative would be most suitable for the Company and the investors as well.
d) Describe the accounting treatment for stock split.

5.12 GLOSSARY

Joint Stock Company

A form of business organization whose capital is contributed by the public at large and is governed by Companies Act, 2017.

Capital Stock

An evidence in the shape of Shares certificates for contribution of resources in a joint Stock Company by the public for conduct of business activities.

Authorized Capital

The total amount of capital ceiling approved by a forum at government level and divided into different classifications which a Company can issue to public from time to time.

Issued Capital

The amount of shares issued by a company to the public against the cash or other considerations.

Subscribed Capital

The total amount of Capital Stock for which the potential investors have expressed willingness for purchase of shares.

Called up Capital
The amount of money which was called up by the company from subscribers of shares for payment.

Paid up Capital
The amount of called up capital which has actually been paid by subscribers to the company.

Par Value
The matching amount at which a share certificated has been issued by a company as indicated on its face.

Market Value
The price at which a share is being traded by sellers and purchases at an arm's length.

No par Value
A share certificate which does not indicate on its face any denomination amount.

Stated Value
The stated value stock is no par Stock to which the directors of a company assign any stated value per share which becomes its minimum legal value.

Common Stock
A general type of share certificate which entitles the holder to the ownership of profits of the Company and the left and assets after satisfying the claims of first priority of other types of shareholders.

Share at Premium
The higher amount at which a share has been issued than its face value.

Share at discount
Any lower amount at which a share has been issued than its face value.

Owner's equity
The total amount of ownership in a company against the assets after deducting all liabilities.

Dividend
The amount of profit distributed by a company to its stockholders in the shape of cash, shares or any other form.

Interim dividend
The amount of profit distributed by a company to its shareholders during currency of the year against considerable profit anticipated by the company.

Stock dividend
The distribution of profit to the stockholders of a company in the shape of additional shares, without receipt of payment, when the company expects that cash dividend would likely involve the company in cash crunches.

Stock splits
A device adopted by the management of the Company to reduce face value of its stocks in some equally divisible proportion to facilitate its trading for potential investors.

Preferred Stock
A type of share certificate issued by a Company which contains some several privileges over the common stocks on profit distribution and payment of principal amount upon liquidation of the company.

Cumulative and non-cumulative Preferred Stocks
The cumulative preferred stock carries the privilege of specified dividend payment during succeeding year as arrears payment if current year's profit is insufficient. The non-cumulative preferred stocks do not carry such privilege as the payment of specified dividend amount would be paid only out of current year's profit and if these are insufficient, the balance amount of dividend would not be carried forward as arrear to the next accounting period.

Participating and non-participating Preferred Stocks
The participating preferred stocks would be entitled to share in the balance profit of the year on the basis of capital contribution by the Preferred and Common Stockholders after allocating the amount of dividend to the Common Stockholders equal to the preferred stockholders. The non-participating preferred stockholders would not be entitled for any additional dividend as the entire balance profit would go to the Common Stockholders.

Convertible Preferred Stocks
The option available with the preferred Stockholders to exercise it for conversion from preferred stocks into common stocks to share greater amount of dividend of the Company.

Redeemable Preferred Stocks
The option available with the company to call for the redeemable preferred Stocks, after a specified period or at any later time, when it is considered expedient for cancellation of such shares and return the money to such stockholders.

Retained Earnings
The amount of profit retained by the company, for use in future, after payment of cash or stock dividends out of it.

Unit–6

ACCOUNTING FOR CORPORATIONS REPORTING STOCKHOLDERS' EQUITY

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Reviewed by: Muhammad Munir Ahmad

CONTENTS

INTRDUCTION

This unit describes the accounting treatment of treasury Stock i.e. the shares of the company once issued, may be purchased for specific purposes. When these purposes are accomplished, these treasury stocks are sold at par, at lower than cost and at higher than cost and are accordingly accounted for. Sometimes the treasury stocks are retired to reduce the capital. The composition of stock holder's equity has also been described in this unit. The objectives of issuance of stock options have also been enlightened in it.

OBJECTIVES

After study of this unit the students would be capable to understand the followings:-

1) The nature and presentation of treasury stock in the equity section of the balance sheet.
2) The accounting treatment of disposal of treasury stocks when sold at par value of purchase cost, at above the purchase cost and at below the purchase cost.
3) Occasionally when the funds are no more needed, the treasury stock is retired reducing the subscribed and paid up capital. This has also been explained.
4) The Composition of the statement of Retained Earnings and Stock Holders' Equity Statement would enable the students as to how these are prepared.
5) The accounting treatment of Stock options which are granted to some staff having core position in the organization is explained for its appropriate understanding and presentation.

6.1 TREASURY STOCK

The Treasury Stock may be defined as the shares of the company which were issued in the past but later have been purchased by the company itself to reduce assets as well as equity of the company. A company's reacquired own shares are called as treasury Stock. The treasury stock is neither considered as an asset investment nor as an unissued stock. The treasury Stock may be held for short term or for the longer period as decided by the boards of the directors. A company may acquire its own stock by purchase, by acceptance in satisfaction of a claim or by donation from stock holders. Such shares may subsequently be re sold or formally retired. The objective for acquisition of company's own stocks may be manifold. The first objective can be to stop the payment of dividend on such treasury Stocks when a company has earned substantial profit which would be drained out with cash resources in the shape of dividends to the stockholders. Another objective may be to avoid a hostile takeover of the company by the beneficial stock holders. The third purpose of treasury Stock may be to reissue such share be to certain employees as compensation. The last but not the least objective may to support the market price of company's own shares specifically when they are of declining on the analogy of some economics rule of fixation of price on the basis of two contributing factors of demand and supply. After reacquisition of Company's own stocks, the supply in the market is reduced whereby it supports the revival of strong prices of the company's shares in the market.

The shares of Capital Stock held in the treasury are not entitled for dividend and also lose the title of voting powers or to share in the assets of the company upon its liquidation. Further the treasury stock would also not be counted in the total outstanding Stocks for computation of earnings per share and book value per share.

A listed company has the powers to purchase its own shares (Treasuring Stocks) as permitted in the Companies Act 2017. However, before acquisition of Treasury Stocks certain procedure it to be followed by it. It may commence with the presentation of a resolution for purchase of treasury Stock before the directors in the meeting. After its approval by the Board of directors, another approval from the shareholders for purchase of its own shares (Treasury Stock) is arranged through a special resolution in a general meeting of members. Such approval would be dependent upon availability of adequate funds, against the distributable profit from retained earnings, disclosure for purchase of such shares at discount or at premium and at competitive rates through tendering. Therefore, the purchase of treasury stocks requires the management of the company to exercise ethical sensitivity because funds are being paid to specific stockholders instead of all stockholders. Management of the company must be sure that purchase of treasury stock transaction is in the best interest of all stock holders. The foregoing concerns cause the company to fully disclose Treasury Stock transaction in its reports.

6.2 PURCHASE OF TREASURY STOCK

When the treasury Stock is purchased it reduces the equity balance and cash balance of the company simultaneously. The purchase of Treasury Stock can be recorded in the accounting on cost method and par value method. In order to demonstrate the accounting treatment of purchase of the treasury stock under both the foregoing methods we may assume the following data of the balance sheet of a company.

Balance Sheet as at 30 June, 2020

Liabilities		Assets	
Accounts payables	Rs. 70,000	Cash at Bank	Rs. 250,000
Dividends payable	Rs. 160,000	Accounts Receivables	Rs. 320,000
Equity		Plant and machinery	Rs. 830,000
Common stock 40,000 shares of Rs. 10 each par authorized issued and subscribed	Rs. 400,000		
Revenues Reserves	Rs. 200,000		
Premium on common Stock	Rs. 200,000		
Retained Earnings	Rs. 370,000		
Total	**Rs. 1.400,000**	**Total**	**Rs. 1,400,000**

The Company has purchased its own 10,000 Common Stocks from the stock exchange at the cost of Rs. 14 each. This cost naturally includes the par value of Rs. 10 and premium of Rs. 4 each share. The accounting entry for purchase of Treasury Stock and presentation in the balance sheet after its acquisition would be as under:-

6.2.1 COST METHOD under Cost method the total cost paid for acquisition would be charged to the Treasury Stock.

Date	Particulars	Dr	Cr
20-09-20	Treasury Stock Account Bank Account (10,000 shares X Rs. 14 each)	140,000	 140,000

Balance Sheet as at 21-09-2020

Liabilities		Assets	
Accounts payables	Rs. 70,000	Cash at Bank	Rs. 110,000
Dividends payable	Rs. 160,000	Accounts Receivables	Rs. 320,000
Equity		Plant and machinery	Rs. 830,000
Common stock 40,000 shares of Rs. 10 each par authorized issued and subscribed	Rs. 400,000		
Revenues Reserves	Rs. 200,000		
Premium on common Stock	Rs. 200,000		
Retained Earnings	Rs. 370,000		
Less Cost of Treasury Stock 10,000 shares	(Rs. 140,000)		
Total	**Rs. 1,260,000**	**Total**	**Rs. 1,260,000**

The purchase of Treasury Stock under cost method has reduced the overall equity by Rs. 140,000 which was the cost of treasury stock and the cash balance has also simultaneously been reduced by this amount.

6.2.2 PAR VALUE METHOD

When the par value method is applied for accounting the acquisition of Treasury Stock, then the par value and any premium paid would separately be treated and incorporated in the record. Taking the same data of balance sheet and purchase of Treasury Stock as at the preceding illustration at cost method, the accounting treatment under par value method would be as hereunder:-

Date	Particulars	Dr	Cr
20-09-20	Treasury Stock	140,000	
	Bank Account		140,000

10,000 shares X Rs. 10 par Value	Rs. 100,000
Premium on 10,000 shares	Rs. 40,000
Total	Rs. 140,000

The above indication of composition of the purchase of treasury stock would facilitate appropriate treatment and presentation in the Balance Sheet as under:-

Balance Sheet as at 21-09-2020

Liabilities		**Assets**	
Accounts Payables	Rs. 70,000	Cash at Bank	Rs. 110,000
Dividends Payable	Rs. 160,000	Accounts Receivables	Rs. 320,000
Equity		Plant & Machinery	Rs. 830,000
Common Stock 40,000 shares of Rs. 10 each par authorized, issued and Subscribed	Rs. 400,000		
Less Treasury Stock 10,000 shares of Rs. 10 par	Rs. (100,000)		
Revenue Reserve	Rs. 200,000		
Premium on Common Stock	Rs. 200,000		
Less Premium paid on Treasury Stock	Rs. (40,000)		
Retained Earnings	Rs. 370,000		
Total	**Rs. 1,260,000**	**Total**	**Rs. 1,260,000**

The purchase of treasury stock and accounting treatment under par value method has reduced the par value of common stock and the premium of common stock separately as was paid on its acquisition to reflect impact of each content in the equity. Further the cash balance has also been reduced by the total purchase consideration of treasury stock.

It may be noted that in both the methods of acquisition of treasury stock, the accounting entry for purchase is similar, while there is only a different treatment of presentation of the treasury stock in the balance sheet under both the methods. However, there is no change in the assets and equity of the company on net-shell basis under the cost method and under the par value method of presentation of treasury stock.

The presentation of treasury stock on the balance sheet under both the methods exhibits that two disclosures are evident. First the common stock description indicates that 10,000 shares are held in treasury learning a balance of 30,000 shares outstanding and held by public. Secondly the description of retained earning balance stands partly restricted to the extent of total amount paid on the acquisition of treasury stock which works out to Rs. 140,000 against the total available balance of Rs. 370,000. This means that in case the dividend is to be paid to stockholders, the retained earnings balance to the extent of Rs. 140,000 is not to be used for the purposes of dividend distribution.

6.3 REISSUE OF TREASURY STOCK

As annotated at para 6.1 regarding objectives behind the acquisition of treasury stocks by the company, it is evident that ultimately the treasury stock is not permanently retained by the company. As soon as the specific purposes are achieved, usually the treasury stock is disposed off. The major course of its disposal is sale in the market. The usual accounting entry would be to debit Bank Account when cash is collected and the treasury stock Account would be credited and any gain or loss on its reissue would be credited or debited to Retained Earnings Account respectively as the case may be. These fluctuations of selling treasury stock at cost, above cost or below cost are deliberated in the ensuing sub-paragraphs.

6.3.1 Selling Treasury Stock at Cost

When the treasury stock is reissued/sold at cost, the original entry when it was purchased is reversed. In this respect the accounting entry for purchase of treasury stock was recorded as at sub para 6.2-1 whereby 1,000 common stock were purchased at Rs. 140,000. When now on 15 October 2020 these 1,000 Common Stock are sold at the same price of Rs. 140,000, the following accounting entry will be recorded:-

Date	Particulars	Dr	Cr
15-10-20	Bank Account	Rs. 140,000	
	Treasury Stock Account		Rs. 140,000

After this accounting entry the cash at Bank Account would be enhanced by Rs. 140,000 and the negative balance of treasury stock shown in the equity section of balance sheet as at sub-paragraph No. 6.2-1 would be eliminated and the balance sheet figures would be revived as at para 6.2 provided no other changes were occurred due to any transactions.

The foregoing situation may be termed as ideal phenomena when no change in the market price of common stock was registered. Usually the prices of common stock fluctuate time and again an even in a day these may change several times. Therefore, accounting treatment of reissue of treasury stock at above or below cost is explained in the forthcoming sub-paragraphs.

6.3.2 Selling Treasury Stock at above Cost

Apart from other objectives for acquisition of treasury stock, the basic purpose is to support the market price of company's own stock being traded at stock exchanges. When the market price of stock is declining some shares are purchased by the company which is later sold when the prices have become stable. In this way the company can earn some gain on disposal of treasury stock provided adequate funds in working capital are available. This situation is categorized as sale of treasury stock at above cost. The gain due to difference in cost and sale price is considered to the retained earnings account through profit and loss account. Taking the same data of purchase of 1,000 common stock at Rs. 140,000 as at sub paragraph 6.2-1, if later these are sold at Rs. 160,000 on 15 October 2020 the accounting entry and presentation in the balance sheet would be reflected in the following manner:-

Date	Particulars	Dr	Cr
15-10-2020	Bank Account	Rs. 160,000	
	Treasury Stock Account		Rs. 140,000
	Gain on sale of Treasury Stock Account		Rs. 20,000

The above entry would enhance the balance of cash at Bank Account, eliminate the negative balance of treasury stock in the equity section of balance sheet and would increase the balance of retained earnings account by Rs. 20,000 as ultimately the gain on sale of treasury stock would be closed in this account through profit and loss account. Afterwards the contents of original balance sheet dated 21-09-2020 as at Para 6.2-1 would describe the changes in balance of effected accounts and would show the following revised position as at 16 October 2020:-

Balance Sheet as at 16 October, 2020.

Liabilities		Assets	
Accounts Payable	Rs. 70,000	Cash at Bank	Rs. 270,000
Dividends Payable	Rs. 160,000	Accounts Receivable	Rs. 320,000
Equity		Plant & Machinery	Rs. 830,000
Common Stock 40,000 shares of Rs. 10 each par authorized, issued and subscribed	Rs. 400,000		
Premium on Common Stock	Rs. 200,000		
Revenues Reserves	Rs. 200,000		
Retained Earnings	Rs. 390,000		
Total	**Rs. 1,420,000**	**Total**	**Rs. 1,420,000**

6.3.3 Selling Treasury Stock at below cost

Occasionally, rather in certain situations frequently, when the economic conditions in the country are deteriorating and general business phenomena is declining, because of international economic slumps , excessive rains, war threats across the borders, decline in purchasing power of public, sustained losses by the business enterprises, decline in production and consumption of consumable products, climate droughts and multiple other identical factors, the prices of stocks on the stock exchange are also adversely affected whereby the investments by several investors are sunk. Similarly if a company has purchased treasury stock and its declining prices are not expected to grow, it is considered expedient , in order to avoid bear greater loss the treasury stocks are disposal off at below the cost. In case the 1,000 common stocks which were purchased at Rs. 140,000 as at Para 6.2-1 are later on 15-10-2020 sold at Rs.115,000 i.e. below the cost, the accounting entry would be passed as under:-

Date	Particulars	Dr	Cr
15-10-20	Bank Account	Rs. 115,000	
	Less On disposal of Treasury Stock	Rs. 25,000	
	Treasury Stock Account		Rs. 140,000

As against the cost of Rs. 140,000 for purchase of the treasury Stock, these have been sold at Rs. 115,000 sustaining the loss of Rs. 25,000 on this transaction. This loss would be charged to the periodic profit and loss account against the retained earnings by decreasing its total balance. After this transaction of sale of treasury stock below the cost, the balance sheet contents as at Para 6.2-1 would be modified and would reflect the following position as at 16 October, 2020:-

Balance Sheet as at 16 October, 2020.

Liabilities		Assets	
Accounts Payables	Rs. 70,000	Cash at Bank	Rs. 225,000
Dividends Payables	Rs. 160,000	Accounts Receivables	Rs. 320,000
Equity		Plant & Machinery	Rs. 830,000
Common Stock 40,000 shares of Rs. 10 each par authorized issued and subscribed	Rs. 400,000		
Premium on Common Stock	Rs. 200,000		
Revenue Reserves	Rs. 200,000		
Retained Earnings	Rs. 345,000		
Total	**Rs. 1,375,000**	**Total**	**Rs. 1,375,000**

It would be observed from the modified balance sheet dated 16 October, 2020 as presented above as compared with the balance sheet dated 21 September 2020 as presented at – Para 6.2-1, the cash balance is increased by Rs. 115,000 being the sale proceeds of treasury stock, the retained earnings balance is reduced by Rs. 25,000 being the loss on sale of treasury stock at lesser than its cost, while the reduction of treasury stock balance of Rs. 140,000 would altogether be eliminated from equity section of the revised balance sheet dated 16 October, 2020 after its disposal.

It is relevant to add here, that some school of thoughts do not support to reflect the gain or loss on sale of treasury stock directly in the profit and loss account and then into retained earnings account. They usually support to use directly the retained earnings account or the premium on common stock Account in case of adjustment of gain or loss on disposal of the treasury stocks. However, it depends upon the policy of the company to adopt any course of treatment of such gain or loss.

6.4 RETIRING STOCK

The Companies Act, 2017 allows that the capital stock can be reduced or retired without prejudice to the claims of creditors on the company and if the articles of association permit by doing so and a special resolution to this effect is passed. The stock can be retired to the extent of unpaid share capital, lost or unrepresented assets (in case of assets lost by fire etc) and any excessive capital which cannot beneficially be used by the company for profitable business activities. The retirement of capital stock against any excessive capital, already issued can be performed through its purchase as treasury stock and then its formal retirement and elimination from the issued capital stock. Thus the retired stock reduces the number of issued shares. When Treasury Stock is purchased with the objectives of its retirement, all its related accounts are removed. In case the purchase price of stock is greater than its issued price, the difference is debited to the retained earnings and vice versa. Further, if the net amount removed from capital account exceeds the purchase price of Stock, this excessive amount is credited to the premium on common stock account of equity section. The cash balance of the company would be reduced parallel to the reduction in equity balance for the retiring stock of the company.

In order to illustrate the accounting treatment of retirement of stock, we may assume the same data as was taken at sub paragraph 6.2-1 of the company when the treasury stock was purchased and accounted for in the books at cost method. Later the company has decided to retire the capital stock to the extent of treasury stock. The accounting treatment for the retirement of stock and the status of balance sheet would represent as under:-

Date	Particulars	Dr	Cr
25-09-2020	Capital Stock Accounts	Rs. 100,000	
	Premium on Common Stock Account	Rs. 40,000	
	Treasury Stock		Rs. 140,000

The Company had originally issued the common stock of Rs. 10 par value at Rs. 15 which included Rs. 5 as premium on each common stock. This is evident from the total Premium on Common Stock of Rs. 200,000 for 40,000 common issued, for which the premium per share works out to Rs. 5 (Rs. 200,000/40,000 shares). The capital stock account is being debited by the same amount of Rs. 10 per share of 10,000 common stock totaling to Rs. 100,000 at which price the capital stock account was originally credited at par value. The premium of Rs. 40,000 paid for acquisition of 10,000 common stock (Rs. 4 per share) is being debited to the premium on common stock account to remove its corresponding balance of premium while the difference amount of Rs. 10,000 (Rs. 50,000-Rs. 40,000) will remain in the premium on common stock. This is in fact a gain from issuance and retirement of capital stock which would be treated as capital gain instead of treating it as revenue income for crediting it to the retained earnings account. However, in case of some loss on acquisition of treasury stock and then its retirement the same can be debited to the retained earnings account as a conservative approach. The balance sheet of the company after retirement of 10,000 common stocks as annotated in the foregoing portion would appear as under:-

Balance Sheet
As at 26-09-2020

Liabilities		Assets	
Accounts Payables	Rs. 70,000	Cash at Bank	Rs. 110,000
Dividends Payable	Rs. 160,000	Accounts Receivables	Rs. 320,000
Equity		Plant & Machinery	Rs. 830,000
Common Stock 40,000 shares of Rs. 10 each par authorized, issued and subscribed 30,000 shares of Rs. 10 each par (10,000 shares retired)	Rs. 300,000		
Premium on Common Stock	Rs. 160,000		
Revenue Reserves	Rs. 200,000		
Retained Earnings	Rs. 370,000		
Total	**Rs. 1,260,000**	**Total**	**Rs. 1,260,000**

This balance sheet is different from the balance sheet as presented as para 6.2-1 on the following three aspects:

a) The issued and subscribed common stock is reduced from Rs. 400,000 to Rs. 300,000 after retirement of 10,000 common stock of Rs. 10 each par value.

b) The premium on common stock is reduced from Rs. 200,000 to Rs. 160,000 for the amount of Rs. 40,000 on account of premium paid on acquisition of 10,000 common stock and subsequently retired.

c) The cost of treasury stock of Rs. 140,000 shown as negative balance is eliminated after retirement of 10,000 common stock. However, the total balance of assets and liabilities with equity are corresponding to each other.

6.5 REPORTING OF EQUITY

The owners' equity in a company is commonly called as stock holders' equity, shareholders' equity, shareholders' investment or capital of owners. Generally the stockholders' equity comprises the contributions in a corporate business enterprise by owners in the shape of cash resources and fixed assets. The company in turn issues common stock alternatively called as ordinary shares and also Preferred Stocks. The redeemable preferred stocks are usually not included in the equity rather these are reported as long term liabilities. The equity also includes some reserves created out of past profit, premium on issuance of capital stock and also the balance of retained earnings after deduction of prepared dividends. All the assets held in an enterprise are usually acquired out of the current and long term liabilities and also through owners' equity.

6.6 STATEMENT OF RETAINED EARNINGS

The retained earnings are an integral part of the owners' equity of a corporate enterprise. After determination of periodic net income or loss through preparation of the Profit and Loss Account or Income Statement the resultant balance of net income is transferred to the statement of retained earnings. This amount is added up in the opening balance of retained earnings brought forward from the last year's closing balance of retained earnings. Out of the total balance available from the retained earnings any prior years' adjustments directly affecting the Profit or loss are incorporated in it. Besides any amount of profits decided by the management for appropriation towards revenue and capital reserves, to be used in future for meeting any revenue requirements or for expansion of business activities and acquisition of fixed assets, is deducted from it. Further the amount of dividends in the shape of interim, cash and stock dividend approved by the board of Directors is deducted from the balance of retained earnings and its net closing balance is reported in the equity section of the balance sheet of the company. A usual format of the retained earnings statement of a company can be presented in the following manner:-

Statement of retained earnings as at 30-06-2020

Opening balance	Rs. 212,000
Less: Prior year's loss on valuation of inventories damaged	Rs. (10,000)
Net balance as on 01-07-2019	Rs. 202,000
Add: current year's net income as per income statement	Rs. 528,000
Total earnings available	Rs. 730,000
Less: Amount set aside for revenue reserves 200,000 and proposed dividends of Rs. 160,000 on common stocks	Rs. (360,000)
Closing balance as on 30-06-2020	Rs. 370,000

The amount of proposed dividend would be reported as current liability in the balance sheet as at 30 June, 2020 while the closing balance of Rs. 370,000 of the statement of retained earnings would be included in the equity section of the stock holders in the balance sheet as at 30 June, 2020 of the company.

6.7 STATEMENT OF STOCKHOLDERS' EQUITY

During conduct of business activities, several transactions relating to the owners' equity section of the balance sheet of a company affect the total equity of the enterprise. Instead of portraying such changes and adjustments in the body of the owners' equity section of the balance sheet, to avoid its complicated presentation, a separate statement of stockholders' equity is prepared by most of the organizations to indicate the workings of each figure of the stockholders' equity. Based upon the data in the foregoing deliberations of the company the statement of stockholders' equity may be drawn as per following: -

Statement of Stockholders' Equity for 2019-20

Particulars	No. of Common Stocks	Amount of Common stock at par	Premium Common Stock	Revenue Reserves	Retained Earnings	Total Balance
Opening Balance on 01-07-20	Rs. 40,000	Rs. 400,000	Rs. 200,000	-	Rs. 212,000	Rs. 812,000
Less: Acquisition of treasury stock and retirement	(Rs.10,000)	(Rs.100,000)	(Rs.40,000)	-	-	(Rs. 140,000)
Less adjustments of Retained Earnings of last year	-	-	-	-	(Rs. 10,000)	(Rs. 10,000)
Add Net income for year	-	-	-	-	Rs. 528,000	Rs. 528,000
Amount Allocated to revenue reserves	-	-	-	Rs. 200,000	(Rs.200,000)	-
Proposed dividends	-	-	-	-	(Rs.160,000)	(Rs. 160,000)
Closing balance as on 30-06-20	Rs. 30,000	Rs. 300,000	Rs. 160,000	Rs. 200,000	Rs. 370,000	Rs. 1,030,000

The above Comprehensive Statement indicates the moments in Stockholders' equity during the year 2019-20. It has been started with the opening balances of various contents and the changes occurred during the year for each item has been presented in it. The closing balance of each content would be presented in the stockholders equity section of the balance sheet prepared as at 30 June, 2020 of the enterprise. It would be noted that all the above details could not be presented in the body of balance sheet; hence preparation of separate statement was necessitated.

6.8 REPORTING STOCK OPTIONS

The Stock Option means some entitlement granted to certain group of employees of the organization to purchase some stock of the company during subsequent period of time say 5 years to 10 years at a predetermined price. The objectives to issue stock options is to motivate managers and employees to focus on better performance of the company, continue to serve the company for longer period and participate in the profitability of the enterprise. This stock option provided to the employees is like an opportunity of investment with no risk of loss, available with employees which can be exercised. In order to illustrate the exercise of stock options, assume that a company has, at the time of their recruitment, provided stock options to employees to purchase 10,000 shares of the company of the par value of Rs. 10 at Rs. 50 each during succeeding 5 years. The employees would definitely exercise the available option of purchase of stocks during any time over 5 years when the market price of such stocks is exceeding Rs. 50 and get benefit of price escalation of stocks apart from dividends on it. If the market price of such stock during 5 years' period is lesser than Rs. 50 each share, they will never exercise such options available with them and would let them expire.

From the accounting point of view when stock options are allowed to the staff at their recruitment, only memorandum indication is made in the stockholders' ledger about such granted options. However, over the period of time of exercising the stock options when the pricing trend of stocks is escalating in the market then any difference in the stock option price and the market price is charged as staff salaries expense account over some years proportionally and credited to the obligations for stock options account. When such stock options are exercised the obligation of stock option account is squared off and the par value of stocks with premium on it is included in the subscribed and issued capital and the Premium on Common Stock Account respectively. This is further illustrated through an example. A company had issued options for purchase of common stock of Rs. 10 each par value at Rs. 50 each during next 5 years by the staff. This position would be indicated in the capital stock ledger as memorandum information. The staff would not exercise the option of stock purchase till the market price is up to Rs. 50 per common stock. However, when the market price exceeds Rs. 50 per common stock, then the chances for exercise of stock option purchase by the staff becomes definite due to financial benefits to the staff. In case the market price of common stock during third year has reached at Rs. 70 each, now the option for purchase of common stock by employees from the company would be definite. Therefore, the company would incorporate the following entry into accounting record to recognize this obligation:-

Date	Particulars	Dr	Cr
15-08-2024	Staff Salaries Expense Account	Rs. 200,000	
	Stock Option Obligation Account		Rs. 200,000

When the stock purchase option is exercised the following accounting entry would be passed:-

Date	Particulars	Dr	Cr
20-09-2024	Bank Account	Rs. 500,000	
	Stock Option Obligation Account	Rs. 200,000	
	Capital Stock Account		Rs. 100,000
	Premium on Capital Stock Account		Rs. 600,000

The Staff salaries expense account will be closed into periodic profit and loss account while the stock option obligation account would be adjusted when the common shares are issued to the staff.

6.9 DEMONSTRATION PROBLEMS

DP.6-1

The stockholders' equity section information of the balance sheet of ABC Company as on 30 June, 2020 was as under:-

Stockholders' Equity

50,000 common stock of Rs. 10 each par authorized and 40,000 common stock of Rs. 10 each par subscribed and issued at Rs. 20 each.	Rs. 400,000
Premium on Common Stock	Rs. 400,000
Retained Earnings	Rs. 500,000
Total equity	Rs. 1,300,000

The following transactions took place during July-August 2020:-

a) On 15 July, 2020 the management decided to purchase 15,000 common stocks from the market at the prevailing price of Rs. 25 each.
b) On 25 July, 2020 the Board of Directors decided which was approved in the annual general meeting to declare and pay cash dividend of Rs. 3 per common stock on the record date of 20 July, 2020.
c) On 30 July, 2020 the management decided to sell remaining 4,000 common stock at Rs. 30 each.

Required

1) Record the above transactions in the books of accounts of the company.
2) Present the Stockholders' Equity section of the balance sheet of the company as at 31 August, 2020.

SOLUTION

i) General Journal Entries

Date	Particulars	Dr	Cr
15-07-20	Treasury Stock Account	Rs. 375,000	
	Bank Account		Rs. 375,000
25-07-20	Retained Earnings	Rs. 75,000	
	Dividends Payable		Rs. 75,000
25-07-20	Dividends Payable	Rs. 75,000	
	Bank Account		Rs. 75,000
30-07-20	Bank Account	Rs. 125,000	
	Treasury Stock Account		Rs. 125,000
10-08-20	Bank Account	Rs. 132,000	
	Less on disposal of treasury stock	Rs. 18,000	

	Treasury Stock Account		Rs. 150,000
10-08-20	Retained Earnings Account	Rs. 18,000	
	Less on disposal of treasury stock		Rs. 18,000
20-08-20	Bank Account	Rs. 120,000	
	Treasury Stock Account		Rs. 100,000
	Gain on disposal of Treasury Stock		Rs. 20,000
20-08-20	Gain on disposal of treasury stock	Rs. 20,000	
	Retained Earnings Account		Rs. 20,000

ii. Part Balance Sheet as at 31 August 2020

Stockholders' Equity

50,000 common stock of Rs. 10 each par authorized and 40,000 common stock of Rs. 10 each par subscribed and issued at Rs. 20 each.	Rs. 400,000
Premium on Common Stock	Rs. 400,000
Retained Earnings	Rs. 427,000
Total Stockholders' equity	Rs. 1,227,000

The balance of Retained Earnings is computed as under:-

Opening balance as per balance sheet as at 30 June, 2020.		Rs. 500,000
Less: Dividend declared	Rs. (75,000)	
Loss on disposal of treasury stock	Rs. (18,000)	
Add: Gain on disposal of treasury Stock	Rs. 20,000	(Rs. 73,000)
Closing balance as at 31 August 2020		Rs. 427,000

DP.6-2

Following was the stockholders' equity information of the balance sheet of Subhan Enterprise, Labor as at 30 June, 2019:-

Stockholders' Equity

Common stock 200,000 of Rs. 50 each par value authorized and 120,000 common stock of Rs. 50 each par subscribed and issued at Rs. 60 each.	Rs. 6,000,000
Premium on Common Stock	Rs. 1,200,000
Retained Earnings	Rs. 2,250,000
Total Stockholders' equity	Rs. 9,450,000

During July, 2019 following transactions took place by the company:-

15 July 2019 The Company declared a cash dividend of Rs. 8 per common stock.

20 July 2019 a revenue reserve of Rs. 600,000 was created from the retained earnings.

10 August 2019 the Company acquired its own common stock of 20,000 from the market at Rs. 55 each.

05 September 2019 The Company decided to retire the Treasury Stock of 20,000 common shares acquired from the market as sufficient liquid surplus funds were available.

Required

A) Pass necessary accounting entries for the above transactions.

B) Prepare Retained Earnings Account as at 30 September, 2019.

C) Draw the stockholders' equity section of the balance sheet of the Company as at 30 September, 2019.

SOLUTION

A) General Journal

Date	Particulars	Dr	Cr
15-07-19	Retained Earnings Account	Rs. 960,000	
	Dividends Payable Account		Rs. 960,000
20-07-19	Retained Earnings Account	Rs. 600,000	
	Revenue Reserve Account		Rs. 600,000
10-08-19	Treasury Stock Account	Rs. 1,100,000	
	Bank Account		Rs. 1,100,000
05-09-19	Capital Stock	Rs. 1,000,000	
	Premium on Common Stock	Rs. 100,000	
	Treasury Stock		Rs. 1,100,000

B) Retained Earnings Account as at 30 September, 2019

15-07-19	Dividend Payable	Rs. 960,000	01-07-19	Opening Balance	Rs. 2,250,000
20-07-19	Revenue Reserve	Rs. 600,000			
30-09-19	Closing Balance	Rs. 690,000			
	Total	**Rs. 2,250,000**		**Total**	**Rs. 2,250,000**

C) Stockholders' Equity (30-09-2019)

Common stock 200,000 of Rs. 50 each par value authorized and 100,000 common stock of Rs. 50 each par subscribed and issued at Rs. 60 each, 20,000 Common Stock acquired as treasury stock at Rs. 55 each and retired.	Rs. 5,000,000
Premium on Common Stock	Rs. 1,100,000
Revenue Reserve	Rs. 600,000
Retained Earnings	Rs. 690,000
Total Stockholders' Equity	**Rs.7,390,000**

6.10 SUMMARY

The Joint Stock Companies, where stocks are traded at stock exchanges, sometimes, in order to avoid release of dividends, when colossal amount of profit has been earned, support market prices when its prices are declining, acquire some shares for distribution to its employees and impede the hostile objectives of some group of investors. The acquisition of Company's own shares is classified as treasury stock. It is neither an investment nor reduction in shares capital of the company. After attaining the specified objectives these treasury stocks are sold in the market. When the treasury stocks are acquired, the price paid is shown as negative balance in the equity section of balance sheet of the company. Later when these treasury stocks are sold out, which may be equal to its purchase price, above the purchase price or below the purchase price the resultant gain or loss is adjusted against the retained earnings.

Further, after acquisition of treasury stock when the company has sufficient liquid resources and do not require so much capital, such treasury stock may be retired and the subscribed and issued capital may be reduced.

The equity section of balance sheet of the company comprises the capital stock issued at par value, premium on issue of shares at above the par value and discount on issue of shares at below the par value. The discount will be a negative balance. Apart from it, any capital and revenue reserve created out of profits in the past or current period would also be a part of the equity. Besides the balance of retained earnings, after distribution of dividend to shareholders, would also be a part of the equity.

Sometimes while recruiting certain staff the company may grant them entitlement to purchase the shares of the company at some specified price over some period of time. The objectives of stock option are to inspire such staff to stay with the company for longer period of time, motivate them to focus on better performance of the company for participation in the profit of the company and their feelings for their ownership in the company. Such stock options are definitely exercised by the staff when market prices are greater than the specified price at which the stock option was given by the company. In case the market price of shares is lesser than the specified price of stock option then it would never be exercised by the staff. Any difference in stock option price and the market price would be charged by the company to staff salaries expense account.

6.11 THEORETICAL QUESTIONS

1) What do you understand by treasury stock, what are its objectives for acquisition?
2) State as to how the treasury stock is treated in the books of accounts of the company.
3) Describe the accounting treatment of disposal of treasury stock at cost, above the cost and below the cost.
4) Explain to what extent the treasury stock can be acquired by a company.
5) Describe as to why the treasury stock is not treated as an investment in the accounting record likewise on the purchase of stocks of other companies.
6) Can the treasury stock be used for retiring of capital stock of the company?
7) What are the contents of the Retained Earnings statement of a company?

8) Describe comprehensively the composition of stockholders' equity of a joint stock company.
9) What do you understand by the term stock options and its objectives?
10) What accounting disclosure and treatment is mandatory for stock options offered by the company and when these options are exercised.
11) Explain the circumstances when the stock options would be exercised.
12) Is it possible that stock options would definitely be exercised by beneficiaries?

6.12 PRACTICAL PROBLEMS

P.6-1

Kashif Industries Ltd was established with an authorized capital of 50,000 common shares of Rs. 100 each. The company issued 30,000 shares at Rs. 140 each. Later the company purchased its 5,000 shares at Rs. 150 each from the market. The revenue reserves and retained earnings balance were amounting to Rs. 800,000 and Rs. 1,000,000 respectively at that time.

Required

A) Pass necessary accounting entries for acquisition of treasury stock by the company.
B) Present equity section of balance sheet of the company.

P.6-2

Wajid Trading Company Ltd was organized during 2015 with an authorized capital of 100,000 Common Stock of Rs. 50 each. The company had issued 70,000 Common Stock at a premium of Rs. 20 each. The operation of company was quite successful over several years. It transferred an amount of Rs. 600,000 in revenue reserves during past. Currently it had a balance in the retained earnings of Rs. 700,000. The Boards of Directors decided to acquire 4,000 Common Stock from the market which had the prevailing market price of Rs. 100 each. The balance of Rs. 568,000 was available in the retained earnings after payment of dividends by the company. Later the company sold out the treasury stocks. Following independent situations are to be considered for the company.

Required

a) Pass accounting entries for purchase of treasury stock by the company and present the equity section of balance sheet of the company.
b) Later, these stocks were sold at Rs. 100 each. Pass accounting entries and draw equity section of balance sheet of the company.

c) In case the treasury stock are sold at Rs. 120 each, pass necessary accounting entries and present equity section of balance sheet of the company.
d) The treasury stocks are sold at Rs. 85 each. Pass necessary accounting entries and draw equity section of balance sheet of the company.

P.6-3

Subhan Industries, Jhelum was established about 10 years ago with an authorized capital of 500,000 Common Stock of Rs. 100 each. The Company had issued 300,000 Common Stocks at Rs. 130 each in the past. The balance of revenue reserves and retained earnings as appearing in the equity section of the balance sheet was amounting to Rs. 800,000 and Rs. 650,000 respectively apart from the Premium on Common Stock Account. The Company last year purchased its common stock of 50,000 at Rs. 125 each and retained it. During current year the Board of Directors decided to retire the common stock equivalent to the purchase quantum as the volume of business was facing market slump.

Required

a) Prepare necessary accounting entry for purchase of own common stock by the company from the market as of last year.
b) During current year prepare necessary accounting entries for retirement of the common stock purchased during last year.
c) Prepare equity section of the balance sheet of the company separately as of the last year after purchase of common stock and of the current year after retirement of certain portion of the common stock of the company.

P.6-4

Reliance Medical Complex Ltd was established some years back under Companies Ordinance with 1,000,000 Common Stock of Rs. 100 each. The Company issued 600,000 Common Stock at Rs. 120 each and 200,000 Common Stock at Rs. 140 each during past period with different intervals. The medical services business was quite profit able and until June, 2019 it had developed reserves of Rs. 3,000,000 and balance of retained earnings of Rs. 2,000,000 after distributing dividends to the shareholders every year as decided by the board of directors and the shareholders. After creeping the Covid-19 pandemic the number of patients visiting the medical complex drastically reduced which affected the medical services business. The company then had sufficient liquid resources and purchased own common stock of 100,000 at Rs. 90 each from the market during end of June, 2020. Noticing the gradual declining trend of business activities the board decided during September, 2020 to retire the common stock to the extent of shares purchased by it from the market.

Required

a) Record the purchase of Common Stock in the books of accounts of the company.
b) Present the equity section of the balance sheet as at 30 June, 2020.
c) Record the partly retirement of the common stock purchased from the market.
d) Present the equity section of the balance sheet as at 30 September, 2020.

P.6-5

Asif Trading Ltd was established during 2017 with an authorized capital of 200,000 common stock of Rs. 50 each. The Company issued 150,000 Common Stock to the public at Rs. 60 each during August, 2017 and continued business. During past two years the performance of the company registered sufficient profitability and after payment of dividends to the shareholders had the balance of Rs. 750,000 in the Retained Earnings Account as on 30 June, 2020 apart from the Premium account. The company purchased it own 20,000 common stocks during August 2020 from the market at Rs. 52 each. These shares were sold at Rs. 48 each and Rs. 55 each in the proportion of 50% at each occasion during January, 2021.

Required

a) Record the purchase of own Common Stock by the company during August 2020 and present the equity section of the balance sheet as at 31 August, 2020.
b) Record the sale of Common Stocks during January, 2021 which were purchased during August 2020 and also present the equity section of the balance sheet as at 31 January, 2021.

P.6-6

Ahmad Furniture Manufacturing Company Ltd was established during 2010 with an authorized capital of 200,000 Common Stock of Rs. 100 each. The company issued 100,000 Common Stocks to the public at the premium of Rs. 50 each during February, 2011. Simultaneously during March-June, 2011 Stocks Options for purchase of 10,000 Common Stocks at Rs. 200 each, over a period of 05 years were granted to the core staff in order to motivate them. The market price of Common Stock of the Company gradually escalated over several years and by the end of 2015 the market price of stocks of the company mounted to Rs. 250 each common stock. Considering this potential trend of market price of the shares the staff of the company exercised during fourth year the purchase option at 80% while the balance 20% staff was still under hesitation. The company recorded the stock option obligations enabling to issue shares upon demand as promised. The stocks against 80% options were accordingly issued up till June, 2016.

Required

a) Record all the above events in the accounting and memorandum record of the Company during the period from 2010 to 2016.

b) Present equity section of the balance sheet of the company as at 30 June, 2016.

P.6-7

The Life Saving Drugs Manufacturing Company Ltd was established during 2016 with an authorized capital of 500,000 Common Stocks of Rs. 100 each. The Company issued 400,000 Common Stocks during July, 2017 at a premium of Rs. 30 each. During July 2018 some technical and marketing staff was recruited to whom apart from salary package, the purchase of Stock Options of 20,000 shares at Rs. 150 each over a period of three years was also granted to them. The market price of shares of the company fluctuated from time to time and by the end of May 2021 the prevailing price touched the ceiling of Rs. 165 each. All the employees exercised the Stock options as committed by the company.

Required

a) Record all the above transactions in the accounting and memorandum record of the company.

b) Present the equity section of the balance sheet of the company as at 30 June, 2021.

P.6-8

Alamgir Company Ltd has presented the following components of the stockholders' equity of the balance sheet as at 30 June 2018:-

Stockholders' Equity

Common stock Rs. 50 par value 100,000 shares authorized 60,000 shares issued and outstanding.	Rs. 3,000,000
Premium on Common Stock	Rs. 1,800,000
Retained Earnings	Rs. 940,000
Total Equity	Rs.5,740,000

During 2018-19 the following transactions were conducted which were related to the stockholders' equity.

20 July 2018	Purchased 5,000 shares of its own Stock from the market at Rs. 60 per share.
25 July 2018	Directors declared Rs. 5 per share on record date of 24 July 2018 as cash dividend payable within 60 days.
20 September	Paid the dividend as declared during July 2018.
15 November	Sold the treasury Stock at Rs. 70 per share
31 December	Directors declared an interim cash dividend of Rs. 2 per share to be paid within 60 days.
28 February	Paid the interim dividend in cash.
24 May	The directors approved re appropriation of Rs. 500,000 towards revenue reserve
30 June	The income Statement showed a pretax profit of Rs. 800,000 for the year 2018-19. The tax rate is 30%

Required

a) Record the above transactions in the books of accounts of the company.

b) Prepare a statement of retained earnings for the year ended 30 June, 2019.

c) Draw the stockholders equity section of the balance sheet as at 30 June, 2019 of the company.

P.6-9

The equity sections of balance sheets of Good Luck Trading Company Ltd as at the close of two years follows:-

Stockholders' equity as at 30 June, 2019

Common stock Rs. 50 par value 60,000 shares authorized and 35,000 shares issued and outstanding.	Rs. 1,750,000
Premium on Common Stock	Rs. 700,000
Retained Earnings	Rs. 350,000
Total Equity	Rs.2,800,000

Stockholders' Equity as at 30 June, 2020

Common stock Rs. 50 par value 60,000 shares authorized and 45,000 shares issued and outstanding 2,000 common stocks on treasury.	Rs. 2,250,000
Premium on Common Stock	Rs. 990,000
Retained Earnings	Rs. 670,000
	Rs. 3,910,000
Less: Cost of treasury stock	(Rs. 130,000)
Total Equity	Rs.3,780,000

During the year 2019-20 the following events took place: -

20 August 2019	A Cash dividend of Rs. 5 per common share was declared on the record date of 1 August 2019.
15 September 2019	The declared cash dividend was paid
30 September 2019	Purchase treasury stock at Rs. 130,000 cost.
15 March 2020	Declared a stock dividend of 10% of outstanding shares. The market value of Stock was amounting to Rs. 70 per share.
05 April 2020	Issued stock dividend as approved by the board of directors.
20 June 2020	Declared and paid interim cash dividend of Rs. 3 per share outstanding.

Required

a) How many common stocks were outstanding on each cash and stock dividend payment/issuance date?
b) What is the rupee's amount for each cash dividends?
c) Compute the amount of capitalization of retained earnings for stock dividend during March, 2020.
d) Workout the per share cost of Treasury stock purchased.
e) How much net income was earned by the company during 2019-20?

P.6-10

Bismillah Trading Company Ltd reported the undernoted components of the stockholders' equity section of its balance sheet as at 30 June, 2020:-

Common stock Rs. 20 par value, 500,000 shares authorized 300,000 shares issued and outstanding.	Rs. 6,000,000
Premium on Common Stock	Rs. 4,500,000
Retained Earnings	Rs. 1,850,000
Total Equity	Rs.12,350,000

The Company Conducted the following transactions relating to stockholders' equity during 2020-21:-

15 July 2020	Purchased 50,000 Common Stock of its own company at Rs. 40 each.
10 August 2020	The Board of Directors recommended and shareholders in its Annual General Meeting approved the cash dividends of Rs. 4 per share on the record date of 31 July 2020.
15 September 2020	Paid Cash dividend as approved.
12 October 2020	Sold Treasury Stock of 30,000 shares at Rs. 50 each.
05 September 2020	Sold balance treasury stock of 20,000 shares at Rs. 35 each.
05 January 2021	The Directors declared an interim cash dividend of Rs. 1.50 each share on record date of 31 December 2020.
20 January 2021	The interim cash dividend was paid.
30 June 2021	Closed the net income of Rs. 830,000 for the year 2020-21 to the retained Earnings Account.

Required

a) Prepare general journal entries for the above transactions.
b) Draw a schedule of Retained Earnings for the year ended on 30 June 2021.
c) Prepare the stockholders equity section of the company's balance sheet as at 30 June, 2021.

6.13 GLOSSARY

Treasury Stock

The Company's own shares which were issued to public but later purchased and retained for some period for some specific purposes

Retiring Stock
The shares once issued to the public and subsequently acquired and retired to curtail the issued capital when the funds are no more needed by the organization for effective usage.

Equity
The total amount of claims of owners on assets. The equity is composed of the amount of capital contributed by owners, Premium on shares, Capital and revenue reserves, retained earnings and any surplus on valuation of assets or liabilities of the enterprise. The equity is also computed by deducting all liabilities from the assets.

Retained Earnings
The amount of net income retained in the organization after distribution of dividends to the stockholders and any other re appropriations carried out from the profit.

Stock Options
The privilege or entitlement granted to the specific staff of the company to purchase shares of the company at predetermined rates within a specified period to motivate them and stay in the organization for longer period of time.

UNIT–7

LONG TERM LIABILITIES

Written by: Muhammad Ashraf Bhutta
Reviewed by: Muhammad Munir Ahmad

CONTENTS

INTRODUCTION

This unit deals with the issuance of long term Bonds Payable which is issued in order to meet long term funds requirements. The bonds are classified as long term liability in the accounting record. The interest accrued thereon is a periodic expense. The bonds can be issued at par value, at discount and at premium. The discount and premium are caused because of lower or higher interest rates respectively as compared with the market interest rates. The discount and premium are amortized over the bonds life. Another may of medium term financing is borrowing funds at interest and issuing notes payable which are repaid according to the terms agreed between borrowers and lenders.

OBJECTIVES

After study of this unit, the students would become conversant to the followings:-

a) The nature and patterns of issuance of bonds to meet funds requirement for a longer period.

b) Issuance of bonds at par, at discount and at premium when lower or higher interest rates are applicable on these bonds respectively as compared with the contemporray market rates and reputation of the bonds issuing organization.

c) Amortization of bonds discount and premium over the life of bonds as adjustment against interest.

d) Issuance of Notes Payable for funds borrowed from bank on long term basis, their payment including interest.

e) Retirement of Bonds at maturity or before maturity and conversion into shares as per the call option available to the organization.

7.1 BASICS OF BONDS

The Bond is an indenture issued by an organization or a government unit indicating name of the holder or otherwise as a bearer, face value, and term of maturity, rate and amount of interest payable on annual basis as a promise. Therefore, it is treated as a legal trust between the issuer and the holder of Bond. The bond document acknowledges indebtedness by the company which are consecutively numerically numbered. Some of the existing assets or additional assets to be created from the bond funds are offered as collateral.

7.2 BOND FINANCING, TRADING AND ISSUING PROCEDURES

7.2.1 Bond Financing

The Bonds are issued usually by commercial and industrial undertakings apart from the government units for meeting its long term financing requirements of acquisition of capital assets and execution of mega projects which are otherwise not possible from short term loans and capital stocks. An organization may need more funds than any single lender can supply. As such the funds are generated from multiple sources of public and organizations. When the organizations require a large amount of capital funds in millions of rupees, these generally sell additional shares of capital stock or alternatively prefer to issue Bonds. The amount of interest is paid periodically on bonds and in certain cases at the end of maturity of bonds according to its terms of sale.

7.2.2 Advantages of Bond Financing

There are numerous advantages for Bond Financing by the organizations which are described as under:-

A) Interest on Bond reduces tax burden. The interest on bonds is allowed as business expense of the organization by the tax laws when the funds generated from issuance of bonds are used for business purposes. Contrary to it, the distribution of dividend on the funds acquired on issuance of shares by a company is not subject to any tax rebate. Approximately 30% of the amount of interest on bonds provides tax savings to the Company. Therefore, this mode of financing is usually adopted by the organizations as a preferred source.

B) Bonds have no control over ownership. The bond holders are classified as creditors of the Company. They are not treated as the owners of the company likewise the shareholders. Therefore, the bondholders do not affect in any manner in the affairs of the company for any decision making. In view of it, the owners of the company prefer the bond financing instead of equity financing. Bondholders also do not posses any voting rights hence they cannot participate in any statutory meetings of the Company for any purposes.

C) Bonds can enhance return on equity. The earnings generated from the bond financing, after payment of due interest thereon, contribute towards the greater profitability of the enterprise which ultimately promotes the return on equity as the profit is ownership of the stockholders for all practical purposes.

7.2.3 Disadvantages of Bond Financing

There are certain disadvantages attributing towards the bond financing as compared with the equity financing. Some are enumerated as below:-

A) Bonds can reduce return on equity. When the funds borrowed through bonds are not effectively and efficiently utilized by the borrowers for generating handsome amount of revenues and profits as compared with the cost of financing i.e. interest on bonds, then the resultant impact over the profitability is dilution downwards. This reduces the return on equity which tantamount to devastation of owners' interest.

B) Bonds require regular payment of interest and par value of bonds at maturity. After issuance, the organizations are legally bound to pay the agreed amount of interest and principal amount of bonds intermittently and after specified intervals to the bond holders irrespective of the fact whether or not the organization has utilized the borrowed funds effectively and the funds flow permit such payments. Contrary to it the equity financing provides leverage to the organizations to refrain from payment of dividends in case of losses and moreover, no payment is made for discharge of shares during currency of the company.

The financing pattern, whether equity source or bond option is entirely dependent upon the duration requirement of funds. Therefore, the board of directors of a company would decide according to the prevailing situations for exercising best suitable option premised upon the risk and return factors.

7.2.4 Bond Trading

After initial issue of the bonds, such securities are readily purchased and sold in secondary market dependent upon its lucrative terms and better reputation of the issuing company with regard to its liquidity and payment system. The trading of bonds changes the ownership which is arranged from the issuing company. In case of bearer bonds no involvement of the company for transfer of ownership is necessitated. These bonds can be traded at par value, at discount and at premium as are dependent upon the demand and supply hypothesis and the terms of interest and maturity period.

7.2.5 Bonds Issuing Procedure

Likewise the shares of a company, the bonds are generally sold through some investment banking institutions, frequently referred to as underwriters. This can also be organized by a consortium of investment banks which is dependent upon the volume of investment funds. The underwriters guarantee the bonds issuing company to acquire or sell all the bonds at specific or sell all the bonds at specific price which are usually at slightly lesser than face value as a compensation for risk and services cost for conduct of this venture. The bonds issuing company is attracted by this arrangement as it acquires all funds at a time at some cost instead of selling bonds in piece meals and scattering funds collection over several months or so. The purchaser of Bonds receiver bond certificates as an evidence of the company's debt which exhibits all the necessary legal terms of its issuance, maturity and redemption including interest rate etc.

7.3 BOND ISSUANCE

The Bonds issuance may take place at par value, at discount or at premium price. The par value means that the bond of Rs. 1,000 for instance, is sold at Rs. 1,000 and any amount of interest would be payable at different intervals as indicated on the face of Bond at specified rate based on face value. While the principal amount as indicated on the bond certificate would be payable to the holder after maturity of its life which may be spread over 5 years or 10 years and so on. The bond issuance at discount means that the bond is sold at somewhat lesser price than its face value. However, the interest would be computed and paid based on its face value while the face value would be payable at its maturity. The bond sale at premium means that the bond would be sold at higher price than its face price. The interest would be payable on the basis of its face price and at its maturity the face price would be payable without regards to its issuance price i.e. at discount or at premium. The interest rate indicated on the bond indenture is called as contract rate, which is also known as coupon rate, stated rate or nominal rate. Bonds interest expense depends on the bond's market value at issuance which is determined by the market expectations of the risk of lending to the issuer. The bond's market rate of interest is the rate that the borrowers are willing to pay and lenders are willing to accept for a particular bond and its risk level. In case the level of risk increases, the rate of interest would risk increase to compensate the lender for increased of bonds. Further, the market rate of interest would be higher when the maturity period of the bond is longer due to the risk of adverse events falling over a longer period of time. At the time of sale of bonds the seller endeavors to set a contract rate of interest equal to the market prevailing rate of interest. When the contract rate of interest is equal with the market rate of interest, the bond sells at par value. However, when the contract rate of interest is greater than the market rate of interest, the bond would sell at premium price. Contrary to it when the contract rate of interest is lower than the market interest rate the bond would sell at discount price. This relationship is integrated to each other for determination of bond prices. The accounting treatments of bond issuance at different values are illustrated in the ensuing paragraphs.

7.3.1 Bond Issuance at Par Value

A company has received an approval for issuance of 05 years maturity 5,000 Bonds of Rs. 1,000 each at 12% per annum interest payable semi annually and sells them all, through an underwriter at its par value on 1 July, 2020. The accounting entry at its sale would be recorded as under:-

Date	Particulars	Dr	Cr
01-07-2020	Bank Account	Rs. 5,000,000	
	Bonds Payable Account		Rs. 5,000,000

The six months interest at 12% PA would be paid on 31 December 2020 and the following accounting entry would be recorded.

Date	Particulars	Dr	Cr
31-12-2020	Interest Expense Account	Rs. 300,000	
	Bank Account		Rs. 300,000

Similar accounting entry would be incorporated in the record after each payment of interest every six months over a period of five years. At maturity of bonds, after 05 years, the redemption would be recorded as under:-

Date	Particulars	Dr	Cr
30-06-2025	Bond Payable Account	Rs. 5,000,000	
	Bank Account		Rs. 5,000,000

7.3.2 Bond Issuance at Discount

When the bonds have been issued at lesser amount than its face value due to lower contract interest rate than the interest rate prevailing in the market and the contemporary bonds, the bond issuance would be termed as at discount. This means that a Company announces an offer to issue bonds of Rs. 1,000 par value with an interest rate of 12% per annum payable semiannually with five years maturity time. The market interest rate is prevailing at 13% on contemporary bonds. In view of the difference in the contract interest rate and the market interest rate the bonds would sell at discount i.e. at lower than its face value of Rs. 1,000 per bond. Assume that the Company has received an offer for issuance of all the 5,000 bonds of Rs. 1,000 at Rs. 960 each. The difference between the par value (face value) of Rs. 1,000 and the offer price of Rs. 960 which works out to Rs. 40 is the discount amount of each bond. Assume that the offer is accepted by the company and all the bonds are issued on 01 July 2020 the accounting entry would be as under:-

Date	Particulars	Dr	Cr
01-07-2020	Bank Account	Rs. 4,800,000	
	Discount on Bonds Payable Account	Rs. 200,000	
	Bonds Payable Account		Rs. 5,000,000

The bonds payable is a long time liability which would be presented in the balance sheet at its face value of Rs. 5,000,000. However, the discount amount of Rs. 200,000 is not the one time current period loss or expense. It would be treated as deferred cost for capitalization in the balance sheet and would be amortized over a period of 5 years on straight line method in the accounting record according to the maturity life of the bonds. The semiannual amortization of the deferred amount of discount on bonds would work out to Rs. 20,000 (Rs. 200,000/10) which would be treated as periodic expense likewise interest expense as the Company saved an amount of Rs. 25,000 from interest expense on each six monthly instalment of interest due to issuance of bonds at 12% PA interest rate as against the market interest rate of 13% per annum. The amortization of deferred expense of discount on Bonds is based on straight line method as it is equally distributed over 5 years life of bonds maturity. The accounting entry for payment of interest and amortization of deferred discount on bonds after expiry of 06 months would be as under:-

Date	Particulars	Dr	Cr
31-12-2020	Interest Expense	Rs. 320,000	
	Discount on Bonds Payable		Rs. 20,000
	Bank Account		Rs. 300,000

Similar accounting treatment would be carried out over 5 years period through 10 semiannual payments of interest and amortization of discount of bonds payable. At the end of 05 years the bonds would be taken back by the company and following accounting entry for payment on bonds at maturity would be passed.

Date	Particulars	Dr	Cr
30-06-2025	Bond Payable	Rs. 5,000,000	
	Bank Account		Rs. 5,000,000

It may be noted that the discount of Rs. 200,000 treated as deferred cost at the time of issuance of bonds at discount was capitalized which was amortized over 05 years through 10 semiannual installments of interest payments. At maturity of bonds, the discount on bonds Payable equals zero balance as it stands squared off during the life of bonds gradually.

7.3.3 Bonds issuance at Premium

The bonds would sell at premium when the interest rate of bonds is greater than the market interest rate of contemporary bonds or identical investment opportunities available to investors. The sale at premium bonds means that the bonds would attract greater sale price than its face value/par value. As such the amount by which the bond price exceeds par value is the premium on bonds. In order to illustrate the concept of issuance of bonds at premium, assume that the company is intending to sell its 5,000 bonds of Rs. 1,000 each for 05 years maturity life at 12% per annum interest payable six monthly which the prevailing interest rate in market for the contemporary indentures or other investment propositions offer 10% interest rate per annum. The Company has received an offer for sale of entire lot of 5,000 bonds Rs. 1,000 par value at Rs. 1,070 each. The excessive offer price of Rs. 70 (Rs. 1,070 less Rs. 1,000) is treated as premium price. This premium is because of lucrative higher contract interest rate of 12% per annum as against the prevailing market rate of 10% per annum on these bonds. The Company has accepted the offer and issued on 01 January, 2020 the entire lot of 5,000 bonds. The following accounting entry would be incorporated in the record for issuance of bonds at premium:-

Date	Particulars	Dr	Cr
01-01-2020	Bank Account	Rs. 5,350,000	
	Bonds Payable Account		Rs. 5,000,000
	Premium on Bonds Payable Account		Rs. 350,000

The Bonds Payable is a long term liability which would work out to Rs. 35,00 (Rs. 350,000/10) which would be presented in the balance sheet at the end of each accounting period of 03 years at its face value of Rs. 5,000,000 while at the end of its 4th year the amount of bonds payable would be presented as current liability as it would be payable at the end of its 5th year. The premium amount of Rs. 350,000 is not treated as one-time current period gain rather it would be capitalized and treated as deferred revenues in the balance sheet with bonds payable which would be amortized over 05 years' period in 10 installments with semi-annual interest payments. The semi-annual amortization of the deferred amount of premium on bonds would work would be adjusted from the periodic six monthly interest payments as worked out below: -

Six monthly interest Rs. 5,000,000 x 12% x1/2	Rs. 300,000
Less amortization of premium on bonds	Rs. 35,000
Net amount of interest expense for each 06 months	Rs. 265,000

The forgoing amortization of premium on Bonds is premised upon the straight line amortization concept which is equally prorated over 5 years life of bonds in 10 installments each of half year. The accounting entry for payment of interest on bonds each six monthly along with amortization of premium on bonds would be recorded as under:-

Date	Particulars	Dr	Cr
30-06-2020	Interest on Bonds Account	Rs. 265,000	
	Premium on Bonds Payable Account	Rs. 35,000	
	Bank Account		Rs. 300,000

Similar accounting treatment would be carried out over 05 year's period through 10 semi-annual payments of interest along with amortization of premium on bonds payable. At the end of 05 years the bonds would be redeemed and the following accounting entry for payment of bonds at maturity would be incorporated: -

Date	Particulars	Dr	Cr
30-12-2024	Bonds Payable Account	Rs. 5,000,000	
	Bank Account		Rs. 5,000,000

It is relevant 10 add here that the premium account of Rs. 350,000 treated as deferred revenues at the very outset at issuance of bonds which was capitalized, stands amortized over 05 years' period through 10 semi-annual installments of interest payment. At maturity of bonds, the premium on bonds equals zero balance as it stands squared off during the life of bonds gradually.

7.4 BONDS RETIREMENT

The Bonds once issued by an organization are to be retired according to the agreed terms as embodied on the bond indenture. The bond may be retired at maturity, before maturity and by conversion into stocks of the Company. The second and third options as aforesaid can be exercised in case the holder of bonds agrees to it or otherwise these options are available to the issuing organization in compliance to the terms of bond issuance. These options are now practiced in the ensuring paras to demonstrate the accounting treatment.

7.4.1 Bond retirement at maturity

The bonds retirement at maturity means that once the bonds have been issued for a specified period, these bonds would be redeemed after expiry of the tenure at its face/par value. The retirement at maturity would be recorded as under:-

Date	Particulars	Dr	Cr
30-12-2024	Bonds Payable Account	Rs. 5,000,000	
	Bank Account		Rs. 5,000,000

This accounting entry is similar to the accounting entries for retirement of Bonds as recorded at paras 7.3-1, 7.3-2 and 7.3-3 in the preceding sections. This retirement accounting entry is apart from the periodic interest payments and amortization of discount on bonds and premium on bonds which we presume have already been recorded at the time of periodic payment of interest on bonds.

7.4.2 Bonds retirement before maturity

The retirement of bonds before maturity is somewhat complicated process as compared with the bond retirement at maturity. The bonds retirement before maturity is possible if the bond certificate stipulates availability of callable option to the bonds issuing organization. The retirement of bonds before maturity generally takes place due to three reasons, once if the requirement of funds is vanished or surplus funds are available and secondly in order to same further levy of interest on these bonds the call option would be exercised by the issuing company for early retirement of bonds in part or as a whole lot according to convenience. Thirdly, when the market rate of interest is significantly declined then the Company would wish to retire such high interest rated bonds and in lieu thereof may issue fresh bonds with comparatively low rated interest thus ensuring savings in the periodic interest payments on the bonds. Another way of retiring the bonds may be the purchase of company's own bonds and then retire it. When the issuing Company calls back such bonds occasionally the Company would have to pay some call premium for early retirement of bonds. In this context in order to explain the accounting treatment of bonds retirement before maturity, assume that the bonds of Rs. 500,000 face value are called back on 01 January 2021 at Rs. 510,000, after payment of periodic interest on 31 December 2020, which have the market carrying value of Rs. 515,000 on that particular day, the accounting entry would be passed as under:-

Date	Particulars	Dr	Cr
01-01-2021	Bonds Payable Account	Rs. 500,000	
	Premium on Bonds Payable Account	Rs. 15,000	
	Gain on Bond retirement Account		Rs. 5,000
	Bank Account		Rs. 510,000

The retirement of above bonds before maturity has saved an amount of Rs. 5,000 apart from the interest expense for the future period which was payable if these were not retired till due maturity. Further any unamortized Premium or Discount portions related to these bonds called and retired before maturity would also be adjusted and squared off.

7.4.3 Bonds retirement by conversion

Sometimes the bond indentures stipulate the conditions of conversion option into shares of the Company. This option is exercised by the Company due to two reasons. First, that the Company requires the bond funds perpetually and secondly in order to avoid interest expenses payable periodically the bonds may be converted into shares before their maturity. In order to illustrate the early bonds retirement and conversion into Common Stocks, assume that a Company who had issued on 01 July 2016 convertible 10% bonds at Rs. 1,000,000 face value for 10 years has decided to convert these bonds into Common Stocks on 01 July 2020 i.e. after 04 years of issuance but before 06 years of maturity. In this respect 5,000 Common Stocks of Rs. 100 each are issued upon surrender of entire bonds of Rs. 1,000,000. The Common Stocks of the Company are being traded at stock exchange at Rs. 200 each. The accounting entry for this conversion would be incorporated in the record as under:-

Date	Particulars	Dr	Cr
01-07-2020	Bonds Payable	Rs. 1,000,000	
	Common Stock		Rs. 500,000
	Premium on Common Stock		Rs. 500,000

The long term liability of Bonds Payable would now be shifted into equity section of the Balance Sheet as on 01 July 2020 and onward. These shares would now become entitled to receive dividend as recommended by the board of directors and as approved by the shareholders in the annual general meeting (AGM) along with other Common Stocks.

7.5 LONG TERM NOTES PAYABLE

The business enterprises frequently require funds for meeting its cash deficits for some large payments other than meeting the current funds requirements which are generally meet with from short term running finance facility or temporary overdraft from banks. The large payments are necessitated for acquisition of Capital assets or the payment of lease installments for the assets acquired on lease basis. This arrangement is an alternate option from bonds financing and Capital Stock financing. When the funds are borrowed from banks for meeting such medium level funds requirements, usually the banks secure their loans by signing a promissory note by the borrower for the amount of loan plus interest thereon which has the maturity period of repayment in future according to the terms agreed upon between the lender and the borrower. From borrower point of view it would be classified as a Note Payable while the lender would define it as Note Receivable.

In order to facilitate the borrower by the lender, instead of arranging a single promissory note, several promissory notes may be signed by the borrower for each equal amount payable at different intervals of equal length as series of payments. The notes payable beyond one accounting period would be classified as long term liability while the payment of notes payable falling due within the next accounting period would be classified as current liability in the balance sheet of the borrower company. In order to illustrate, assume that Atlas Company has borrowed funds of Rs. 500,000 from a bank at 10% interest rate and issued six promissory notes, payable after every one year. The accounting entry for recording the borrow of funds and signing of Notes Payable would be recorded as under:-

Date	Particulars	Dr	Cr
01-07-2020	Bank Account	Rs. 500,000	
	Notes Payable		Rs. 500,000

The repayment of above loan with interest will be spread over 6 years for which an amortization schedule is prepared. The present value of interest factor of an ordinary annuity for 10% interest over 6 years of Rs. 500,000 as per table (iv) works out at 4. 35525 which can also be calculated at the following formulae:-

$$\text{PVIFA} = \frac{1-\left[\frac{1}{(1+i)^n}\right]}{i}$$

Where i = interest rate
n = No. of years

When the total loan amount of Rs. 500,000 is divided by the above factor of 4.35525 the annual equal installment of loan with interest works out to Rs. 114,804 over a period of 06 years. Therefore, the borrower would sign and issue six notes payable of Rs. 114,804 each comprising the principal amount and interest to discharge the loan with interest thereon. The amortization schedule of this loan is presented as under:-

Amortization Schedule

Sr. No.	Year ending	Interest on loan	Repayment of loan	Installment	Loan Balance
1	30-06-21	Rs. 50,000	Rs. 64,804		Rs.500,000
2	30-06-22	43,520	71,284	Rs. 114,804	435,196
3	30-06-23	36,391	78,413	114,804	363,912
4	30-06-24	28,550	86,254	114,804	285,499
5	30-06-25	19,925	94,879	114,804	199,245
6	30-06-26	10,438	104,366	114,804	104,366
Total			**Rs. 500,0000**	**114,804**	**00**

According to the above amortization, the first payment of Note Payable of Rs. 114,804 would be recorded as under:-

Date	Particulars	Dr	Cr
30-06-2021	Note Payable Account	Rs. 64,804	
	Interest Expense Account	Rs. 50,000	
	Bank Account		Rs. 114,804

The Payment of Rs. 114,804 has been made according to the amount indicated on the note payable. However, in accounting record the Notes Payable, once issued at the time of borrowing funds, were credited at the net amount of loan, instead of adding the interest thereon, therefore, the net amount of principal amount of loan has been debited to the Notes Payable Account in the accounting entry as at 30-06-2021 when one note payable was paid with interest which has separately been accounted for as periodic expense. Alternatively the total amount of interest payable on Six Notes payable can be recognized as deferred liability which can be periodically discharged with the principal amount of loan through notes payable of full amount.

The accounting entries in the subsequent five years, till all payment are made will be recorded at each annual payment of Notes Payable in accordance with the amortization schedule to square off the liabilities of Notes Payable.

7.6 DEMONSTRATION PROBLEMS WITH SOLUTIONS

Problems No. 01
Arshad Trading Company was in need of some additional funds for establishment of a sales branch in the commercial area of the city. Therefore, it issued on 01 March 2020 4,000 12% Bonds of Rs. 2,000 at Rs. 2100 each with the maturity of 04 years. The interest is payable after every 06 months. The bonds are retired at maturity.

Required:

a) Record necessary accounting entries for issuance of bonds and payment of periodic interest.
b) Carryout adjustment of amortization of Bonds premium under straight line method at each interest payment.
c) Present the bonds and premium in balance sheet prepared as at 30 June, 2020
d) Retirement of Bonds at maturity.
e) What was the effective rate of interest on these bonds?

SOLUTION
(A & B) Accounting Entries

General Journal

Date	Particulars	Dr	Cr
01-03-20	Bank Account	Rs. 8,400,000	
	Bonds Payable		Rs. 8,000,000
	Premium on Bonds		Rs. 400,000
30-06-20	Interest Expense	Rs. 286,667	
	Premium on Bonds	Rs. 33,333	
	Interest Payable		Rs. 320,000

Interest for 4 months Rs. 8,000,000 x 12% x 4/12 =	Rs. 320,000
Less amortization of Premium Rs. 400,000/4 x 4/12 =	33,333
Net interest expense for 4 months	Rs. 286,667

Date	Particulars	Dr	Cr
31-08-20	Interest Expense	Rs. 143,333	
	Premium on Bonds	Rs. 16,667	
	Interest Payable	Rs. 320,000	
	Bank Account		Rs. 480,000

Interest for 2 months Rs. 8,000,000 x 12% x 2/12 =	Rs. 160,000
Less amortization of Premium Rs. 400,000/4 x 2/12 =	16,667
Net interest expense for 2 months	Rs. 143,333

Date	Particulars	Dr	Cr
28-02-21	Interest Expense	Rs. 430,000	
	Premium on Bonds	Rs. 50,000	
	Bank Account		Rs. 480,000

Interest for 6 months Rs. 8,000,000 x 12% x 6/12 =	Rs. 480,000
Less amortization of Premium Rs. 400,000/4 x 6/12 =	50,000
Net interest expense for 6 months	Rs. 430,000

Date	Particulars	Dr	Cr
30-06-21	Interest Expense	Rs286,667	
	Premium on Bonds	Rs. 33,333	
	Interest Payable		Rs. 320,000
31-08-21	Interest Expense	Rs. 143,333	
	Premium on Bonds	Rs. 16,667	
	Interest Payable	Rs. 320,000	
	Bank Account		Rs. 480,000
28-02-22	Interest Expense	Rs. 430,000	
	Premium on Bonds	Rs. 50,000	
	Bank Account		Rs. 480,000
30-06-22	Interest Expense	Rs. 286,667	
	Premium on Bonds	Rs. 33,333	
	Interest Payable		Rs. 320,000
31-08-22	Interest Expense	Rs. 143,333	
	Premium on Bonds	Rs. 16,667	
	Interest Payable	Rs. 320,000	
	Bank Account		Rs. 480,000
28-02-23	Interest Expense	Rs. 430,000	
	Premium on Bonds	Rs. 50,000	
	Bank Account		Rs. 480,000
30-06-23	Interest Expense	Rs. 286,667	
	Premium on Bonds	Rs. 33,333	
	Interest Payable		Rs. 320,000
31-08-23	Interest Expense	Rs. 143,333	
	Premium on bonds	Rs. 16,667	
	Interest payable	Rs. 320,000	
	Bank Account		Rs. 480,000
28-02-24	Interest Expense	Rs. 430,000	
	Premium on Bonds	Rs. 50,000	
	Bank Account		Rs. 480,000

C) Presentation of Bonds in Balance Sheet

Balance Sheet as at 30-06-2020

Long Term Liabilities			
Bonds Payable	Rs. 8,000,000		
Bonds Premium Rs. 400,000			
Less amortization Rs. 33,333	Rs. 366,667		

D) Retirement of Bonds at maturity

Date	**Particulars**	**Dr**	**Cr**
28-02-24	Bonds Payable	Rs. 8,000,000	
	Bank Account		Rs. 8,000,000

E) Effective rate of Interest on Bonds

Nominal interest rate specified	12% PA
Less impact of bonds premium Rs. 400,000/4 years = Rs. 100,000/Rs. 8,000,000 x 100	1.25% PA
Effective rate of interest	10.75% PA

Problem No. 02

Umair Medical Services is in need of some funds in order to expand laboratory services in the clinic. In this respect the Company has raised funds on 01 July, 2020 by issuance of 10% 1,500 Bonds of Rs. 1,000 each at 5% discount for 2 years maturity with interest payable after every 3 months.

Required

a) Pass necessary accounting entries for:-

i) Issuance of Bonds
ii) Interest Payment at each interval
iii) Amortization of Bonds discount at each interest payment
iv) Retirement of Bonds at due maturity

b) Compute real rate of interest on these bonds.

SOLUTION

a) Accounting Entries

Date	**Particulars**	**Dr**	**Cr**
01-07-20	Bank Account	Rs. 1,425,000	
	Discount on Bonds	Rs. 75,000	
	Bonds Payable		Rs. 1,500,000
30-09-20	Interest Expense	Rs. 46,875	
	Discount on Bonds		Rs. 9,375
	Bank Account		Rs. 37,500

Interest of 3 months Rs. 1,500,000 x 10% x 3/12	Rs. 37,500
Add Discount amortization Rs. 75,000/2 x 3/12	Rs. 9,375
Interest expense	Rs. 46,875

Date	Particulars	Dr	Cr
31-12-20	Interest Expense	Rs. 46,875	
	Discount on Bonds		Rs. 9,375
	Bank Account		Rs. 37,500
31-03-21	Interest Expense	Rs. 46,875	
	Discount on Bonds		Rs. 9,375
	Bank Account		Rs. 37,500
30-06-21	Interest Expense	Rs. 46,875	
	Discount on Bonds		Rs. 9,375
	Bank Account		Rs. 37,500
30-09-21	Interest Expense	Rs. 46,975	
	Discount on Bonds		Rs. 9,375
	Bank Account		Rs. 37,500
31-12-21	Interest Expense	Rs. 46,875	
	Discount on Bonds		Rs. 9,375
	Bank Account		Rs. 37,500
31-03-22	Interest Expense	Rs. 46,875	
	Discount on Bonds		Rs. 9,375
	Bank Account		Rs. 37,500
30-06-22	Interest Expense	Rs. 46,875	
	Discount on Bonds		Rs. 9,375
	Bank Account		Rs. 37,500
30-06-22	Bonds Payable Account	Rs. 1,500,000	
	Bank Account		Rs. 1,500,000

A) Computation of real rate of Interest

Nominal interest rate	10% PA
Add impact of Bonds discount Rs. 75,000/2 years = Rs. 37,500/ Rs. 1,500,000 x 100 =	2.5 % PA
Real rate of interest	12.5% PA

7.7 SUMMARY

The bonds financing is considered as a medium range financing and is usually cheaper with regard to interest expense as it is allowable expense for tax reduction of a company. The bonds are usually issued from 03 years to 10 year duration according to the length of funds requirement. The bonds are issued at par value, at discount and at premium. The par value mean that issuance price of bond is equal to the face value. The bonds issued at discount mean that the bonds selling price are lower than its face value. The issuance of bonds at discount is usually because of lower rate of interest and longer period of the bonds. The bonds issuance at premium mean that the contract rate of interest on bonds is slightly greater than the market rate of interest and better reputation of the organization with regard to meeting its maturing obligations. The bond discount and premium are amortized over a period of bonds life under straight line method and adjusted against periodic interest expense.

The bonds are retired at maturity and even before maturity if call options are available to the organization in order to sae interest expense. Further the bonds can be converted into Capital Stock at maturity or before maturity provided the issuing organization and owner of bonds agree to it.

When the funds are borrowed from banks or other financial institutions for some period of 2 to 3 years or so the promissory note is signed by the borrower and issued to the lender. The interest is also payable periodically or at its maturity according to the terms of agreement. The bonds and Notes Payable are long term liabilities and are accordingly presented in the balance sheet of the borrowing Company.

7.8 THEORETICAL QUESTIONS

1) Define the bond and describe its common features contained on it.
2) Explain the objectives and purposes of meeting funds requirement through issuance of bonds instead of capital stock by a joint stock company.
3) What are the advantages and disadvantages of bond financing?
4) What is the procedure of bonds issuance and how these are traded in the market?

5) Explain the term bond issuance at par value. Under what circumstances the bonds are issued at par value.
6) Explain the criteria of issuance of bonds at discount. How this loss is recovered by the organization?
7) The issuance of bonds at premium means that the bonds are being issued at greater than its face value. Elucidate the circumstances when the bonds are issued at premium and how this gain is adjusted in the accounting record.
8) Describe various methods for retirement of bonds by a Company.
9) How the bonds are converted into Stock of the company at maturity or earlier than its maturity.
10) State the issuance of long term Notes Payable and their redemption over its tenure.

7.9 PRACTICAL PROBLEMS

P.7-01

Decent Trading Company was in need of funds in order to join a venture with some other organization. Accordingly the Company issued on 01 July, 2020 10% 2,000 Bonds of Rs. 500 each at par value with maturity of 05 years. The interest is payable after each 06 months period.

Required:

Record these bonds in accounting books of the company for:-
a) Issuance of bonds
b) Periodic payment of interest on bonds.
c) Presentation of bonds on the balance sheet as at 30-06-2021.
d) Redemption of bonds at maturity.

P.7-02

Zoobi Manufacturing Company is planning to introduce a new product for which it requires funds amounting to Rs. 3.000 million for purchase of some plant and factory building. A friend of the owner of the company has suggested him to meet funds requirement through issuance of Bonds. Accordingly, on 01 April, 2020 the Company issued 3,000 bonds of Rs. 1,000 each at par value carrying 10% interest payable semiannually over a period of 03 years.

Required

a) Record the issuance of Bonds.
b) Record the interest accrued at the end of each financial years and payment of interest as per terms of bond over its life.
c) Presentation of Bonds and its accrued interest at financial year end.

d) Retirement of bonds upon expiry of its tenure.

P.7-03

Subhan Mobiles Trading Company is intending to establish a mobiles repair work shop for which it needs funds amounting to Rs. 2.000 million for purchase of some tools; jigs spare parts and installation of repair panel. These funds are needed for about 04 years. Accordingly the Company issued 2,000 Bonds of Rs. 1,000 each on 01 July, 2020 at 4% discount. The bonds carry interest of 08% per annum payable semiannually.

Required

a) Record the issuance of bonds.
b) Interest payment at each 6 months period.
c) Amortization of bonds discount at each interest payment under straight line method.
d) Retirement of Bonds at maturity.
e) Compute effective rate of interest on these bonds.

P.7-04

Hassan Furniture Company after approval of its Board of Directors has issued on 01 March, 2020 5,000 bonds at 10% interest of Rs. 500 each at 2% discount with maturity of 03 years. The interest is payable after every 06 months.

Required

a) Record the issuance of bonds.
b) Record the accrual of interest at each financial year end.
c) Amortization of Bond discount at each interest payment under straight line plan.
d) Interest payment at each 06 months period.
e) Retirement of bonds at maturity.
f) Calculate real interest rate on these bonds.

P.7-05

Shayan Domestic Appliance Company has been established mainly through issuance of Stock and partly by issuance of 05 years 12% 1,000 bonds of Rs. 1,000 each on 01 July, 2020 at 2% premium. Interest is payable annually.

Required

a) Record necessary accounting entries for the issuance of bonds.
b) Payment of periodic interest on Bonds.

c) Carry out adjustment of amortization of bonds premium under straight line method at each interest payment.
d) Present the bonds and premium in the balance sheet prepared as at 30 June, 2021.
e) Retirement of bonds at maturity.
f) Compute the effective rate of interest on these bonds.

P.7-06
Tariq Fan Manufacturing Company has decided to launch new product of exhaust fan for which funds of Rs. 5,000,000 were need for acquisition of plant, raw material and certain tools. The board of directors decided to issue 10% 2,000 Bonds of Rs. 2,500 each at Rs. 2,550 each as on 01 April 2020 with tenure of 04 years. The interest is payable annually.

Required
a) Accounting entry for issuance of Bonds.
b) Payment of periodic interest on Bonds.
c) Adjustment of amortization of bonds premium based on straight line system against each interest payment.
d) Presentation of bonds and premium in the balance sheet prepared as at 30 June, 2022.
e) Retirement of bonds at maturity.
f) Computation of real rate of interest on these bonds.

P.7-07
Afnan Trading Company has issued 05 years 14% 5,000 Bonds of Rs. 1,000 each at par value as on 01 May 2020. The interest is payable semiannually. The availability of funds facilitated the company to retire these bonds as on 30 June, 2023 as permissible in terms of these bonds but with premature service charge of 2%.

Required
a) Record the issuance of Bonds.
b) Record the accrued interest at each financial year end.
c) Record the payment of interest at each semiannual period.
d) Record the retirement of bond as at 30 June 2023 before maturity along with payment of service cost/charges.

P.7-08
Zeenat Home Appliances Company issued 12%, 6 years maturity, 5,000 bonds of Rs. 2,000 each par value at Rs. 2,100 each as on 01 September, 2020.The interest is payable bi-annually. The financial year closes on 30 June each year. These bonds had call option before maturity, hence as approved by the board of directors of the Company, these bonds were converted into Common Stock of Rs. 100 each

par value and upon surrender of all outstanding bonds, the company issued 80,000 common stocks as on 30 June 2022.

Required

a) Record issuance of Bonds.
b) Record payment of interest for first year six months and accrual of interest for 04 months as at 30 June 2021.
c) Record payment of succeeding year's payment of interest and accrual of interest on bonds.
d) Record amortization of premium on bonds till conversion into stocks.
e) Record retirement of bonds premature and conversion into Capital Stock of the Company.

P.7-09

Sohail Trading Corporation was operating for the last several years. Currently the Company decided to borrow Rs. 1,000,000 from its bank as on 01 July, 2020 for a period of 04 years at interest rate of 15% per annum payable annually along with installment of principal amount of loan in equal proportions. In this respect four promissory notes were issued for equal amounts payable at the end of each year commencing on 30 June 2021.

Required

a) Record the borrow of money from the bank against Promissory Notes.
b) Prepare a Schedule of amortization of loan and interest thereon for 04 years to discharge liability in equal proportions.
c) Record accounting entries for payment of Notes Payable comprising principal installment of loan and interest thereon for whole of the loan period.
d) Present the liability of loan in the balance sheet as at 30 June 2021 after discharge of its first installment.

P.7-10

On November 01, 2020 Western Holel borrows Rs. 800,000 cash from a bank by signing a five-year installment note bearing 14% interest. The note requires equal total payments each year on 30 October over its tenure.

Required

a) Calculate the total amount of each installment payment to the bank.
b) Prepare an amortization schedule for the installments of promissory note over its entire period.
c) Prepare accounting entries for recording accrued interest as on 30 June 2021 being end of its first installment of loan against the promissory notes as at 30 October 2021.

7.10 GLOSSARY

Bonds
An indenture and agreement/trust between the two parties specifying the names of issuer and holder, amount of the bond, rate of interest payable at intervals and maturity date or callable before maturity.

Registered Bond
The bond document which is registered in the name of holder as specific in the indenture.

Bearer Bond
The bond document which keeps the name of owner as open and holder is the owner as open and holder is the owner of this bond.

Bond issued at par value
When the bond is sold at the price which is equal with its face value.

Bond issued at discount
When the bond is sold at the price which is lesser than its face value.

Bond issued at premium
When the bond is sold at the price which is greater than its face value.

Trading of Bonds
It means and includes sale and purchase of Bonds by seller and purchaser in a financial market openly.

Bond retirement
The redemption/repayment of the bonds upon expiry of its stated period it can be retired before maturity, if the bond document states call option.

Bond Conversion
The conversion of bonds into shares of the Company at agreed formulae as stated on the face of bond and call/conversion option is available to the bond issuer.

Amortization of bond discount and premium
The amount of loss from discount and gain from premium on issuance of bonds by a Company and prorating it over the specified life of the bonds for adjustment against the periodic interest expense on bonds.

Effective rate of interest

The nominal interest rate as stated on the body of the bond duly adjusted by the amortization of bond discount or premium to ascertain net rate of interest on bond.

Real rate of interest

An alternative name of the effective rate of interest. The nominal rate of interest as stated on the face of bond duly decreased or increased by the rate of amortized premium or discount at the issuance of bonds.

Long Term Notes Payable

The notes payable whose repayment due date/period is longer than one accounting period and is presented as long term liability in the balance sheet.

Unit–8

REPORTING THE SATEMENT OF CASH FLOW

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CONTENTS

INTRODUCTION

This unit-8 deals with the preparation of the cash flow statement of a business organization for making part and parcel of the other financial statements as are mandatory required under International Accounting Standards. The objectives of the cash flow statement is to abridge the net income as reported by the Income Statement prepared under accrual basis of accounting with the cash balance as shown in the balance sheet. Thus it also exhibits the details of sources from which each was collected and the account heads where it was disbursed during an accounting period. It can be prepared under two prevailing methods of direct and indirect approaches. The direct method is used by small firms while the indirect method is generally applied by large organizations.

OBJECTIVES

After studying this unit, the students would become conversant with the significance and preparation of the cash flow statement in respect of the following major aspects: -

- The necessity of preparation of cash flow statement at period end by every business organization.
- The basic purpose for reconciliation of net income as reported by income statement, prepared under accrual basics of accounting, with the closing cash balance as shown by the balance sheet.
- Giving details of the sources and application of funds during the period, classified under operating, investing and financing activities, and their combined result.
- Application of direct and indirect methods which have similar concluding results of cash inflows and outflows under the three classified sections of the cash flow statement.
- The convenience in using the working capital approach under indirect method for preparation of cash flow statement by large organizations.

8.1 BASICS OF CASH FLOW REPORTING

A Statement which presented the flow of funds in a business enterprise existed as early as 1862 in England and 1863 in the United States of America. The preparation and submission of the funds flow statement is much later than the first issuance of the income statement and the balance sheet of business organizations. Thus the preparation and issuance of a statement flow of funds is now over 150 years old. By early of 19th century, there were at least four conceptually different named statements of funds flow which described the focal points of flow of funds pertaining to cash current assets, working capital and other activities involving financial outlays. This statement was referred to as multimode statement of application of funds, the source and application of funds statement, the statement of financial operations, the statement of resources provided and applied, and the where-got and where-gone statement. Thus during over a century of years from 1862 to 1977, after passing through gradually the various names and classifications of business resources ultimately its name was identified as cash Flow Statement according to the International Accounting Standard-7 which was originally developed during 1977 but subsequently revised during 1992. The International Accounting Standard -1 relating to Presentation of Financial Statements specifies that apart from the Income Statement, Statement of Changes in Equity and the Balance Sheet, a Cash Flow Statement is an essential and integral part of the composition of the financial statements of all business enterprises constituted under Companies Act, 2017 (formerly known as Companies Ordinance, 1984). During a decade commencing from 1910 an educator named H.A. Finney presented the statement using a format that identiced the causes of changes in the working capital items which were successful, and the working capital approach became the dominant format. The elements that increased the working capital were regarded as sources of funds and the items that decreased the working capital were considered as uses of funds.

8.2 PURPOSE AND IMPORTANCE OF CASH FLOW STATEMENT

The purpose and importance of cash flow statement are multiple in the sense that it provides significant information to the users of financial statements of an organization relating to the cash receipts (inflows) and cash disbursements (outflows) during an accounting period. The cash is constituted as a life blood of a business. Therefore, the managers and the owners critically focus on importance of cash flow statement as it portrays the movement of cash over a period of time. Understanding the flow of cash is specifically important to having a handle on the pulse of the enterprise. The detailed disclosure of individual sources and uses of cash makes the cash flow statement useful to the users. The cash flows information embodied in this statement facilitates the users to answer some questions such as the following: -

a) Why do the net incomes as reported in the income statement of joint stock companies, applying accrual basis of accounting, differ from the cash balance as reported in the balance sheet of the same year and how it was reconciled?
b) How much the cash was collected from different sources during the period?
c) How much the cash was disbursed on different heads of accounts during the period?
d) How much the tax and dividends were paid during the period?
e) What were the non-cash items which were readjusted in the net income?

All the above detailed information provides explanation of the changes that occurred in the firm's cash balances from opening to closing during a specific period. The management may use the statement of cash flows to determine dividend policy, cash generated from operations, investing and financing activities to develop different business policies. Outsiders such as creditors and investors may use it to determine the company's ability to increase the dividends, its capacity to pay debt with cash flow from operations and percentage of cash flow from operations in relations to the cash from financing sources. The information about cash flows can also influence the decision making executives in important ways. If is usually considered a better way to finance the expansion from the funds generated from business operations rather than taking loans for this purpose. This can be assessed from the information mentioned in the cash flow statement.

There are two systems for accounting of business activities in the record. One is the cash basis of accounting while the other is accrual basis. Under cash basis of accounting the transaction is entered in the accounting record when either the cash is collected or paid for any sale, purchase or other expense. Under this system the closing cash balance would match with the reported net income for the period. Conversely under accrual basis of accounting the transactions would be recorded in the accounts immediately when those events took place irrespective of the fact whether or not the cash was collected or paid. Therefore, the closing cash balance would never agree with the reported profit. The management would enquire as to how the matching cash is not available as compared with the profit. As such it would be considered either the profit amount is incorrect or the cash was embezzled. In order to satisfy the confusion of management and similarly all the external users of financial statements, reconciliation between the closing cash balance and the reported profit is arranged which function is managed through preparation of cash flow statement which would facilitate the resolution of any confusion. This is in the perspective of forgoing objectives which necessitates the preparation of cash flow statement by all the joint stock business organizations established under the Companies Act, 2017. Small business organizations usually need not to prepare the cash flow statement as such enterprises adopt the cash basis of accounting where no variance in the closing cash balance is found with the reported profit.

8.3 CLASSIFICATION OF CASH FLOWS

All the business transactions conducted and entered in the accounting record are classified into different categories namely operating, investing or financing activities for the preparation of cash flow statement. Some of the transactions would transpire collection of cash while others would lead to the disbursement of cash. All such collections and disbursements would be labelled with any of the aforesaid three categories. The cash disbursement (outflow) would be deducted from the cash collection (inflow) in each of the three classifications of operating, investing and financing activities. The resultant balance would then show either positive or negative net cash inflow or net cash outflow which would be off-set with each other to compute on an overall basis the net cash inflow or outflow. The opening cash available would be added up to compare the net cash so computed with the balance of cash as shown in the balance sheet. When both balances of cash are matching with each other, the cash flow statement stands completed and in case of any variance the contents would be reviewed to reconcile it.

The cash inflows and cash outflow of each of the three classified categories presented in the cash flow statement are now further deliberated to understand computation of balances of cash flows.

A) Operating Activities

The items classified in the cash collection (inflows) and cash disbursement (outflows) in the operating activities are enumerated below: -

Cash inflows

- Cash sales or cash collected from rendering services.
- Cash collection from Accounts Receivables/credit sales.
- Cash received from disposal marketable securities.
- Cash received from royalties, fees, commission and other revenues.
- Cash collected from the periodic premium of insurance policy holders by an insurance Company.
- Cash collected for tax refund.
- Cash collected from rentals
- Advances from customers and clients.

Cash Outflows

- Cash paid on purchase of merchandise
- Cash paid for operating expenses of various kinds.
- Payment of salaries and wages
- Cash paid for purchase of trading securities
- Cash paid for taxes and penalties
- Payment of interest on loans

- Cash paid against Accounts Payable for purchase of merchandise on credit basis.
- Cash paid on rentals, Commission and dividends.
- Cash paid by insurance enterprise for annuities and policy benefits.

B) Investing Activities

The items classified in the cash inflows and outflows falling in the investing activities are described below: -

Cash inflows

- From sale/disposal of property, plant and equipment
- From sale of intangible assets
- From collection of Notes receivables of long term
- From selling/discounting of Notes receivables
- From disposal of investments excluding short term marketable securities.
- From sale of long term investments.
- From sale of equity or debt instruments of other enterprises and interests in joint ventures.
- Cash collected from advances and loans already made to other parties.

Cash outflows

- Cash paid for purchase of property, plant and equipment
- Cash paid for purchase of intangible assets.
- Cash paid as loan against long term notes receivable.
- For purchase of long term investments.
- For purchase of short term investment excluding marketable trading securities.
- Cash payment for future contracts and options etc.

C) Financing Activities

The items classified in the cash inflows and outflows for financing activities are indicated below: -

Cash inflows

- From issuance of Common and Preferred Stocks
- From issuance of short and long term notes Payables
- From issuance of Bonds and Debentures.
- From sale of treasury Stocks.
- From other contributions by owners

Cash outflows

- For purchase of treasury stocks.
- For redemption of Bonds and Debentures
- For withdrawals by owners other than joint stock Companies.
- For payment against short and long terms notes payables.
- For payment of dividends.

It is worthwhile to add here that the above items of cash inflows and outflows are not the conclusive. Certain other items according to the nature of business activities and transactions conducted can be identified and classified in the operating investing and financing activities. It may also be noted that dividend payment to shareholders can be presented either in the operating activities or in the financing activities. One school of thought for presentation of dividend payment in the operating activities is of the view that the dividend can only be paid out of profits. The receipt of profit is presented in the operating activities; therefore, the distribution of profit should be presented in the operating activities. The other school of thought is of the view that the dividend is always paid against the financing made by owners/shareholders and the periodic earnings are presented as increase in the owners' equity. The dividend payment decreases equity, therefore, the payment of dividends should be presented as cash outflows in the financing activities. Therefore, it depends upon the professional opinion of the concerned organization/staff either to present the payment of dividends in the operating or the financing activities. Both the treatments are acceptable. The foregoing treatments are not controversial and can be dealt with according to the expediency.

8.4 FORMAT OF CASH FLOW STATEMENT

The cash flow statement is usually prepared at end of the year for inclusion in the annual financial statements of the company. However, it can also be prepared at quarterly or semiannually as the other financial statements are prepared. The prescribed format of the cash flow statement according to IAS-7 comprises three sections which are the cash flows from operating, investing and the financing activities. The cash flow statement can be drawn under the direct and indirect methods. These methods are only applicable on the preparation of one section of the cash flow statement namely the cash flow from operating activities while other two sections namely the investing and the financing activities are identical in both the methods. These are now presented as under: -

1) DIRECT METHOD
A) Cash flow from operating activities

Cash inflows		
Cash sales	Rs. 75,000	
Collection from credit sales	Rs. 170,000	
Encashment of marketable securities	Rs. 25,000	Rs. 270,000
Cash outflows		
Cash paid for purchases	(Rs. 135,000)	
Cash paid for operating expenses	(Rs. 25,000)	
Cash paid for salaries	(Rs. 10,000)	
Income tax paid	(Rs. 55,000)	(Rs. 225,000)
Net cash flow from operating activities		Rs. 45,000

B) Cash flow from Investing Activities

Cash inflows		
Cash collected from disposal of vehicle	Rs. 75,000	
Cash collected from disposal of old machinery	Rs. 20,000	Rs. 95,000
Cash outflows		
Cash paid for purchases of air conditioner	(Rs.180,000)	
Cash paid for purchase of vehicle	(Rs. 570,000)	(Rs. 750,000)
Net cash outflow from investing activities		(Rs. 655,000)

C) Cash flow from financing activities

Cash inflows		
Cash collected from issuance of Common Stocks	Rs. 350,000	
Cash collected from issuance of Bonds	Rs. 500,000	
Cash outflows	Rs. 850,000	
Cash paid for dividends	(Rs. 5,000)	
Net inflows from financing activities		Rs. 845,000
Net increase in cash (A+B+C)		Rs. 235,000
Add opening cash balance		Rs. 35,000
Closing cash balance at year end		Rs. 270,000

2) INDIRECT METHOD
A) Cash flow from operating activities

Net income before income tax	Rs. 30,000	
Add non cash expenses:		
Depreciation	Rs. 7,000	
Bad debts written off	Rs. 3,000	
Adjusted net income	Rs. 40,000	
Cash inflow Working Capital Items		
Add decrease in marketable securities	Rs. 25,000	
Add decrease in accounts receivables	Rs. 5,000	Rs. 70,000

Cash Outflows

Working Capital items		
Decrease in accounts payables	(Rs. 10,000)	
Decrease in salaries payables	(Rs. 5,000)	
Decrease in tax payable	(Rs. 10,000)	(Rs. 25,000)
Net cash flow from operating activities		Rs. 45,000

B) Cash flow from investing activities

Cash inflows		
Cash collected from disposal of vehicle	Rs. 75,000	
Cash collected from disposal of old machinery	Rs. 20,000	Rs. 95,000
Cash outflows		
Cash paid for purchase of air conditioner	(Rs. 180,000)	
Cash paid for purchase of vehicle	(Rs. 570,000)	(Rs. 750,000)
Net cash outflows from investing activities		(Rs. 655,000)

C) Cash flow from Financing activities

Cash inflows		
Cash collected from issuance of Common Stocks	Rs. 350,000	
Cash collected from issuance of Bonds	Rs. 500,000	
Total	Rs. 850,000	
Cash outflows		
Cash paid for dividends	(Rs. 5,000)	
Net cash inflow from financing activities		Rs. 845,000
Net increase in cash (A+B+C)		Rs. 235,000
Add opening cash balance		Rs. 35,000
Closing cash balance at year end		Rs. 270,000

8.5 CASH FLOW FROM OPERATING ACTIVITIES

A comparison of the cash flow statements prepared under direct and indirect methods reveals that there is only difference in the presentation of the contents of cash flow from operating activities as per preceding pages while the contents of cash flow from investing and financial activities are uniform. The application of direct method necessitates that all the income statement items including ledger accounts and cash book entries may be scanned for retrieving the transactions causing flow of cash from operating activities. This is a cumbersome task for searching out the relevant items from the entire annual record when there may be multiple transactions of identical and non-identical nature found in whole of the annual record. This practice may be possible in an organization where the small quantity of transactions was conducted during a year and tracing the selective information may be possible. Contrary to it, the aforesaid exercise would not be practically possible in the organizations where there are multiple transactions conducted and recorded in accounts for the period of complete one year.

In view of the aforesaid obstacles and hardships indirect method of preparation of cash flow from operating activities is applied by large organizations as it combats the extensive exercise and relies upon the reported net income duly adjusted by non-cash items like depreciation, bad debts written off and amortization expenses etc. Further the increase and decrease in the working capital items of the current year balance sheet as compared with the last year balance sheet are considered as the bases for supplementing the contents for preparation of cash flow from operating activities section of the cash flow statement. This is called as working capital approach. The items of current assets and current liabilities of the current year are compared with that of the last year and any decrease and increase in these items are considered as the elements of cash inflows and outflows during the current year under operating activities. These items are summarized as under to understand it at a glance.

a) Current assets items

Decrease in Accounts Receivables	Cash inflow
Increase in Accounts Receivables	Cash outflow
Decrease in Inventories	Cash inflow
Increase in Inventories	Cash outflow
Decrease in Marketable Securities	Cash inflow
Increase in Marketable Securities	Cash outflow
Decrease in prepaid expenses	Cash inflow
Increase in prepaid expenses	Cash outflow
Decrease in short term advances	Cash inflow
Increase in short term advances	Cash outflow

b) Current liabilities items

Increase in Accounts Payables	Cash inflow
Decrease in Accounts Payables	Cash outflow
Increase in accrued expenses	Cash inflow
Decrease in accrued expenses	Cash outflow
Increase in unearned revenues	Cash inflow
Decrease in unearned revenues	Cash outflow
Increase in tax and dividends payable	Cash inflow
Decrease in tax and dividends payable	Cash outflow
Increase in rent payable	Cash inflow
Decrease in rent payable	Cash outflow
Increase in bank overdraft/short term financing	Cash inflow
Decrease in bank overdraft/short term financing	Cash outflow

The increase or decrease items as enumerated above are not exhaustive. Some other items of current assets and current liabilities are to be analyzed on the basis of the criteria whether it is causing inflow or outflow of cash and is accordingly to be dealt with in the cash flow from operating activities.

8.6 CASH FLOW FROM INVESTING ACTIVITIES

The investing activities in a business organization demonstrate the payment made for fixed assets items of balance sheet on purchase of property, plant and equipment and other tangible assets. It also includes the air-conditioning, office equipment furniture and fixtures and Motor Vehicles. Apart from it, the intangible assets acquired like copy rights, patents, franchise, good will, and trademarks etc. are also classified in the investing activities. All these assets when acquired affect the cash outflows. The disposal of all such assets leads to cash inflows. The treatment of these assets is summarized as under in the cash flow from investing activities: -

Increase in property, plant and equipment	Cash outflow
Decrease in property, plant and equipment on disposal	Cash inflow
Increase in other tangible assets like air conditioning, office equipment, furniture and fixture and motor vehicles	Cash outflow
Decrease in other tangible assets due to disposal	Cash inflow
Increase in other intangible assets like copy rights, patents, franchise, good will and trademarks etc.	Cash outflow
Decrease in other intangible assets due to disposal	Cash inflow
Increase in Investment made in the subsidiary companies or other investments	Cash outflow
Decrease in Investment made in the subsidiary companies or other investments	Cash inflow

The forgoing items of investing activities are the presumptive elements and are not conclusive. Some other assets acquisition and disposal can also fall in the investing activities which can also be classified for cash inflow/outflow according to their perspective impact on cash. Usually the cash flow from investing activities show negative i.e. deficient balance as the purchase cost of assets is usually greater than the disposal proceeds from assets.

8.7 CASH FLOW FROM FINANCING ACTIVITIES

The cash flow from financing activities normally comprise the changes in all the long term liabilities accounts like bonds and debentures capital stocks consisting of Common and preferred, premium on capital stocks and discount on Capital Stocks presented in the balance sheet. The changes in these accounts are then analyzed from the available information for computation of cash flows from this prominent source. Normally this section indicates positive cash balance enabling to supplement cash deficiency in the Investing activities section on acquisition of long term assets. The impact on cash flows on the foregoing accounts are summarized as under:

Increase in Common and Preferred Stocks	Cash inflow
Increase in premium on capital stock	Cash inflow
Increase in discount on capital stock	Cash outflow
Increase in treasury stocks	Cash outflow
Decrease in treasury stocks	Cash inflow
Increase in long term Bonds and Debentures	Cash inflow
Decrease in long term Bonds and Debentures	Cash outflow
Payment of dividends	Cash outflow

Apart from above accounts, some other accounts can also be analyzed for cash inflow and outflow in the financing activities according to their nature.

8.8 PROVING CASH BALANCES

After completion of analysis of all the relevant accounts of income statement and the balance sheet and classification of these accounts either for causing cash inflows and cash outflows under three categories in operating, investing and financing activities, as annotated at paras 8.5 to 8.7 in the preceding pages, the next step is the consolidation of the balances of all the three categories to combine the results of cash movements and flows during the period to match the resultant balance of cash flow either as net positive or negative balance and merging with it the opening cash balance brought forward from the previous year, provides us the net closing cash balance. When this cash balance is found matching with the closing cash balance as portrayed in the balance sheet, then it ensures us that the cash flow statement prepared is accurate and complete in all respects. Now this cash flow statement is ready for inclusion with the other statements to describe it as complete financial statements. The step of consolidation of cash balances is tabulated below: -

Net cash provided by operating activities	Rs. 45,000
Net cash provided by investing activities	(Rs. 655,000)
Net cash provided by financing activities	Rs. 845,000
Net increase in cash for the period	Rs. 235,000
Add opening cash balance brought forward from previous year	Rs. 35,000
Closing cash balance at year end	Rs. 270,000

The above statistical data is extracted from the summarized contents of para 8.4 where a complete format of the cash flow statement was presented and the reconciliation has proved the cash balance available at the end of the year. In case of any variance, the contents are reviewed to reconcile the balances.

8.9 DEMONSTRATION PROBLEMS WITH SOLUTIONS

D.P.No.01
The International Trading Corporation has provided the following Income statement for the year ended on 30 June 2020: -

Income statement for year ended 30.06.2020

Sales	Rs. 1,000,000
Less Cost of goods Sold	Rs. 650,000
Gross Profit	Rs. 350,000
Operating Expenses:	
Selling and Admin exp including depreciation of Rs. 100,000	Rs. 200,000
Operating Income	Rs. 150,000
Other expenses-Interest	Rs. 50,000
Net Income before Income Tax	Rs. 100,000
Less: Income Tax expense	Rs. 40,000
Net Income after tax	Rs. 60,000

Balance Sheet as at:

Assets	**30-06-2019**	**30-06-2020**
Cash	Rs. 50,000	Rs. 60,000
Accounts Receivable	Rs. 500,000	Rs. 520,000
Inventory	Rs. 750,000	Rs. 770,000
Total Current Assets	Rs. 1,300,000	Rs. 1,350,000
Fixed Assets (net)	Rs. 500,000	Rs. 550,000
Total Assets	**Rs. 1,800,000**	**Rs. 1,900,000**
Liabilities and Equity		
Accounts Payable	Rs. 590,000	Rs. 615,000
Interest Payable	Rs. 10,000	Rs. 20,000
Tax payable	--	Rs. 10,000
	Rs. 600,000	**Rs. 645,000**
Long term Debt-Bonds	Rs. 400,000	Rs. 425,000
Capital Stock	Rs. 700,000	Rs. 700,000
Retained Earnings	Rs. 100,000	Rs. 130,000
Total liabilities and Equity	**Rs.1,800,000**	**Rs. 1,900,000**

Required: Prepare a cash flow statement for the year ended 30 June, 2020 using direct method.

SOLUTION

The International Trading Corporation
Cash Flow Statement for the year ended 30 June, 2020 (under direct method).

A) Cash Flow from operating activities

Cash inflow		
Cash collected from sales:		
Total sales	Rs. 1,000,000	
Add: Opening Accounts Receivables	Rs. 500,000	
	Rs. 1,500,000	
Less Closing Accounts Receivables	Rs. 520,000	
Cash collected from sales	Rs. 980,000	Rs. 980,000
Cash outflows:		
Cash disbursed for purchases:		
Cost of goods sold	Rs. 650,000	
Add closing inventory	Rs. 770,000	
Cost of goods available	Rs. 1,420,000	
Less opening inventory	Rs. 750,000	
Cost of purchases	Rs. 670,000	
Add opening Accounts Payable	Rs. 590,000	
Total dues for purchases	Rs. 1,260,000	
Less closing Accounts Payable	Rs. 615,000	
Payment for purchases	Rs. 645,000	(Rs. 645,000)
Selling and Admin Expenses	Rs. 200,000	
Less depreciation (non cash exp)	Rs. 100,000	
Expenses paid in cash	Rs. 100,000	(Rs. 100,000)
Interest Expense for the year	Rs. 50,000	
Add opening interest payable	Rs. 10,000	
Total dues for interest	Rs. 60,000	
Less closing interest payable	Rs. 20,000	
Payment for interest expense	Rs. 40,000	(Rs. 40,000)
Tax expense for the year	Rs. 40,000	
Less Tax payable	Rs. 10,000	
Payment for tax	Rs. 30,000	(Rs. 30,000)
Net cash flow from operating activities		Rs. 165,000

B) Cash Flow from Investing Activities

Cash inflow	NIL	
Cash outflow		
Closing net balance of fixed Assets	Rs. 550,000	
Add depreciation charged during the year	Rs. 100,000	
Total cost of fixed assets	Rs. 650,000	
Less opening balance of fixed Assets	Rs. 500,000	
Net cash flow from investing activities	Rs. 150,000	(Rs. 150,000

C) Cash Flow from Financing Activities

Cash inflow		
Closing balance of long term debts-Bonds	Rs. 425,000	
Less opening balance of long term debts-Bonds	Rs. 400,000	
Cash collect from issuance of Bonds	Rs. 25,000	

Cash outflow		
Opening balance of Retained Earnings	Rs. 100,000	
Add net income for the year	Rs. 60,000	
Total balance of retained earnings	Rs. 160,000	
Less closing balance of retained earnings	Rs. 130,000	
Cash dividends paid during the year		Rs. 30,000
Net cash flow from financing activities		(Rs. 5,000)
Net cash increase during the year		Rs. 10,000
Add opening cash balance		Rs. 50,000
Closing cash balance at year end (30.06.2020)		Rs. 60,000

Demonstration Problem No. 02

The data relating to income statement for the year ended 30 June, 2020 and two years balance sheet in comparative format at 30 June, 2019 and 30 June, 2020 of the International Trading Corporation is given at the demonstration problem No. 01. On the basis of the foregoing data, prepare cash flow statement for the year ended 30 June, 2020 applying working capital approach under indirect method.

SOLUTION

The International Trading Corporation
Cash Flow Statement
For the year ended 30 June, 2020

(under indirect method)

A) Cash Flow from operating activities

Net income as per Income Statement	Rs. 60,000	
Add non cash expenses-Depreciation exp	Rs. 100,000	
Adjusted net income		Rs. 160,000
Working Capital items		
Cash inflow:		
Increase in Accounts Payable (Rs. 615,000 – 590,000)	Rs. 25,000	
Increase in interest payable (Rs. 20,000 – 10,000)	Rs. 10,000	
Tax payable	Rs. 10,000	Rs. 45,000
Cash outflows		**Rs. 205,000**
Increase in Accounts Payable (Rs. 520,000 – 500,000)	Rs. 20,000	
Increase in Inventory (Rs. 770,000 – 750,000)	Rs. 20,000	(Rs. 40,000)
Net cash inflow from operating activities		Rs. 165,000

B) Cash Flow from Investing Activities

Cash inflow	NIL	
Cash outflow		
Increase in fixed assets balance (Rs. 550,000 – 500,000)	Rs. 50,000	
Add periodic depreciation	Rs. 100,000	
Net cash outflow from Investing activities	Rs. 150,000	(Rs. 150,000)

C) Cash Flow from Financing Activities

Cash inflow		
Increase in long term debts	(Rs. 425,000 – 400,000)	Rs. 25,000
Cash outflow		
Opening balance of Retained Earnings	Rs. 100,000	
Add net income for the year	Rs. 60,000	
Total balance of retained earnings	Rs. 160,000	
Less closing balance of retained earnings	Rs. 130,0000	
Cash dividends paid during the year	Rs. 30,000	(30,000)
Net cash flow from financing activities		(Rs. 5,000)
Net cash increase during the year		Rs. 10,000
Add opening cash balance		Rs. 50,000
Closing Cash balance year end (30.06.2020)		Rs. 60,000

A note for the students

The perusal of the cash flow statements presented under direct and indirect methods as at demonstration problems No. 01 and 02 portrays that there is a change in the cash flow from operating activities (section A) due to different methods used in both the solutions but the resultant cash balance is matching with each other. However, the other two sections (B&C) can identically be presented in the cash flow statements but slight change in the procedure is adopted in these sections to diversify and enhance the knowledge of student to practice for either pattern of presentation.

8.10 SUMMARY

The cash flow statement is an integral part of the financial statements of all business organization established under Companies Act, 2017. The cash flow statements are prepared in accordance with International Accounting Standard No.7. The cash flow statement indicates the sources of cash inflows and cash outflows during a period of time. The cash flow statement comprises three sections namely operating activities, investing activities and financing activities. The cash flow from operating activities exhibits the cash collections and disbursements on income and expenses items of the income statement excluding non-cash items like depreciation and bad debts writing off. The Investing activities present cash inflows and outflows from disposal of capital assets and acquisition of fixed assets. The financing activities exhibit the cash flow from long term loans and their redemption apart from issuance of additional common and preferred shares during the period with premium or discount or at par.

The cash flow statement can be prepared under direct and indirect methods. Normally the direct method is used by small companies whose business transactions are small while the indirect method is applied by large companies where periodic transactions are manifold. The objectives of presentation of the cash flow statement are to create linkage between the reported net income with the closing cash balance because such income statements are usually prepared under accrual basis of accounting. The resultant cash balances of operating, investing and financing activities are consolidated and opening cash balance is added in it to reconcile it with the closing cash balance as shown in the balance sheet.

8.11 THEORETICAL QUESTIONS

Q.1 What is the purpose and significance of the cash flow statement?

Q.2 What the major contents of the cash flow statement?

Q.3 Describe the items of cash inflows and cash outflows of the operating activities of the cash flow statement.

Q.4 Enumerate the relevant accounts involving the cash inflows and cash outflows of the investing activities of the cash flow statement.

Q.5 State the major accounts relating to the cash inflows and cash outflows of the financing activities of the cash flow statement.

Q.6 Describe the various methods permissible under IAS-7 for preparation of the cash flow statement by joint stock companies.

Q.7 Which one of the methods is generally adopted by the organizations established under the Companies Act, 2017 for preparation of the cash flow statements and elucidate its composition.

Q.8 The indirect method of preparation of the cash flow statement is normally named as the working capital approach. Discuss certain features of such an approach to identify the specific accounts involved in it.

Q.9 How the reported net income under accrual basis of accounting is reconciled with the closing cash balance of an organization?

Q.10 The dividends payment can either be presented as cash outflow in the operating activities or in the financing activities. Which one approach would you prefer as a professional expert? Support your recommendations in this context.

8.12 PRACTICAL PROBLEMS

P.8-1 The undernoted data was extracted from the accounting record of Arshad Company for the year ended 30 June, 2021. The Company is using cash basis of accounting.

a	Cash collection from customers for sale of merchandise.	Rs. 250,000
b	Cash payment to suppliers of merchandise	Rs. 120,000
c	Purchase of land on cash.	Rs. 80,000
D	Disposal of equipment on cash.	Rs. 25,000
E	Opening cash balance as on 01 July 2020.	Rs. 16,000
F	Payment of interest on loan	Rs. 5,000
G	Redemption of long term debentures	Rs. 40,000
H	Dividends payment to shareholders	Rs. 4,000
I	Payment of salaries to staff	Rs. 45,000
J	Purchase of equipment on cash	Rs. 32,000
K	Issuance of Common Stock at par	Rs. 60,000
L	Closing cash balance as on 30 June 2021	Rs. 25,000

Required: Prepare a cash flow statement under direct method.

P.8-2

The financial statements of Ashar Trading Company are presented as under:-

Income Statement for the years ended 30-06-2021

Net Sales revenues	Rs. 450,000
Less Cost of Goods Sold including depreciation	Rs. 280,000
Gross income	Rs. 170,0000
Less operating expenses-Selling & Admin	Rs. 40,000
Operating income before tax	Rs. 130,000
Less income tax	Rs. 40,000
Net income after tax	Rs. 90,000

Comparative Balance Sheets

Assets	**30-06-2020**	**30-06-2021**
Cash	Rs. 25,000	Rs. 42,000
Accounts Receivables	Rs. 120,000	Rs. 145,000
Inventory	Rs. 60,000	Rs. 50,000
Fixed Assets	Rs. 230,000	Rs. 260,000
Less accumulated depreciation	(Rs. 69,000)	(Rs. 95,000)
Total assets	Rs. 366,000	Rs. 402,000
Liabilities and Equity		
Accounts Payable	Rs. 36,000	Rs. 30,000
Debentures	Rs. 40,000	Rs. 25,000
Common Stock	Rs. 230,000	Rs. 230,000
Retained Earnings	Rs. 60,000	Rs. 117,000
	Rs. 366,000	**Rs. 402,000**

Required:

a) Prepare cash flow statement for the year ended 30 June, 2021 under direct method.

b) Prepare cash flow statement for the year ended 30 June 2021 under indirect method.

P.8-3

The Income Statement for the year ended 30 June, 2020 of Alpha Pharmaceutical Company is presented as under:

Income Statement for the year ended 30.06.2020

Sales revenues		Rs. 670,000
Less Cost of goods Sold		Rs. 345,000
Gross income		Rs. 325,000
Less operating expenses:		
Staff Salaries expenses	Rs. 76,000	
Selling Staff Commission expenses	Rs. 15,000	
Rent and utility expenses	Rs. 25,000	
Depreciation expenses	Rs. 25,000	
Bad debt expenses	Rs. 3,000	Rs. 144,000
Net income before tax		Rs. 181,000
Less Income Tax		Rs. 54,300
Net Income after tax		Rs. 126,700

The comparative balance sheet for two years is as under:

Assets	**30-06-2019**	**30-06-2020**
Cash	Rs. 40,000	Rs. 10,000
Accounts Receivables	Rs. 305,000	Rs. 300,000
Inventories	Rs. 120,000	Rs. 125,000
Prepaid expenses of rent	Rs. 30,000	Rs. 42,000
Plant and machinery	Rs. 270,000	Rs. 270,000
Accumulated depreciation	(Rs. 155,000)	(Rs. 170,000)
Motor vehicle	Rs. 100,000	Rs. 100,000
Accumulated depreciation	(Rs. 40,000)	(Rs. 50,000)
Total	Rs. 670,000	Rs. 627,000
Liabilities and Equity		
Accounts Payable	Rs. 125,000	Rs. 62,300
Salaries Payable	Rs. 42,000	Rs. 35,000
Long term Notes Payable	Rs. 160,000	Rs. 160,000
Capital Stocks	Rs. 300,000	Rs. 300,000
Retained Earnings	Rs. 43,000	Rs. 69,000
Total	Rs.670,000	Rs. 627,000

The analysis of the record reveals that the company paid the dividends amounting to Rs. 100,000 to shareholders.

Required:

1) Prepare a cash flow statement for the year ended 30 June, 2020 under direct method.
2) Prepare a cash flow statement for the year ended 30 June, 2020 under indirect method.
3) Draw a comparison of the relevant sections of the cash flow statements prepared under (1) and (2) above and comment on any difference found in it.

P.8-4

The following data was extracted from the accounting record of Decent Home Appliances Company for the year ended 30 June, 2021:-

Cash collect from customers	Rs. 1,200,000
Cash paid to suppliers	Rs. 1,000,000
Proceeds from sale of motor cycle	Rs. 19,000
Proceeds from long term loan	Rs. 325,000
Cash paid to acquire air conditioner	Rs. 175,000
Interest and dividend collected	Rs. 12,000
Purchase of shares of subsidiary company	Rs. 100,000
Short term loans to staff	Rs. 150,000
Dividends paid	Rs. 18,000
Interest paid	Rs. 4,500
Income tax paid	Rs. 45,000
Closing cash balance	Rs. 22,500
Opening cash balance	Rs. 86,000

Required:

Prepare a cash flow statement under direct method.

P.8-5

The following income statement and selected balance sheet accounts information was extracted from the record of Decent Trading Company for the year ended 30 June, 2020.

Income Statement for the year ended 30 June, 2020.

Sales revenues		Rs. 1,540,000
Less Cost of Goods Sold		Rs. 1,210,000
Gross Income		Rs. 330,000
Less operating expenses		Rs. 112,000
Operating income		Rs. 218,000
Other items		
Interest income	Rs. 22,000	
Dividend income	Rs. 18,000	
Gain on sale of marketable securities	Rs. 40,000	
Interest expenses	(Rs. 6,000)	Rs. 74,000
Net income before tax		Rs. 292,000
Income tax		Rs. 87,600
Net income after tax		Rs. 204,400

Balance Sheet Data

	Opening balances	Closing balances
Accounts Receivables	Rs. 680,000	Rs. 535,000
Accrued interest income	Rs. 4,500	Rs. 6,300
Inventories	Rs. 675,000	Rs. 750,000
Prepaid expenses of interest	Rs. 4,300	Rs. 5,800
Accounts Payable	Rs. 530,000	Rs. 435,000
Accrued operating expenses	Rs. 12,000	Rs. 18,000
Income tax payable	Rs. 18,000	Rs. 15,000

Additional information as mentioned below was also extracted from the record.

a) Operating expenses include depreciation expense of Rs. 15,000 for the period.
b) Dividend income is recognized on cash basis while all other expenses and incomes are accounted for on accrual basis.

Required

a) Prepare the operating activities section of the cash flow statement based on direct method.
b) Prepare the operating activities section of the cash flow statement based on indirect method.

P.8-6

The Income Statement for the year ended on 30 June, 2020 of Asghar Trading Company is as follows.

Income Statement for the year ended 30-06-2020

Sales Revenues		Rs. 1,280,000
Less Cost of Goods Sold	Rs. 570,000	
Selling and admin expenses	Rs. 218,000	
Other expenses	Rs. 6,500	Rs. 794,500
Net income before tax		Rs. 485,500
Less income tax		Rs. 145,650
Net income after tax		Rs. 339,850

Following additional information was also available:

a) Depreciation of Rs. 15,500 was included in the selling and admin expenses
b) Other expenses include the bad debts of Rs. 3,000
c) Accounts receivables were increased by Rs. 118,000 at the end of the year. The opening cash balance was Rs. 70,500.
d) Accounts payable were increased by Rs. 70,800 at the end of the year.
e) Inventories were increased by Rs. 125,000 at the end of the year.
f) Tax payable was decreased by Rs. 22,000 at end of the year.

g) Salaries payable of selling staff were decreased by Rs. 23,000 at end of the year.
h) Dividend of Rs. 120,000 was paid to stockholders.
i) Plant amounting to Rs. 250,000 was purchased during the year.
j) Debentures amounting to Rs. 400,000 were issued during the year.
k) Old motor car was sold at Rs. 122,000 at cash.
l) A motor cycle for marketing staff was purchased at Rs. 130,000.

Required: Prepare cash flow statement at end of the year under direct and indirect method approaches for operating, investing and financing activities.

P.8-7
Shandan Furniture Company provided the following information from its accounting record.

Income Statement for the year ended 30-06-2021

Sales Revenues		Rs. 1,836,500
Less Cost of Goods Sold		Rs. 1,220,000
Gross Income		Rs. 616,500
Operating expenses		
Salaries of staff	Rs. 132,000	
Depreciation expenses	Rs. 75,000	
Amortization of Bond discount	Rs. 22,000	
Bad debts expenses	Rs. 10,500	
Rent expenses	Rs. 118,000	
Utilities expenses	Rs. 75,000	Rs. 432,500
Operating income		Rs. 184,000
Interest expenses		Rs. 12,000
Net income before tax		Rs. 172,000
Income tax		Rs. 51,600
Net income after tax		Rs. 120,400

1) Treasury stock purchased last year was decreased by Rs. 350,000 during current year.
2) Bonds Payable was increased by Rs. 250,000.
3) Dividend paid during the year amounted to Rs. 80,000.
4) Accounts receivables increased by Rs. 175,000.
5) Inventories decreased by Rs. 35,000.
6) Accounts Payable decreased by Rs. 170,000.
7) Tax liability increased by Rs. 30,000.
8) Interest payable decreased by Rs. 7,500.
9) Plant of Rs. 480,000 was increased during the year.
10) Rent payable was decreased by Rs. 35,000 during the year.

11) The opening cash was Rs. 18,500 while closing cash balance was Rs. 233,900.

Required:
Based upon the above data prepare cash flow statements under direct method and under indirect method.

P.8-8
From the following information extracted from the accounting record of AB&C Company, prepare cash flow from operating activities for the year ended on 30 June, 2020 under indirect method:-

a) Net income for the year amounted to Rs. 110,000 after charging depreciation of Rs. 23,000 and providing for bad debts of Rs. 7,500.
b) The balances of working capital items were as under.

Balance sheet data

	Opening of the year	Closing of the year
Accounts Receivables	Rs. 175,000	Rs. 190,000
Notes Receivables	Rs. 72,000	Rs. 70,000
Inventories of merchandise	Rs. 55,000	Rs. 65,000
Store supplies	Rs. 10,000	Rs. 8,000
Marketable Securities	Rs. 170,000	Rs. 160,000
Bills Payable	Rs. 45,000	Rs. 65,000
Notes Payable	Rs. 70,000	Rs. 85,000
Prepaid expenses	Rs. 12,000	Rs. 9,500
Accrued income	Rs. 15,000	Rs. 17,500
Utilities expenses payable	Rs. 18,000	Rs. 22,500
Unearned income	Rs. 14,000	Rs. 13,000

P.8-9
The comparative balance sheet of Hassan Carpets Trading Company for the two years is presented below:-

	At 30-06-2020	**At 30-06-2021**
Cash	Rs. 149,000	Rs. 197,000
Accounts Receivable	Rs. 210,000	Rs. 455,000
Inventory	Rs. 540,000	Rs. 510,000
Long term investments	Rs. 150,000	Rs. 250,000
Show Room Building	Rs. 1,400,000	Rs. 1,320,000
Motor Vehicle	Rs. 500,000	Rs. 450,000
Total	Rs. 2,949,000	Rs. 3,182,000
Accounts Payable	Rs. 168,000	Rs. 134,000
Tax Payable	Rs. 75,000	Rs. 30,000
Mortgage loan	Rs. 370,000	Rs. 570,000
Capital Stock	Rs. 2,280,000	Rs. 2,380,000
Retained Earnings	Rs. 56,000	Rs. 68,000
Total	Rs. 2,949,000	Rs. 3,182,000

Additional information

a) Short term investments amounting to Rs. 100,000 were made during the year.
b) Show Room Building and Motor Vehicles were depreciated during the year.
c) Mortgage loan was taken by the company for meeting funds requirements.
d) Additional shares were issued during the year.
e) The dividend accounting to Rs. 300,000 was paid during the year.
f) The company earned some profit which affected the retained earnings during the period.

Required: Prepare a cash flow statement under indirect method for the year ended 30 June, 2021.

P.8-10

The management of Kashif Trading Company was worried at the deteriorating financial condition of the Company. The Company has availed full overdraft facility from its bank but it was not possible to pay its suppliers on due dates through the periodic profit earned was satisfactory. The comparative balance sheet of two years is presented below: -

	At 30-06-2020	At 30-06-2021
Cash	Rs. 20,000	Rs. 18,000
Accounts Receivables	Rs. 920,000	Rs. 1,200,000
Inventories	Rs. 440,000	Rs. 1,440,000
Prepaid expenses	Rs. 62,000	Rs. 72,000
Land and Building	Rs. 1,000,000	Rs. 1,200,000
Vehicle	Rs. 430,000	Rs. 390,000
Total	Rs. 2,872,000	Rs. 4,320,000
Accounts Payables	Rs. 420,000	Rs. 900,000
Bank overdraft	Rs. 300,000	Rs. 1,000,000
Share capital	Rs. 2,000,000	Rs. 2,000,000
Retained Earnings	Rs. 152,000	Rs. 420,000
Total	Rs. 2,872,000	Rs. 4,320,000

Scrutiny of the record revealed that depreciation amounting to Rs. 100,000 on Building and Rs. 40,000 was applied on the vehicle during the year. An additional room for store was constructed in the building at the cost of Rs. 300,000. The dividend of Rs. 200,000 was paid to shareholders.

Required: Prepare a cash flow statement under indirect method to indicate the movement of cash during the period.

8.13 GLOSSARY

Cash flow statement

A statutory report prepared at the end of an accounting period to give details of cash movement and reconciliation of reported net income under accrual basis of accounting with the closing cash balance.

Classification of cash flows
It indicates the segregation of cash inflows and outflows during the period under three categories of operating, investing and financing activities of the organization.

Operating activities
The business activities which are related to income and expenses items for the reporting period

Investing activities
The business activities which are related to the acquisition and disposal of assets of a relatively longer period of service

Financing activities
The business activities which are related to the collection and disbursement of funds from capital, long term loans and similar nature

Cash inflows
This means receipt and collection of cash from different resources of business activities during a period of time.

Cash outflows
The payments and disbursements of cash during a period of time against different heads of accounts like expanses, prepayments, repayment of loans, dividends, taxes, acquisition of assets, advances, redemption of debentures and discharge of other liabilities.

Direct Method of cash flow
Where all relevant heads of accounts relating to income, expenses, assets, liabilities and equity are scanned to report cash inflows and outflows on it in the cash flow statement under three categories of operating, investing and financing activities.

Indirect Method of cash flow
Where the operating activities section of the cash flow statement is presented starting with the net income duly adjusted by non-cash expenses and income and adjustments of increase and decrease in working capital items to find out net cash flow from operating activities while the other two sections of investing and financing activities cash flows are uniformly prepared identically as stated in the direct method.

Poring cash balance
It means that the net result of cash inflows and outflows from operating, investing and financing activities are combined together and adding in it the opening cash balance to reconcile it with the closing cash balance as reported in the balance sheet.

Unit–9

ANALYSIS OF FINANCIAL STATEMENTS

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CONTENTS

INTRODUCTION

The uint-9 is related to the analysis of financial statements. The financial statements are the results of different activities performed during a period and the balances of all the related accounts are grouped to gather in the financial statements are analyzed by the management and outsiders for taking different business decisions. The analysis of financial statements is a professional technique employed by experts in analyzing and interpretations on different aspects of operating performance and financial condition at a given time. The analysis is conducted through the tools of horizontal, vertical, ratios and trends in order to find out strength or weaknesses of the multifarious facts relating to the specific organization. Greater focus for the analysis is towards profitability and liquidity to which almost all stakeholders are interested for their own objectives and dealing with the enterprise.

OBJECTIVES

After learning the contents of this unit the students are expected to become well conversant with the following objectives of analysis of financial statements: -

- The composition of financial statements and importance with different information available from each element.
- The method for carrying out horizontal analysis of each component of the income statement and the balance sheet at a given time.
- The procedure followed for vertical analysis of the income statement and balance sheet items to find out their percentage share with the total weights.
- The techniques for computation of diversified ratios relating to profitability and liquidity analysis and their interpretation to find out the status of operating performance and financial condition to establish strength of the organization at a given period.
- To find out the behavior of different ratios through trend analysis and comparison with industry norms.
- Based on the above ratio analysis the management and other stakeholders take decisions on business activities to be conducted with the enterprise.

9.1 BASICS OF ANALYSIS

The financial statements comprise Income Statement, Balance Sheet, and Statement of changes in equity and the cash flow statement for a specific period of time which generally is spread over an accounting year. The aforesaid general purpose statements are accordingly prepared almost for every business entity and particularly for the enterprises established under the Companies Act, 2017. The forgoing statements are usually supplemented by some explanatory notes to provide details of some information summarized in the financial statements apart from policies, rules and regulations adopted for preparation and presentation of the information embodied in these statements. These financial statements are drawn in accordance with the requirements of International Accounting Standard No.01 so as to ensure uniformity, compatibility, reliability and harmonization in the reported results. Further, it is ensured to record the business transactions in compliance to the Generally Accepted Accounting Principles (GAAP) in the accounting record.

The financial statements so prepared by the business enterprise are then analyzed intermittently or at end of the year to ascertain performance of the business organization and also determine financial condition. Further the accounting data selected from these financial statements are analyzed in different perspectives by the management and outsiders according to their specific requirements. This analysis reduces reliance on estimations, guesses and other crude information. The analysis of financial statements also dilutes uncertainty in decision making in view of availability of supportive analyzed information. It is a way by which operating and the financial stability and health of the organization can be gauged. Therefore, it does not require any expert judgment of any outsiders for any decision making perspectives.

9.2 PURPOSES OF ANALYSIS

The purposes of analysis are segregated according to the interests involved in the specific field. The primary objective may be to identify major changes and investigation for such changes. The management may undertake the analysis of financial statements to ascertain profitability, liquidity and on an overall basis efficiency and effectiveness in producing and marketing the merchandises and services. On the other hand, the external users of accounting information like shareholders, lenders, vendor's regulatory agencies, customers and brokers may be interested in evaluating the performance and financial condition and also the future prospects of the company for taking diversified business decisions and dealing with the enterprise. Each external agency would analyze the financial statements according to its specific requirement. For instance, the shareholders would be interested in the profitability analysis for payment of dividends. The creditors and lenders would be interested to ascertain short term and long term liquidity analysis of the company. The regulatory agencies may be concerned with profitability of the company for taxation and also compliance to the legal requirements and fair presentation of information. The trade unions may be concerned with the performance and stability of the company for negotiation with management for welfare and rewards of employees. The brokers would be interested with the performance of the company for trading its shares by the potential investors on the stock markets. The rating agencies would be involved in the past, present and forecast future performance of the enterprise for different reporting purposes. The analysis of financial Statements is a judgmental process. Every person interested in the analysis of financial Statements is not expert to understand the meanings and impact of analytical results. Therefore, the interpretation of analysis is also arranged by the professional experts to understand realistically, the meanings of analysis, by the concerned internal and external users.

9.3 TOOLS OF ANALYSIS

The financial statements can be analyzed through application of various techniques in selective manner and in broader perspective according to the particular needs of the analysis. The tools of analysis can be classified into major three categories as commonly used which are the following: -

1) Horizontal analysis for the comparison of the performance and financial condition of the company across the time i.e. from one period to the other.
2) Vertical analysis for comparison of the performance and financial condition of the company to a base amount of the same period.
3) Ratio analysis for assessment of the key relations between the various items of financial statements as much as the pairs of figures can be ascertained. The horizontal and vertical analysis are also known as common size analysis as it expresses comparison of figures and computation in percentages to work out changes from period to period and within the same period for different items of analysis. These tools of analysis are described in the forthcoming paragraphs to understand its application properly.

9.4 HORIZONTAL ANALYSIS

In the field of analysis any single numerical number may be of little use until several figures are adopted for comparison to derive meaningful objectives and conclusions. This is possible through horizontal analysis whereby several absolute figures of income statement and the balance sheet items are compared across the time. The figures of bare year are considered at 100% and the figures of subsequent period/year of income statement and balance sheet are compared with the bare year for computation of increase or decrease in amount as well as in percentage to determine improvement or decline during the period. This is called as horizontal analysis. This comparison is conducted through the figures of two or more years from right to left or left to right as is considered expedient. The changes are then investigated to ascertain the causes of improvement or deterioration over the time for managerial purposes. The comparison of sales figures, for example, of two years under horizontal analysis is carried out as under: -

		Million
Sales	2020	Rs. 216
Less	2019	Rs. 180
Change in Sales		Rs. 36
Change in percentage		36/180x100
		= 20%

The investigation of this analysis may indicate that the enhancement in sales by Rs. 36 million during 2020 as compared with the sales of 2019 may be due to strenuous efforts of the marketing staff or because of improvement in quality of products and through launching of some new product in the market.

The next item of the income statement is usually the Cost of Goods Sold. The horizontal analysis of this item is conducted as under: -

Cost of Goods Sold		Million
	2020	Rs. 140
Less	2019	Rs. 120
Change in COGS		Rs. 20
Percentage change		20/120x100
		= 16.667%

The investigation of this analysis reveals that the Cost of Goods Sold is increased by Rs. 20 million during 2020 as compared with the cost of goods sold for the year 2019 which registers 16.667% increase. When this increase is compared with the increase in sales of 20%, it indicates net reduction in cost by 3.333% during the year 2020 which has direct relation to the increase in gross profit during 2020 as tabulated below through horizontal analysis: -

	Rs. In Million			
	2019	**2020**	**Difference**	**Percentage**
Sales revenues	180	216	36	**20%**
Less Cost of goods sold	120	140	20	**16.667%**
Gross profit	60	76	16	**26.667%**
Gross profit percentage	**33.333%**	**35.185%**		

The above comparison depicts the growth of gross profit percentage from 33.333% in 2019 to 35.185% during 2020 which is the net impact of increase in sales and the cost of goods sold during the period.

The horizontal analysis of balance sheet items can also be computed based upon the above pattern of comparison as presented below:-

	Rs. In Million			
Current Assets	**2019**	**2020**	**Increase Amount**	**Percentage**
Cash	12	15	3	**25%**
Marketable securities	10	12	2	**20%**
Accounts Receivables	50	60	10	**20%**
Inventories	40	45	5	**12.5%**
Total	**112**	**132**	**20**	**17.857%**

The horizontal analysis of current assets items of the balance sheet for 2020 as compared with 2019 depicts that the cash is increased by Rs. 3 million during 2020 as compared with the cash balance of 2019 which shows 25% increase. Considering all other items of current assets for 2020 in comparison with 2019, it represents increase of 20 million which is 17.857%. This growth indicates better liquidity during 2020.

9.5 COMPARATIVE STATEMENT ANALYSIS

Based upon the foregoing analogy of working out the horizontal analysis, we can now draw comparison of all income statement items and the balance sheet items for two or more years' side by side arranging additional columns for change in rupee amount and in percentage for each component to highlight large changes in the current year as compared with the previous year. This analysis is now presented in exhibit 9-A for Income Statement and in the exhibit 9-B for the balance sheet of Arshad Trading Company, Rawalpindi that follows in the succeeding portion.

Exhibit 9-A

Arshad Trading Company, Rawalpindi

Comparative Income Statement for the year ended on 30 June 2019 and 30 June 2020.

Rs. In Million				
			Change	
	2019	2020	Amount	Percentage
Sales Revenues	Rs. 180	216	36	20%
Less Cost of goods sold	Rs. 120	140	20	16.667%
Gross income	Rs. 60	76	16	26.667%
Operating expenses:				
Selling expenses	Rs. 9	11	2	22.222%
Admin expenses	Rs. 12	14	2	16.667%
Total expenses	Rs. 21	25	4	19.048%
Operating income	Rs. 39	51	12	30.769%
Less Income Tax	Rs. 12	15	3	25%
Net income after tax	Rs. 27	36	9	33.333%

In the above horizontal analysis, the change in amount of each component is worked out by deducting the base year (2019) amount from the analysis year (2020) amount. The percentage change is computed through dividing the change amount by the base year amount multiplied by 100. This analysis indicates that the gross profit is increased by 26.667%, operating income by 30.769% while net income after tax by 33.333% during 2020 as compared with the previous year of 2019. This growth can be attributed towards the better performance of the management and its team by controlling expenses as compared with growth in revenues.

Exhibit 9-B

Arshad Trading Company, Rawalpindi
Comparative Balance Sheet
As at 30 June, 2019 and 30 June, 2020.

In Million Rupees

	2019	2020	Change	
Current Assets			Amount	*Percentage*
Cash	12	15	3	***25%***
Marketable Securities	10	12	2	***20%***
Accounts Receivables	50	60	10	***20%***
Inventories	40	45	5	***12.5%***
Prepaid expenses	5	2	(3)	***(60%)***
Sub. Total	117	134	17	***14.53%***
Fixed Assets				
Land	10	10	—	–
Building	18	20	2	***11.111%***
Machinery	25	30	5	***20%***
Vehicles	8	10	2	***25%***
Sub. Total	61	70	9	***14.754%***
Total	**178**	**204**	**26**	***14.607%***
Current Liabilities				
Accounts Payable	25	37	12	***48%***
Dividends Payable	21	25	4	***19.048%***
Wages Payable	6	5	(1)	***(16.607%)***
Sub. Total	52	67	15	***28.846%***
Long term loans	20	20	—	—
Equity				
Capital Stock	100	100	—	—
Retained Earnings	6	17	11	***183.333%***
Sub total	106	117	11	***10.377%***
Total	**178**	**204**	**26**	***14.607%***

The horizontal analysis of balance sheet items for 2020 as compared with 2019 depicts that the current assets have been increased by 14.53% while fixed assets registered enhancement by 14.754% totaling to net assets increase of 14. 607%. This increase is reciprocated by 28.846% increase in current liabilities and 183.333% increase in the retained earnings totaling to net increase in liabilities and equity by 14.607% on an overall basis. Further investigation exhibits that the net increase in income by Rs. 9 million after tax during 2020 is invested in the acquisition of fixed assets during 2020 as compared with 2019. Besides the growth in current assets during 2020 is due to reciprocal increase in the amount of current liabilities during 2020.

9.6 TREND IN HORIZONTAL ANALYSIS

The analysis in the preceding paragraphs was conducted by comparing the current year figures with the last year figures of Income Statement items and the balance sheet items. It indicates only the current changes but did not exhibit the trend changes. The trend determination in the horizontal analysis is the system of analysis which reveals pattern changes in data of several years. It involves calculating trend percentages for a series of consecutive numerical numbers of several periods. The difference is that the trend analysis does not subtract the base period amount from the numerator. The trend percentage is computed by allotting 100% weight to each item of base year and any subsequent year figures are computed in terms of percentage through dividing it by the base year amount. The trend analysis for few years is now computed as per exhibit-9-C that follows: -

Exhibit 9-C

Trend Analysis of Sales and Cost of Goods Sold
Rupees in million

Year	Sales	Percentage	Cost of Goods Sold	Percentage
2016	40	100%	30	**100%**
2017	50	125%	36	**120%**
2018	56	140%	42	**140%**
2019	66	165%	48	**160%**
2020	74	185%	54	**180%**

The above trend of five years' analysis reveals that there was a gradual growth in the sales from 2017 to 2020 as compared with the sales of 2016 which was treated as the base year. This growth probably was the result of better marketing strategies over the period. In contrast, the trend analysis of five years for the cost of goods sold reveals that some increase was registered in it but it was lower than the increase in sales revenues which provides an evidence of adequate cost controls by the management. The trend analysis leads to the significance of the behavior of sales, cost of goods sold and profitability over the years.

9.7 VERTICAL ANALYSIS

The vertical analysis is another tool of common site analysis for evaluation of the financial statement components or a group of items in reference to the specific base amount. Usually for income statement vertical analysis the aggregate base amount is taken as the sales revenues which are allocated 100 weights and all other items of cost, expenses, tax and net income are treated to compute percentage weight. Similarly, the total amount of assets and liabilities including equity items are considered each aggregate base at 100 weight and its individual items are computed at relevant weight percentage to ascertain the share of each item. In case of Income statement items, the attempt of vertical analysis is carried out from up to down while in case of balance sheet items it is attempted from down to up. The common size vertical analysis of Income Statement and balance sheet are presented as per Exhibits 9-D and 9-E respectively that follow.

Exhibit 9-D

Arshad Trading Company, Rawalpindi
Common size Vertical analysis of Income Statement
For the years ended 30 June 2019 and 30 June 2020

In Million Rupees

	2019		2020	
	Amount	Percentage	Amount	**Percentage**
Sales revenues	1800	100%	216	**100%**
Less Cost of Goods Sold	120	66.667%	140	**64.815%**
Gross income	60	33.333%	76	**35.185%**
Operating expenses:				
Selling expenses	9	5%	11	**5.093%**
Admin expenses	12	6.667%	14	**6.481%**
Total expenses	21	11.667%	25	**11.574%**
Operating income	39	21.667%	51	**23.611%**
Less Income tax	12	6.667%	15	**6.944%**
Net income after tax	27	15%	36	**16.667%**

The Common size vertical analysis of the income statement items for 2019 and 2020 depict that the cost of goods sold during 2019 was 66.667% of sales while during 2020 it declined to 64.815% which expresses good cost control by the management. This has resulted into growth in the gross income from 33.333% during 2019 to 35.185% during 2020.

Further the operating expenses were decreased to 11.574% during 2020 in reference to 11.667% during 2019 which registers enhancement in net income after tax from 15% during 2019 to 16.667% of sales during 2020 which exhibits better business performance.

Exhibit 9-E

Arshad Trading Company, Rawalpindi
Common size vertical analysis of Balance Sheet
As at 30 June, 2019 and 30 June, 2020

In Million Rupees

	2019		2020	
	Amount	**Percentage**	**Amount**	**Percentage**
Current Assets				
Cash	12	6.742%	15	7.353%
Marketable Securities	10	5.618%	12	5.882%
Accounts receivables	50	28.090%	60	29.412%
Inventories	40	22.472%	45	22.059
Prepaid expenses	5	2.809%	2	0.980%
Sub. Total	117	65.731%	134	65.686%
Fixed Assets				
Land	10	5.618%	10	4.902%
Building	18	10.112%	20	9.804%
Machinery	25	14.045%	30	14.706%
Vehicles	8	4.494%	10	4.902%
Sub. Total	61	34.269%	70	34.314%
Total	**178**	**100%**	**204**	**100%**
Current liabilities				
Accounts Payable	25	14.045%	37	18.137%
Dividends Payable	21	11.798%	25	12.255%
Wages Payable	6	3.371%	5	2.451%
Sub. Total	52	29.214%	67	32.843%
Long term loans	20	11.236%	20	9.804%
Equity				
Capital Stock	100	56.180%	100	49.020%
Retained Earnings	6	3.370%	17	8.333%
Sub. Total	106	59.550%	117	57.353%
Total	**178**	**100%**	**204**	**100%**

Few computation of the vertical analysis of income statement items and balance sheet items for 2019 is presented below to understand the workings.

Income Statement items

-	Cost of Goods Sold percentage Rs. 120/180x100 = 66.667%
-	Selling expenses percentage Rs. 9/180x100 = 5%
-	Operating income percentage Rs. 39/180x100 = 21.667%
-	Net income after tax percentage Rs. 27/180x100 = 15%
Balance Sheet items	
-	Accounts Receivable percentage Rs. 50/178x100 = 28.090%
-	Machinery percentage Rs. 25/178x100 = 14.045%
-	Retained earnings Rs. 6/178x100 = 3.370%

Rest of the items of income statement and the balance sheet can also be analyzed for percentage computation by the similar procedure.

The above common size vertical analysis exhibits the percentage share of costs and expenses of each year in relation to the sales figure for income statement and the percentage share of variety of assets, liabilities and equity items in relation to the total strength of the balance sheet. This evaluation and investigation depicts that the cost of goods sold during 2019 was 66.667% of its sales which was reduced to 64.815% of sales for 2020. This shows good cost control during 2020. Similarly, other expenses were controlled which ultimately enhanced the net income from 15% in 2019 to 16.667% during 2020.

With regard to the common size analysis and investigation of the components of balance sheet indicate slight changes in cash and accounts receivables during 2020 as compared to 2019 and also changes in fixed assets. The liabilities and owners' equity have also expressed certain changes because of impact of periodic operating activities and retention of some funds and net income within the organization during 2020.

9.8 RATIO ANALYSIS

The horizontal and vertical common size analysis dealt with in the preceding paragraphs is generally understandable to the skillful and professional people for evaluation purposes. A common person cannot conveniently understand this analysis. Thus ratio analysis of income statement and balance sheet items is also conducted to understand the results of investigations. The ratio is the numerical or an arithmetical relationship between two figures. Absolute figures are valuable but alone do not convey any meaning unless compared with another figure. Accounting ratios show inter- relationships which exist among various accounting data. When relationships existing amongst various accounting data supplied by the financial statements are worked out, they are known as accounting ratios. The ratio analysis stands for the process of determining and presenting the relationship of items and groups of items of the financial statements. It is an important technique of financial analysis. It is a technique by which operating, financial and health of an enterprise can be judged. Thus the ratio analysis is the widely used tools of financial analysis as it provides clues to any symptoms of underlying conditions in an absolute manner. The ratios can be developed as many as the pairs of two figures relevant to each other are inter faced. A ratio expresses some relationship between two figures which can be presented in percentage and in certain cases as time age. There are multiple ratios which can be developed. The appropriate evaluation of an enterprise cannot be premised upon the single or few ratios rather overall judgment would be based upon several ratios developed from the accounting data taken from the financial statements. These ratios can now be computed as elucidated in the ensuing portion.

9.9 PROFITABILITY RATIOS

The determination of profitability ratios is the most important ratio to which every stakeholder would be interested to know. The profitability ratios are the ability of a concern to generate earnings. The shareholders are vitally concerned with profitability because they get dividends from earnings and it also causes enhancement in the market value of shares leading to the capital gains. The creditors also look at the profits of the company as the profitable operations are the source of funds generation for redemption of liabilities. The performance of the management is generally gauged on the basis of profitability. The profitability ratios can be computed in several ways as deliberated below.

A) Gross Profit Margin

The gross profit margin is the residual amount after deducting the cost of goods sold from the sales revenues. The periodic sales revenues and the cost of goods sold fluctuate owing to the changes in selling prices, buying cost of merchandise and mix of merchandise or any inventory pilferage in the warehouse. The gross profit margin is now worked out by picking up the figures from the income statement as presented at exhibit 9-D in the preceding paragraphs.

Amount in million Rupees

	2019	2020
Sales	180	216
Less cost of goods sold	120	140
Gross Profit Margin	60	76

The formula for determination of gross profit margin ratio in percentage is as under:-

Amount of Gross Profit / Net Sales revenues x 100

	2019	2020
Gross Profit Ratio =	Rs. 60 / 180 x 100 = 33.333%	Rs. 76 / 216 x 100 = 35.185%

The above tabulation portrays that during 2019 the gross profit was to the tune of Rs. 60 million which represented gross profit ratio of 33.333% of sales. During 2020 the gross profit increased to Rs. 76 million which depicts 35.185% to sales. This reveals growth in gross profit during 2020 as compared to 2019. This is treated as progress of the business performance and the credit goes to the management of the organization.

B) Net Profit margin

The net profit margin is computed by deducting all operating expenses and income tax from the gross profit margin. The net profit margin in percentage is worked out through dividing the net profit by the sales amount as tabulated below. The data is adopted from the exhibit 9-D in preceding paras.

Rs. In million

	2019	2020
Gross profit	Rs. 60	Rs. 76
Less operating expenses and income tax	33	40
Net income	Rs. 27	Rs. 36

The net profit ratio is computed through dividing the net income after tax by the amount of Sales as tabulated below:

Rs. In million

2019	2020
Gross Profit Ratio = Rs. 27 / 180 x 100 = 15%	Rs. 36 / 216 x 100 = 16.667%

The net profit margin and net profit ratio represent growth during 2020 as compared to 2019. This is again linked with the better performance of the management which is resulted through adequate cost controls.

C) Operating Income Margin

This ratio represents the relationship of operating income with the sale revenues. The deduction of operating expenses from gross income / profit provides the amount of operating income for the period. The operating income is compared with the sales revenues to determine the ratio of operating income as calculated below:

Rs. In million

	2019	2020
Gross income	Rs. 60	Rs. 76
Less operating expenses	Rs. 21	Rs. 25
Operating income	Rs. 29	Rs. 51

Operating income Ratio = Operating income / Sales x 100

Rs. 39 / Rs. 180 x 100 = 21.667%	Rs. 51 / Rs. 216 x 100 = 23.611%

This ratio depicts improvement in operating income during 2020 as composed with 2019 which is better performance of the management.

D) Return on Total assets

The return on total assets is the evaluation technique for determining the productive utilization of the assets of the organization. This ratio is computed through dividing the periodic net income by average total assets held and used during the period. The formula is as under:

Return on total assets = Net income / Average Total assets X 100

2019	2020
Rs. 27 / Rs. 178 x 100 = 15.169%	Rs. 36 / Rs. 204 x 100 = 17.647%

The data as used above is picked up from the Income Statements and Balance Sheets as at exhibit 9-D and 9-E in the preceding paras. This analysis represents that the net income generated for 2019 is equal to 15.169% of the total assets and 17.647% during 2020. This analysis portrays better utilization of business resources as increase during 2020 is registered as compared with 2019. Here total figures of assets are taken as average assets figure was not available.

E) Return on Operating Assets

The return on operating assets is the relationship of operating income with the operating assets. The assets like construction work in progress and uninstalled machinery is deducted from the total assets to find out the operating assets. The operating income is divided by the average operating assets to find out the return on operating assets. This is worked out as under:-

Return on operating assets = Operating income / Average operating assets

Rs. In million

	2019	2020
Return on operating assets	= Rs. 39 / (Rs. 55+61) /2 x 100	Rs. 51 / (Rs. 61+70) /2 x 100
	= Rs. 39/ 58 x 100	Rs. 51/Rs. 65.5 x 100
	= 67. 24%	= 77. 86%

The above comparison exhibits that during 2020 the operating income is increased from 2019 due to effective utilization of the operating assets to generate operating income.

F) Operating Assets turnover

This ratio measures the capability of the operating assets to generate sales revenues through the application of following formula:-

Operating assets turnover = Net Sales / Average Operating Assets

	2019	**2020**
Operating assets turnover	= Rs. 180 / (Rs. 55+61)/2	Rs. 216/ (Rs. 61+70)/2
	= Rs. 180 / Rs. 58	Rs. 216/ Rs. 65.5
	= 3.1 X	= 3.30 X

The above ratio indicates that the operating assets have been applied for generation of sales during 2020 more effectively as compared to 2019 which is termed as better utilization of resources.

G) Return on Investment Ratio

The return on investment alternatively known as return on Capital employed is the relationship of net income with the average amount of owners' equity plus long term loans. This ratio is developed as under

Net income / Average of Equity + Long term loans x 100

Rs. In million

2019	2020
Rs. 27 / Rs. 106 + Rs. 20 x 100	Rs. 36 / Rs. 117 + Rs. 20 x 100
Rs. 27/ Rs. 126 x 100 = 21.43%	Rs. 36/ Rs. 137 = 26.28%

This analysis indicates that owners' investments were more effectively utilize during 2020 as compared with 2019.

H. Return on Equity Ratio

The return on equity ratio is computed through dividing the net income by the average amount of equity for the period as worked out below:-

Net Income/Average equity (Capital Stock + Reserves and Retained Earnings) x 100

2019	2020
Rs. 27/ 100+6 x 100	Rs. 36 / 100+17 x 100
=25.47%	= 30.77%

The above analysis represents sufficient growth in return on equity during 2020 as compared with 2019. This ratio is usually computed for common equity as the return on preferred equity is usually guaranteed at prefixed rates.

I-Earning per share (EPS)

The earnings per share is the computation of net income relationship with the total number of Common Stocks subscribed, paid up and outstanding for the relevant year. This ratio is worked out as under:-

EPS = Net income / No. of Common Stocks outstanding

	2019	2020
EPS	= Rs. 27,000,000/ 1,000,000	Rs. 36,000,000/ 1,000,000
	= Rs. 27	Rs. 36

The capital stock of Rs. 100 million mentioned in the balance sheet at Exhibit 9-E is 1,000,000 shares of Rs. 100 each.

The analysis of earning per share portrays a significant amount of earning per share in both the years. However, the earnings per share during 2020 are sufficiently high which show better performance of the management.

J-Dividend per Share

The dividend is the amount which is paid to the stockholders out of periodic earnings. The entire amount of earnings is usually not distributed amongst the stockholders. Certain amount of earnings is generally retained in the organization for different purposes. The dividend per share is computed through dividing the amount of proposed dividend by the total number of Common Stocks outstanding. This is worked out as under:-

Dividend per share = Proposed Dividend / No. of Common Shares outstanding

2019	2020
= Rs. 21,000,000 / 1,000,000	= Rs. 25,000,000 / 1,000,000
= Rs. 21 per share	= 25 per share

The above calculation indicates that the dividend of Rs. 21 and Rs. 25 per share was distributed amongst stockholders during 2019 and 2020 respectively. This represents sufficiently adequate return to stockholders in the shape of dividend. Greater rate of dividend attracts the potential investors to purchase shares of the company which tantamount to increase in market value of shares. The above dividend can be compared with the dividends of other companies or the prevailing interest rates on investment to gauge returns.

K- Interest Coverage Ratio

The interest coverage ratio alternatively known as times interest earned indicates the ability of the company to earn and pay the interest on long term loans. In case this ratio indicates several times greater ratio then it means that the organization is performing well to earn profit and out of its earnings can easily pay the interest and loan installments. This ratio is worked out as under:-

Net income before interest and tax interest expense

	2019	2020
Net income	Rs. 27,000,000	Rs. 36,000,000
Add interest	Rs. 2,400,000	Rs. 2,400,000
Add Tax	Rs. 12,000,000	Rs. 15,000,000
Earnings before interest and tax	Rs. 41,400,000	Rs. 53,400,000
Interest coverage Ratio	Rs. 41,400,000/2,400,000	Rs. 53,400,000/2,400,000
	= 17.25X	= 22.25X

The above interest coverage ratio represents sufficient protection available with the organization for better utilization of loan and competency to pay interest dues out of available profits. This ratio portrays significant growth during 2020 as compared with 2019.

L- Dividend yield Ratio

The dividend yield ratio indicates the relationship between the dividend per Common Stock declared and paid and the market price per common share to ascertain realistic yield to the investors. This ratio is computed through the following formula:

Dividend Yield = Dividend per Common Stock/Market value per Common Stock x 100

	2019	2020
Dividend Yield	= Rs. 21/Rs. 150 x100	Rs. 25/Rs. 160x100
	= 14%	= 15.63%

The amount of dividend per common stock of Rs. 100 par value received by stockholders amounting to Rs. 21 per share during 2019 and Rs. 25 during 2020 was considered significant return to stockholders. However, when this dividend is evaluated on the basis of current market prices of common stock which are higher than the par value, the resultant figure expenses realistic yield of dividend on stocks. This dividend yield is also adequate as alternative investment opportunities may not provide so much returns.

M-Price Earnings Ratio

The price earnings ratio portrays the relationship between the market price per share and the current earnings per share of the company. The market prices of different organizations can conveniently be taken from the stock exchanges and other media sources. The price earnings ratio is computed as under:

Price Earnings Ratio = Market price per common share/Earnings per share

	2019	2020
Price Earnings Ratio	Rs. 150/ 27	Rs. 160/36
	= 5.55X	= 4.44X

The above price earnings ratio indicates that the market price of the shares of the company are priced lower during 2020 as compared to 2019 due to higher earnings per share. The market price per share during 2020 should be greater than Rs. 160. This indication forestalls the potential investors that the market value of shares of this company is expected to grow in view of the trend of earning per share which is increasing. The investors usually view the price earnings ratio as a gauge of future earnings power and market price of shares of the company.

However, in certain circumstances the forgoing predictions may not become true every time because of other market influences effecting changes in economy.

9.10 LIQUIDITY RATIOS

Apart from assessing the profitability status of an organization another pertinent analysis is related to the evaluation of liquidity position which expresses the capability to discharge its maturing short term and long term liabilities of the organization. An organization can operate with losses but it cannot sustain operations when it does not pay its maturing obligations as its credibility is deteriorated in the market gradually. The liquidity ratios are worked out as under:-

A) Current Ratio and Working Capital

The working capital is the difference between the amount of current assets and current liabilities for the specific period as tabulated hereunder: -

Working Capital

Rs. In Million

	2019	**2020**
Current Assets		
Cash	12	15
Marketable Securities	10	12
Accounts Receivables	50	60
Inventories	40	45
Prepaid expenses	5	2
Total	117	134
Current liabilities		
Accounts payable	25	37
Dividend payable	21	25
Wages payable	6	5
Total	52	67
Working Capital	65	67

The working capital means the excessive liquid resources available with the organization to meet its day to day operating requirements for conduct of business activities without resource impediments. In the above tabulation adequate resources of working capital are available during both the years so it exhibits sound financial health of the organization.

B) Current Ratio

Current Ratio = Current Assets/Current liabilities x 100

2019	2020
Rs. 117/Rs.52x100	Rs. 134/Rs. 67 x100
= 225%	= 200%

The above current ratio of each year indicates 225% for 2019 while 200% for 2020. Although no specific and absolute yardstick for current ratio is prescribed yet generally 200% or 2 times current ratio is considered adequate for an organization which reveals that the company is liquid to discharge its maturing liabilities in due course. A slight lower percentage can be acceptable. But higher current ratio as for 2019 represent that somewhat surplus liquid resources were available as idle which may alarm that some surplus funds were not in productive use which can lessens the profitability ultimately. The higher current ratio can also be a result of seasonal influence over credit sales and accumulation of inventories.

C) Acid Test Ratio

The acid test ratio can also be known as quick ratio. The acid test ratio represents comparison of most liquid assets in reference to its liabilities redemption. The current assets excluding the inventories and prepaid expenses are taken for comparison with the current liabilities to find out the acid test ratio which is worked out as here under:-

Rs. In million

	2019	2020
Liquid current assets		
Cash	12	15
Marketable Securities	10	12
Accounts Receivables	50	60
Total	72	87
Current Liabilities	52	67

Acid Test Ratio = Liquid current Assets/Current liabilities x 100

= Rs. 72/52x100 = 138.46% = Rs. 87/67x100 = 129.85%

The general criteria for assessing adequate acid test ratio is 150% or 1.5 times. In the present calculation the acid test ratio during 2019 is 138.46% while it is 129.85% during 2020. These ratios are lower than the general criteria which may alarm the management that it may not be quite sound financially to discharge its liabilities timely, hence either the liquid resources need to be enhanced or liabilities be reduced to ensure smooth functioning without liquidity crunches.

D) Cash Ratio

Sometime an analyst need to view the liquidity of an enterprise through extremely conservative approach by considering only the cash and cash equivalent items of current assets in comparison with current liabilities as per the following formula: -

Cash Ratio = Cash + Marketable Securities/Current liabilities x 100

The cash ratio is now worked out as under: -

Rs. In million

Most liquid	2019	2020
Current Assets		
Cash	Rs. 12	Rs. 15
Marketable Securities	Rs. 10	Rs. 12
Total	Rs. 22	Rs. 27
Current liabilities	Rs. 52	Rs. 67
Cash Ratio	= Rs. 22/52 x 100	= Rs. 27/67 x 100
	= 42.31%	= 40.30%

The above cash ratios for 2019 and 2020 are somewhat reasonable as the entire current liabilities do not become due for payment rather gradually these are paid in due course of time. Excessive cash retention in the organization may lead to the conclusion that excessive cash is housed for no productive use. The objectives of the organizations necessitate that the resources should be kept on moving for business activities to generate revenues. Hence ideal cash ratio should move around 50% of the current liabilities.

E) Days Sales in Receivables

The compilation of sales in accounts receivables is a common phenomenon in most of the organizations. In the competitive market scenario, no one can sell its products purely on cash basis. Therefore, the trading organizations are compelled to follow the market practices like selling on credit basis to survive in the market. However, the management needs to focus vigilance over the behavior of collection of accounts receivables within the credit period and the balance of accounts receivables should not exceed the sales allowed for credit period. However, instead of all tremendous efforts it seldom is achieved. The delay in collection of accounts receivable creates severe liquidity and financial crunches to the organization. The days' sales in receivable are computed through the following formula: -

$$\textbf{Day Sales in Receivable} = \frac{\textbf{Average Gross Accounts Receivable}}{\textbf{Net Credit Sales/300 days}}$$

The computation of day's sales in receivables is as under:-

	2019	2020
Day Sales in Receivables =	$\frac{\text{Rs. 47,500,000}}{\text{Rs. 180,000,000/365 days}}$	$\frac{\text{Rs. 55,000,000}}{\text{Rs. 216,000,000/365days}}$
	$\frac{\text{Rs. 47,500,000}}{\text{Rs. 493151}}$	$\frac{\text{Rs. 55,000,000}}{\text{Rs. 591,781}}$
	= 96 days	= 93 days

The above workings depict that 96 days' credit sales are piled up in the accounts receivables of 2019 and 93 days' sales in accounts receivables of 2020. This is a sustained level of receivables. The delay in recovery of receivables leads to non-recovery causing bad debts expense.

This analysis indicates that in case the credit period allowed by the concern is 30 days then the 96 days' accounts receivables for 2019 are significantly accumulated for which the recovery staff should carry out strenuous efforts for collections. However, in case the concern has allowed 60 days' credit terms than 36 days, accounts receivables are excessively piled up for which management should focus for stimulating recovery staff for exercising greater efforts of recovery. It may be noted that delay in recovery of dues from accounts receivables results into delay in meeting the operational liabilities and sometimes the suppliers decline to supply the merchandise on credit basis.

F) Accounts Receivable Turnover Ratio

The accounts receivable turnover can be expressed in times of sales. The sales amount would be divided by the average gross receivable to work out this ratio as computed below:

$$\textbf{Accounts Receivable Turnover Ratio} = \frac{\textbf{Sales}}{\textbf{Average gross Receivables}}$$

	2019	2002
Credit Sales	Rs. 180,000,000	Rs. 216,000,000
Accounts Receivables Opening	Rs. 45,000,000	Rs. 50,000,000
Closing	Rs. 50,000,000	Rs. 60,000,000
Average	Rs. 47,500,000	Rs. 55,000,000

$$\text{Accounts Receivable Turnover Ratio} = \frac{\text{Rs. } 180{,}000{,}000}{\text{Rs. } 47{,}500{,}000} = 3.79\text{X}$$

$$\frac{\text{Rs. } 216{,}000{,}000}{\text{Rs. } 55{,}000{,}000} = 3.93\text{X}$$

The Accounts Receivables Turnover Ratio as worked out above indicates that how many times the sales have been converted into accounts receivables and then into cash during a year. Higher this ratio would express efficiency of the management for collection of accounts receivables during the year. This ratio is also connected with the policy of credit terms of sale. If the longer credit period of sales is allowed, then the accounts receivables turnover ratio would be lower as found in the above computation. The shorter credit period of sales would ensure quick recovery and accounts receivables would indicate lower balance ultimately the accounts receivable turnover ratio would be higher. This ratio exhibits efficiency of collections.

G) Days Sales in inventory

This ratio depicts the number of days needed to dispose-off the inventory available in the organization. The lower amount of inventory would be preferred as it would indicate lesser period of inventory storage. Several organizations are confronting with compilation of inventories which ultimately prove to be redundant due to change in fashion. This analysis is computed as under: -

Formula= $\frac{\text{Ending Inventory}}{\text{Cost of Goods Sold/365}}$

	2019	2020
Days sales in inventory =	Rs. 40,000,000 / Rs. 120,000,000/365days	Rs. 45,000,000 / Rs. 140,000,000/365days
=	Rs. 40,000,000 / Rs. 328,767	Rs. 45,000,000 / Rs. 383,652
=	122days	117 days

The inventory liquidity for 2019 and 2020 is ranging from 117 to 122 days for sale and convert it into accounts receivables and then into cash. The longer period of day's sales in inventory is considered as slow liquidity because greater resources are invested in the acquisition of inventory which is for longer period of disposal. The management should curtail the level of inventory and it should be for lower days. The position of 2020 inventory is slightly improved as compared with 2019.

H) Inventory Turnover Ratio

The inventory turnover ratio reveals the number of times the inventory was turned over during the period. Higher the ratio would indicate better control as the inventory stock was rapidly turned over. The lower inventory turnover ratio is not desirable because it may indicate the accumulation of obsolete stock or carrying of too much inventory. This ratio is worked out through dividing the cost of goods sold by the average inventory as per the following formula.
Inventory Turnover Ratio = Cost of goods sold/average inventory

		2019	2020
Cost of goods Sold		Rs. 120,000,000	Rs. 140,000,000
Inventory:	Opening	Rs. 32,000,000	Rs. 40,000,000
	Closing	Rs. 40,000,000	Rs. 45,000,000
	Average	Rs. 36,000,000	Rs. 42,500,000
Inventory Turnover Ratio =		Rs.120,000,000 / Rs. 36,000,000	Rs. 140,000,000 / Rs. 42,500,000
		= 3.33X	**=3.29X**

The above ratio depicts inefficiency of the management because the turnover is quite low and the inventory is excessively piled up and financial resources are blocked in it in both the years. Management needs to focus on curtailing inventory and also investigate into obsolete items for quick disposal.

I) Operating Cycle

The operating cycle represents the total period that lapses between the acquisition of inventories and final cash realization from sales and subsequent collections. The operating cycle is thus determined by combination of accounts receivable days and inventory day's sales as presented below:

	2019	2020
Accounts receivables in days	96 days	93 days
Days sale in inventory	122 days	117 days
Total days of operating cycle	218 days	210 days

The computation of operating cycle for 2019 and 2020 depict that it took 218 days and 210 days respectively to realize cash from inventory. This analysis indicates sufficient longer period in both the years for operating cycle which needs to be reduced around 60 days to ensure liquidity and efficiency in business operations.

J) Assets Turnover Ratio

The assets turnover ratio expresses the number of times the fixed assets are being utilized to achieve sales and turned over during an accounting period. It is calculated as under:-

Sales / Net fixed assets

2019	2020
Rs. 180,000,000	Rs. 216,000,000
Rs. 61,000,000	Rs. 70,000,000
2.95X	3.08X

This ratio indicates how well the fixed assets are being used in the business for sales generation. Thus ratio is important in care of manufacturing concerns because sales are produced not only by use of current assets but also by the amount invested in fixed assets. The higher ratio reveals better performance. Conversely lower ratio represent that the fixed assets are not being used efficiently. The above ratios for 2019 and 2020 can be evaluated as sufficiently better performance.

K) Debt to Equity Ratio

This ratio is computed to measure the relative proportions of outsiders' funds and the shareholders' funds invested in the organization. Following formula is applied for working out this ratio

Debt to Equity Ratio = Long term debts / Shareholders' funds

	2019	2020
Debt to Equity Ratio =	Rs. 20,000,000 x 100 Rs. 106,000,000	Rs. 20,000,000 x 100 Rs. 117,000,000
	= 18.87%	= 17.09%

The above workings indicate that external financing is only 17 to 19% in the organization. This low ratio is generally viewed as favorable from the long term financial agencies because a large margin of protection provides safety for the loan giving agencies. The same low ratio can be considered as quite unsatisfactory by the shareholders because they feel least protected in case of insolvency of the company.

9.11 TREND IN RATIO ANALYSIS

In the preceding paragraphs variety of ratios have been computed, analyzed and also interpreted. It is worthwhile to express that a single ratio or some ratios for one period may not reflect true and reliable performance and position as well as financial strength of the organization to deal with if for business transactions of investment in the shape of purchase of shares. Therefore, the management and outsiders may be interested to know these ratios for several years i.e. from three to five years for ascertaining growing or otherwise status of the organization. This several year's comparison of ratios is known as trend analysis of ratios. These trends can be developed for every ratio if the data is available. Apart from it these ratios are also compared with industry averages which are computed by data survey and rating companies and the financial experts for the benefits of potential investors and businessmen to analyze performance and financial strength of the organization. The trend analysis of the net profit ratio, for instance is presented below:

Year	Ratio
2016	13%
2017	14%
2018	14.5%
2019	15%
2020	16.667%

Looking at the net profit ratios for five years exhibits that the performance of the company is growing as gradual increase in profitability is registered over five years. Further industry average indicates that the net profit of such industry is in the range of 14 to15%. As such the profit percentage trend shown by the organization is almost matching with the industry averages hence its performance is found to be satisfactory for dealing with it.

9.12 RECAPITULATION OF RATIOS

1. Gross Profit Ratio = $\frac{Gross\ Income}{Sales} \times 100$

2. Net Profit Ratio = $\frac{Net\ income\ after\ tax}{Sales} \times 100$

3. Operating income Ratio = $\frac{Operating\ income}{Sales} \times 100$

4. Return on total assets Ratio = $\frac{Net\ income\ after\ tax}{Average\ total\ assets} \times 100$

5. Return on investment Ratio = $\frac{Net\ income\ after\ tax}{Average\ equity\ and\ long\ term\ loans} \times 100$

6. Return on Equity Ratio = $\frac{Net\ income\ after\ tax}{Average\ total\ equity} \times 100$

7. Earnings per share = $\frac{Net\ income\ after\ tax}{No.of\ common\ shares}$

8. Dividend per share = $\frac{Total\ ammount\ of\ Proposed\ dividend}{No.of\ common\ shares}$

9. Interest Coverage ratio or Times Interest Earned = $\frac{Net\ income\ before\ interest\ and\ tax}{Interest\ expense}$

10. Dividend Yield Ratio = $\frac{Dividend\ per\ Common\ Stock}{Market\ price\ per\ Common\ Stock}$

11. Price Earnings Ratio = $\frac{Market\ price\ per\ Common\ Stock}{Earnings\ per\ share}$

12. Return on operating assets = $\frac{Operating\ income}{Average\ operating\ assets} \times 100$

13. Working Capital = $Current\ Assets\ Less\ Current\ Liabilities$

14. Current Ratio = $\frac{Current\ Assets}{Current\ Liabilities} \times 100$

15. Acid Test Ratio = $\frac{Liquid\ Current\ Assets}{Current\ Liability} \times 100$

16. Cash Ratio =$\frac{Cash\ and\ Marketable\ Secuirities}{Current\ Liability} \times 100$

17. Days Sales in Receivable = $\frac{Average\ Gross\ Accounts\ Receivables}{Net\ credit\ Sales/300days} \times 100$

18. Accounts Receivable Turnover Ratio = $\frac{Sales}{Average\ gross\ Accounts\ Receivables}$

19. Days sales in inventories =$\frac{Ending\ inventory}{Cost\ of\ Goods\ Sold/300days}$

20. Inventory turnover Ratio = $\frac{Cost\ of\ Goods\ Sold}{Average\ inventory}$

21. Operating cycle = $Accounts\ Receivable\ in\ days + days\ Sales\ in\ inventory$

22. Assets turnover Ratio = $\frac{Sales}{Net\ fixed\ assets}$

23. Debt to Equity Ratio =$\frac{Long\ term\ debts}{Shareholders\ equity}$

24. Operating assets turnover =$\frac{Sales}{Average\ Operating\ assets}$

9.13 SUMMARY

The analysis of financial statements is a professional technique to determine performance of the organization and its financial condition at a given time. This analysis is carried for different purposes. The management and outsider suppliers, financers, investors, regulatory agencies and customers may be interested to ascertain profitability, stability, liquidity and dividend paying ability analysis. This analysis is carried out through Common size horizontal and vertical analysis to compute the behavior and trend of operating and financial results. The horizontal analysis is comparison of income statement items and balance sheet components with a base year and change in rupee amount is converted into percentage change to assess the results either as growing or declining and investigation into the factors of such changes. The vertical analysis is the computation of each item of income statement in percentage in reference to the sale value treating it as base with 100 weights. Similarly, the composition of balance sheet items are analyzed in percentage in reference to the total value of assets side and liabilities with owner's equity side treating it as base with 100 weights and changes in percentage of each item are further analyzed.

The ratio analysis is another critical technique of analysis of the financial statements to compute the profitability and liquidity ratios spread over multiple ratios from the perspective of different agencies associated with the organization for conduct of business transactions. Another technique of trend analysis of different ratios is also applied by the management and other professionals to ascertain to performance status and financial condition over the periods and comparison with industry averages to gauge the status of the organization and interpret its strength.

9.14 THEORETICAL QUESTIONS

Q.1 What do you understand by the analysis of financial statements?

Q.2 What are the objectives and the purposes of analysis of financial statements?

Q.3 Explain with presumptive data about the horizontal analysis of income statement and balance sheet of a trading enterprise and comment on each item of it.

Q.4 Explain with presumptive data about the vertical analysis of the income statement and balance sheet of a manufacturing enterprise and comment on each item of it.

Q.5 Elucidate the computation procedure of trends in the horizontal analysis of the financial statements of a trading concern.

Q.6 What do you understand by the term ratio analysis and how it differs from the horizontal and vertical analysis.

Q.7 Explain the workings of some ratios relating to the profit ability analysis of a service organization.

Q.8 Elucidate the workings of some ratios relating to liquidity analysis of trading concern.

Q.9 How a company's capital structure as measured by debt and equity ratios is important to financial statements analysis?

Q.10 What is trend analysis in the ratio analysis of a concern and what does it indicate?

9.15 PRACTICAL PROBLEMS

P.9-1

Comparative income statements for 2 years of Decent Trading Company are presented as under:-

Income Statement

All amounts are in Rs.

	Year A	Year B
Net Sales	780,000	955,000
Less: Cost of goods Sold	540,000	630,000
Gross income	220,000	325,000
Less: Operating expenses:		
Selling & Marketing	70,500	80,200
Administration	40,300	45,000
Operating income	109,200	199,800
Interest expenses	200	300
Net income before tax	109,000	199,500
Income tax	33,000	58,000
Net income after tax	76,000	141,500

Required:

a) Work out the horizontal analysis of the above income statement.

b) Analyze and interpret the changes found in it.

P.9-2

The Comparative balance sheet for two years of the Decent Trading Company is presented below:

All amounts are in Rs.

Assets	**19-A**	**19-B**
Cash	35,000	55,000
Marketable Securities	130,000	130,000
Accounts Receivables	370,000	420,000
Inventories	230,000	325,000
Prepaid expenses	25,000	12,000
Accrued interest income	1,000	1,200
Land and Building	850,000	850,000
Equipment	250,000	250,000
Furniture & Fixture	130,000	175,000
Total	2,021,000	2,218,200
Liabilities and Equity		
Accounts Payables	295,000	380,700
Dividends Payable	40,000	85,000
Salaries payable	28,000	35,000
Utilities bills payable	12,000	15,000
Long term Bank Loan	600,000	600,000
Capital Stock	1,000,000	1,000,000
(10,000 shares of Rs. 100 each)		
Revenue reserves	30,000	50,000
Retained Earnings	16,000	52,500
Total	2,021,000	2,218,200

Required:

a) Compute the horizontal analysis of the above balance sheet items.

b) Comment on the variances found.

P.9-3

The Comparative five years data pertaining to the sales, cost of Sales and dividends declared of Alpha Trading Company was extracted from the financial statements which is presented as under:-

	Sales	Cost of Sales	Dividend declared
2017	750	500	20
2018	800	550	22
2019	900	600	25
2020	1,000	700	30
2021	1050	780	35

Required: Based upon the above data, Compute trends in horizontal analysis and comment on it.

P.9-4

The income statement of Gift Toys Company for two years is presented as below:-

Income Statement

	2019	2020
Sales	Rs. 1,500,000	Rs. 1,600,000
Cost of Sales	850,000	960,000
Gross income	650,000	640,000
Commercial expenses		
Selling & Marketing	212,000	230,000
Administrative	118,000	120,000
Total	330,000	350,000
Operating income	320,000	290,000
Income Tax	96,000	88,000
Net Income after Tax	Rs. 224,000	Rs. 202,000

Required:

a) Compute the vertical analysis of the above income statement items.

b) Comment on the composition of income statement items and variances in vertical analysis.

P.9-5

A Comparative balance sheet of two years of Zeenat Furniture Company is appended below:

Assets	**2020**	**2021**
Cash at bank	Rs. 170,000	Rs. 215,000
Accounts Receivables	530,000	475,000
Inventories	230,000	315,000
Prepaid expenses	70,000	75,000
Plant & Machinery	540,000	720,000
Office equipment	212,000	212,000
Furniture	175,000	225,000
Motor vehicles	420,000	420,000
Total	**2,347,000**	**2,657,000**
Liabilities and equity		
Accounts Payable	270,000	300,000
Notes Payable (Short term)	150,000	50,000
Wages payable	45,000	32,000
Dividends payable	100,000	150,000
Tax payable	75,000	120,000
Long Term Notes Payable	420,000	600,000
Capital Stock	1,000,000	1,000,000
Capital reserves	170,000	200,000
Revenues reserves	100,000	150,000
Retained Earnings	17,000	55,000
Total	**Rs. 2,347,000**	**Rs. 2,657,000**

Required:

a) Carry out vertical analysis of the balance sheet components of each year.

b) Comment on the variances found in total and each item of the balance sheet and indicate the trends of each component.

P.9-6

The comparative income statement for 2020 and 2021 of Good Fit Garments Company is presented below:

	2020	2021
Sales	RS. 2,570,000	Rs. 2,815,000
Other income	30,000	25,000
Total	2,600,000	2,840,000
Costs and expenses		
Cost of goods sold	1,500,000	1,600,000
Marketing expenses	75,000	80,000
Administrative expenses	100,000	120,000
Interest expenses	4,000	10,000
Total	1,679,000	1,810,000
Net income before tax	921,000	1,030,000
Income tax	276,000	30,000
Net income after tax	Rs. 645,000	Rs. 730,000

Some additional data extracted from the accounting record is as under:-

	2020	2021
Total assets	Rs. 1,400,000	Rs. 1,300,000
Operating assets	1,200,000	1,100,000
Long term debts	500,000	400,000
Stock holders equity	800,000	800,000

Required:

a) Compare the sales for 2021 with the last year and comment on the behavior.

b) Analyze the net income after tax for the year 2021 with last year and comment on variance.

c) Compute the following ratios for both years and comment on each ratio:-

   i) Gross income ratio
   ii) Net income ratio
   iii) Operating income ratio
   iv) Return on assets
   v) Total assets turnover
   vi) Return on investment
   vii) Return on equity
   viii) Return on operating assets

P.9-7

Reliable Trading Company presented the following comparative income statements for three years:-

	2019	2020	2021
Sales	Rs. 1,400,000	Rs. 1,600,000	Rs. 1,800,000
Cost of Sales	1,000,000	1,100,000	1,300,000
Gross income	400,000	500,000	500,000
Commercial expenses:			
Selling and marketing	100,000	120,000	130,000
Administrative	60,000	60,000	70,000
Net income before tax	240,000	320,000	300,000
Income tax	70,000	90,000	90,000
Net income after tax	170,000	230,000	210,000
Additional data			
Average operating assets	1,000,000	1,100,000	1,200,000
Average total assets	1.200,000	1,300,000	1,400,000
Average long term debt	300,000	350,000	400,000
Average stockholders' equity	800,000	800,000	800,000
Average common shares issued	Rs. 8,000	Rs. 8,000	Rs. 8,000

Required: Compute the following ratios for each of the three years and analyze the profitability trend of the company:-

a) Gross Profit Ratio
b) Net Profit ratio
c) Operating profit ratio
d) Return on total assets
e) Total assets turnover
f) Return on operating assets
g) Operating assets turnover
h) Return on investment
i) Return on total equity

P.9-8

The following partial income statement and balance sheet contents are extracted from the financial statements of Silver Grill Corporation, Islamabad:-

Partial Income Statement for the year ended 30 June, 2020

Net Sales	Rs. 5,120,000
Cost of Sales	3,570,000
Selling expenses	430,000
Administrative expenses	315,000
Income tax	Rs. 250,000

Partial Balance Sheet as at 30 June 2020

Asset

Accounts Receivables	Rs. 1,200,000
Inventories	500,000
Cash	130,000
Prepaid expenses	42,000
Marketable Securities	350,000
Plant and Machinery	870,000
Liabilities	
Income tax payable	150,000
Accounts payable	670,000
Notes Payable	320,000
Long term loans	400,000
Accrued expenses	Rs. 32,000

Required:

From the above data compute the following ratios and comment on each ratio:-

a) Working Capital
b) Current Ratio
c) Acid test Ratio
d) Cash ratio
e) Days Sales in Accounts receivables
f) Accounts receivable turnover
g) Days Sales in inventories
h) Inventory turnover ratio
i) Operating cycle.

P.9-9

The following financial data was extracted from the financial statements of three consecutive years of Arshad Trading Corporative:-

	2018	2019	2020
Sales	Rs.2,500,000	Rs.2,600,000	Rs.2,400,000
Cost of Sales	2,000,000	2,100,000	1,900,000
Current assets	1,200,000	1,300,000	1,200,000
Current liabilities	950,000	1,050,000	1,000,000
Inventories	650,000	700,000	600,000
Accounts Receivables	320,000	400,000	350,000
Prepaid expenses	Rs.20,000	Rs.25,000	Rs.30,000

Required:

Compute the following ratios for the year 2019 and 2020 and comment on each to ascertain liquidity analysis:-

a) Working Capital
b) Current Ratio

c) Acid Test ratio
d) Days sales in Receivables
e) Accounts Receivable Turnover ratio
f) Days sales in inventories
g) Inventory turnover ratio
h) Operating cycle

P.9-10

The Shadman Textile Mills and Fashion Textile Mills are competitors in the textile industry. Some financial data extracted from their financial statements for the year ended 30 June 2021 is as under:-

Income Statement for 2021

	Shadman	Fashion
Sales	Rs. 2,500,000	Rs. 3,200,000
Cost of Sales	1,600,000	2,060,000
Marketing expenses	500,000	600,000
Admin expenses	250,000	300,000
Interest expenses	36,000	96,000
Income Tax	34,000	43,000
Net income	Rs. 80,000	Rs. 101,000

Balance Sheet as at 30-06-2021

	Shadman	**Fashion**
Cash	Rs. 135,000	Rs. 350,000
Accounts Receivables	632,000	1,050,000
Inventory	130,000	212,000
Investments in Securities	100,000	300,000
Trade Marks	100,000	200,000
Property and Equipment	812,000	1,200,000
Total	1,909,000	3,312,000
Accounts Payable	400,000	800,000
Tax Payable	34,000	43,000
Bonds Payable	300,000	800,000
Common Stock of Rs. 100 each	1,000,000	1,500,000
Retained Earnings	175,000	169,000
Total	Rs. 1,909,000	Rs. 3,312,000

Following industry average of ratios was taken from the publication of professional surveyors for ratings:-

- Times interest earned 4.0 time
- Debt ratio 40%
- Debt/Equity ratio 60%
- Debt to tangible Net worth ratio 70%

Required:

a) Compute the following ratios for each company.
   i) Times interest earned
   j) Debt ratio
   k) Debt/Equity ratio
   l) Debt to tangible net worth ratio

b) Based upon above data analyze whether Shadman or Fabron Mills is in a better Position to borrow loan. Explain it.

c) Which Mills has better long-term debt position? Explain it.

P.9-11

The undernoted selective information was gathered from the financial statements of Asif Trading Corporation and some other market sources.

	2019	2020
Net income	Rs. 1,582,000	Rs. 1,750,000
Total Assets	8,750,000	12,000,000
Total liabilities	3,250,000	6,500,000
No. of Common Stocks	55,000	55,000
Market price per stock	140	135
Cash dividend paid	1,375,000	1,400,000
Total equity	5,500,000	5,500,000
Par value of share	Rs. 100	Rs. 100

Required

1- Compute the following ratios for both the years:-
   a) Dividend per share of common stock
   b) Dividend yield
   c) Earnings per share
   d) Price Earnings ratio

2- Discuss your findings about performance of the company from the perspective potential investors for purchase of shares of this company.

P.9-12

The following information from the financial statements and other sources has been extracted for Reliance Engineering Ltd for the year just completed:-

- 10% Preference shares of Rs. 100 each Rs. 1,000,000
- Common shares of Rs. 10 each Rs. 4,000,000
- Dividend on common shares paid 15%
- Net income after tax 900,000
- Market price per common stock Rs. 15

Required

A) Compute the following ratios
   1) Dividend per Preferred Stock and the Common Stock.
   2) Dividend yield on Common Stock
   3) Earnings per Common Stock
   4) Price Earnings Ratio

B) Evaluate performance of the Company from investor's point of view.

9.16 GLOSSARY

Financial Statements analysis

Evaluation of income statement and balance sheet to ascertain performance during the year and financial condition and strength at end of the year

Tools of analysis

Different methods and techniques like horizontal, vertical and ratio analysis applied for the purpose.

Horizontal analysis

Comparison of performance and financial condition of the company across the time.

Vertical analysis

Comparison of the performance and financial condition of the company to a base amount of Sales or total assets respectively

Ratio analysis

Computation of relationship of two numerical figures as a pair income statement items and balance sheet items as may be suitable.

Trend analysis

Computation of ratios of a specific item being analyzed for several number of years to show gradual behavior of decline or growth.

Profitability ratios

Those ratios which are linked with income and compared with sales and other assets and equity to ascertain performance of the organization over a period of time.

Liquidity ratios

Determination of capability and strength of an organization to discharge its maturing liabilities within prescribed time period out of its liquid resources

Industry average

Average percentages or time age of different ratios developed by professional rating and analytical firms of specific industries to be used by organizations to gauge their performance and financial strength based on industry averages as yardsticks.