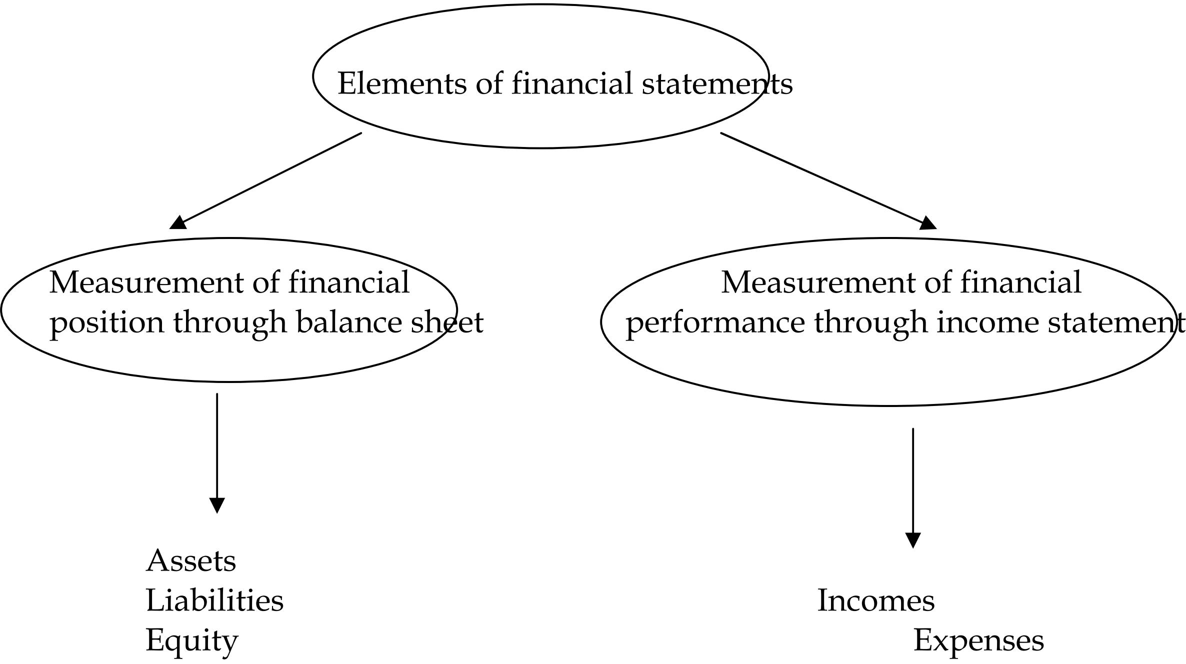
LESSON # 26

ELEMENTS OF FINANCIAL STATEMENTS

Financial information of an entity are classified into five main heads, these main heads are elements of financial statements.



Assets:

These are the resources in control of the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

Points to remember:

1. Resources in control
2. Past event
3. Future inflow

Liabilities:

These are the present obligations of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

Points to remember:

1. Present obligation
2. Past event
3. Future outflow

Equity:

It is the residual interest in the assets after deducting all its liabilities. In other words, equity is what is left when all liabilities have been settled.

Points to remember:

1. Equity contributed
2. Reserves created

Incomes:

Incomes establish increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity other than those relating to contributions from equity participants.

Incomes include:

1. Revenue
    a. Sales of goods
    b. Sales of services
    c. Returns on investments
2. Gains
    a. Disposal of assets at a value higher than its carrying amount
    b. Discharge of liabilities at a value lesser than its carrying amount

Expenses:

Expense is decrease in economic benefits during the accounting period in the form of outflows or decrease in assets or incurrence of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

Expenses include:

1. Revenue Expenses
    a. Expenses that arise in the course of ordinary activities of an entity.
2. Losses
    a. Disposal of assets at a value lesser than its carrying amount
    b. Discharge of liabilities at a value higher than its carrying amount

Measurement of the Elements of Financial Statements

A number of different measurement bases are employed to different degrees and combinations in financial statements. These include:

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1. **Historical Cost**

Assets are recorded at the amount of cash paid to acquire them. Sometimes the terms cash equivalents or fair value at acquisition will be used instead.
Liabilities are recorded at the proceeds received in exchange for the obligation on the date of transaction.

2. **Current Cost**

Assets are carried at their current purchase price.
Liabilities are carried at the undiscounted amount currently required to settle them.

3. **Realizable Value**

Assets are carried at the amount, which could currently be obtained by an orderly disposal.
Liabilities are carried at their settlement values, the amount to be paid to satisfy them in the normal course of business.

4. **Present Value**

Assets are carried at the present discounted value of the future net cash inflows that the item is expected to generate in the normal course of business.
The most common measurement basis adopted by the entity in preparing financial statements is historical cost. This is usually combined with other bases.

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LESSON # 27

IAS 10 – EVENTS AFTER THE BALANCE SHEET DATE

Before starting discussion on the IAS 10 that is about the events that occur after the balance sheet date, let us differentiate between the:

- Draft Financial Statements and
- Published Financial Statements

Draft financial statements:

Draft financial statements are one that are prepared by the accounts department, audited by the external auditors and put in front of the board of directors for approval.

Published financial statements:

Published financial statements are one that has been approved by the board of directors and has also been published for issuance to the shareholders of the company.

Here we must also discuss different dates that are pertinent to the **IAS 10** for better understanding.

- Balance Sheet Date
- Date of the Board of Director's Meeting (BOD)
- Date of the Annual General Meeting (AGM)

Balance sheet date:

It is the closing date on which the balance sheet is prepared. This is the closing date of the accounting year.

Date of BOD meeting:

It is the date in which the directors approve the financial statements of the company. This date is obviously after the balance sheet date but before the date of annual general meeting (AGM). The BOD meeting should be held at least 21 days before the date of the annual general meeting. Because members of the company should receive 21 days notice of the AGM along with the published financial statements.

Date of AGM:

It is the date that should not be after the expiry of four months (in Pakistani scenario according to the requirements of the securities and exchange commission of Pakistan-SECP) and six months (in international scenario according to the provisions of IAS-1)

Note:

The BOD holds meeting after the balance sheet date but before the annual general meeting.

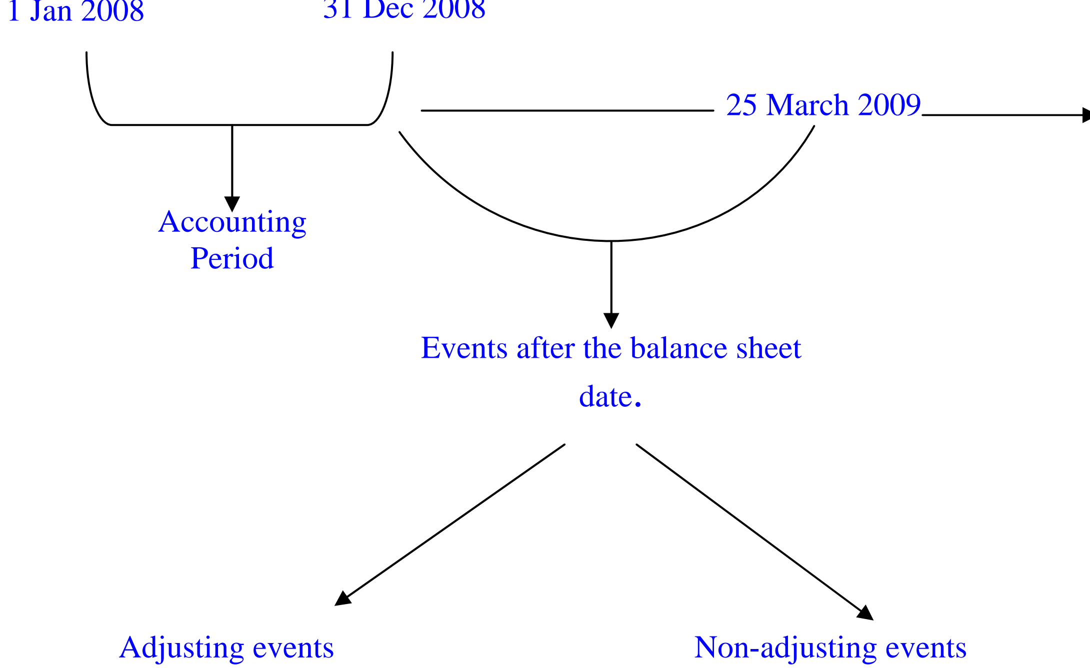
Events after the balance sheet date

These are those events, favorable and unfavorable, that occur between the balance sheet date and the date when the financial statements are authorized for issue. Two types of events can be identified:

(a) Those events that provide evidence of conditions that existed at the balance sheet date (adjusting events after the balance sheet date); and

(b) Those events that are indicative of conditions that arose after the balance sheet date (non-adjusting events after the balance sheet date).

Following figure will help to under stand the events after the balance sheet date;



In this figure balance sheet date is December 31, 2008 and the date of BOD meeting is March 25, 2009. So the events that occur in between these two dates will be the events after the balance sheet date.

Explanation:

A Good Stock costing Rs. 100,000 was written down to NRV of Rs. 97,500 at the Balance Sheet date. After the Balance Sheet date it is sold for Rs. 96,000.

The condition of stock at the balance sheet date has not changed till sale and the future event provides evidence regarding the decline in its value. Thus, it is an adjusting event after the balance sheet date.

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On the other hand, a Good Stock costing Rs. 200,000 was written down to NRV of Rs. 197,000 at the balance sheet date. After the balance sheet date the stock was spoiled and sold for only Rs.10, 000 as scrap.

In this case the condition of spoilage did not exist at the balance sheet date. This spoilage is indicative of condition that arose after the balance sheet date. So, this is a non-adjusting event after the balance sheet date.

Example-1:

Classify the following events after the balance sheet date as adjusting or non-adjusting:

(a) Creative Textile (Private) Limited decided to takeover Saga Sports (Private) Limited after the balance sheet date.

(b) QSA Surgical announces a plan to discontinue its Marala Branch after the balance sheet date.

(c) Sale of inventory after the balance sheet date below its cost and also below its NRV (Inventory was measured at NRV on the Balance Sheet Date).

(d) Changes in tax rates after the balance sheet date having a significant effect on current and deferred tax assets and liabilities.

(e) A doubtful customer defaults after the balance sheet date; provision for such customer has been made @ 10%.

(f) Asset purchased on 27th December 2004, invoice has been received on 5th January 2005. The year ends on 31st December 2004.

(g) The discovery of fraud that shows that the financial statements are incorrect.

Solution:

Adjusting events after the balance sheet date.

(c), (e), (f), (g)

Non-adjusting events after the balance sheet date.

(a), (b), (d)

The process involved in authorizing the financial statements for issue will vary depending upon the management structure, statutory requirements and procedures followed in preparing and finalizing the financial statements.

In some cases, an entity is required to submit its financial statements to its shareholders for approval after the financial statements have been issued. In such cases, the financial statements are authorized for issue on the date of issue, not the date when shareholders approve the financial statements.

Example-2:

The management of an entity completes draft financial statements for the year to 31st December 2005 on 28th January 2006. On 18th February 2006, the board of directors reviews the financial statements and authorizes them for issue. The entity announces its profit and selected other financial information on 19th February 2006. The financial statements are made available to shareholders and others on 1st March 2006. The shareholders approve the financial statements at their annual meeting on 15th April 2006 and the approved financial statements are then filed with a regulatory body on 17th April 2006.

The financial statements are authorized for issue on 18th February 2006 (date of board authorization for issue).

In some cases, the management of an entity is required to issue its financial statements to a supervisory board (made up solely of non-executives) for approval. In such cases, the financial statements are authorized for issue when the management authorizes them for issue to the supervisory board.

Example-3:

On 18th February 2002, the management of an entity authorizes financial statements for issue to its supervisory board. The supervisory board is made up solely of non-executives and may include representatives of employees and other outside interests. The supervisory board approves the financial statements on 26th February 2002. The financial statements are made available to shareholders and others on 1st March 2002. The shareholders approve the financial statements at their annual meeting on 15th April 2002 and the financial statements are then filed with a regulatory body on 17th April 2002.

The financial statements are authorized for issue on 18th February 2002 (date of management authorization for issue to the supervisory board).

RECOGNITION AND MEASUREMENT:

Adjusting Events after the Balance Sheet Date:

An entity shall adjust the amounts recognized in its financial statements to reflect adjusting events after the balance sheet date.

Example-4:

A customer was considered doubtful at the balance sheet date. A provision for such customer was made @ 50%. After the balance sheet date, customer was declared as insolvent based on his financial position on year end.

Required: What will be the accounting treatment?

Solution:

This is an adjusting event after the balance sheet date and should be recognized in the financial statements. At the balance sheet date, 100% provision shall be made against that debtor i.e. provision is to be increased by further 50%.

Example-5:

A customer was doubtful at the balance sheet date. A provision for such customer was made @ 5%. After the balance sheet date, customer paid 85% of the total amount.

Required: What will be the accounting treatment?

Solution:

This is an adjusting event. This event shall be recognized in the financial statements. At the balance sheet, provision shall be made @ 15% i.e. Additional 10% provision shall also be recorded.

Non-adjusting Events after the Balance Sheet Date:

An entity shall not adjust the amounts recognized in its financial statements to reflect

Non-adjusting events after the balance sheet date.

Example-6

An asset, whose book value is Rs. 89,000, was destroyed by fire after the balance sheet date.

Required:

(i) Identify event type

(ii) What will be accounting treatment?

Solution:

(i) This is non-adjusting event as the condition arose after the balance sheet date.

(ii) An entity shall not recognize such event in the financial statement. It shall only be disclosed.

Examples are:

a) Decline in market value of investments between the balance sheet date and the date when the financial statements are authorized for issue.

b) Loss of stock after the date of financial statements.

The following are the examples of non-adjusting events after the balance sheet date that would generally result in disclosure:

(a) A major business takeover after the balance sheet date or disposing of a major subsidiary;

(b) Announcing a plan to discontinue an operation;

(c) Major purchases of assets, classification of assets as held for sale, other disposals of assets, or expropriation of major assets by government;

(d) The destruction of a major production plant by a fire after the balance sheet date;

(e) Announcing, or commencing the implementation of, a major restructuring;

(f) Abnormally large changes after the balance sheet date in asset prices or foreign exchange rates;

(g) changes in tax rates or tax laws enacted or announced after the balance sheet date that have a significant effect on current and deferred tax assets and liabilities;

(h) Entering into significant commitments or contingent liabilities, for example, by issuing significant guarantees; and

(i) Commencing major litigation arising, solely out of events that occurred after the balance sheet date.

Dividends

If an entity declares dividends to holders of equity instruments after the balance sheet date, the entity shall not recognize those dividends as a liability at the balance sheet date.

If dividends are declared (i.e. the dividends are appropriately authorized and no longer at the discretion of the entity) after the balance sheet date but before the financial statements are authorized for issue, the dividends are not recognized as a liability at the balance sheet date because they do not meet the criteria of a present obligation in IAS-37. Such dividends are disclosed in the notes in accordance with IAS-1 Presentation of Financial Statements.

Example-7:

Mobitel Private Limited announces dividend to its shareholders amounting to Rs.1,500,000 after the Balance Sheet Date. The closing balance of Retained Earnings is Rs. 7,000,000 including above dividend.

Required: Effect of the above on Financial Statements.

Solution:

It shall be disclosed in the notes to the accounts as follows:

Proposed Dividend

Dividend proposed for the year is Rs.1,500,000.

Going Concern

An entity shall not prepare its financial statements on a going concern basis if management determines after the balance sheet date either that it intends to liquidate the entity or to cease trading, or that it has no realistic alternative but to do so.

Deterioration in operating results and financial position after the balance sheet date may indicate a need to consider whether the going concern assumption is still appropriate. If the going concern assumption is no longer appropriate, the effect is so pervasive that this Standard requires a fundamental change in the basis of accounting, rather than an adjustment to the amounts recognized within the original basis of accounting.

Example-8:

Elahi (Private) Limited is in the course of finalizing its financial statements for the year ended 30th June 2004.

Due to market competition and loss of customers, company intends to cease its business and liquidate the company.

Should the company prepare financial statement on a going concern basis or not?

Solution:

The company should not prepare the financial statement on a going concern basis. It must also disclose the fact that financial statements are not prepared on a going concern basis. The amounts appearing in Financial Statements would also be adjusted appropriately according to new basis of accounting i.e. current market values.

LESSON # 28

IAS – 37 PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS

DEFINITIONS:

The following terms are used in this Standard with the meanings specified:

Liability:

A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. Definition of liability can be divided into three parts:

- Present obligation
- Arising from the past event
- Probable outflow of resources in future

Provision:

A provision is a liability of uncertain timing or amount. For a provision following points must be kept in mind:

- Present obligation
- Arising from the past event
- Probable outflow of resources in future
- Amount can be estimated reliably.

Provision is created for two motives:

- ***One to reduce Assets***
- ***Second to create a liability against losses***

Provision that is created for reduction in assets is of two types:

1. Provision against receivables (also known as contra to receivables – Provision for doubtful debts)
2. Provision against the expiry of economic benefits of fixed assets (Provision for depreciation/amortization).

IAS 37 does not talk about the provisions created to reduce the carrying amount of assets. It only talks about the provision that is created to recognize a liability against probable losses.

Obligation Event:

An obligating event is an event that creates a legal or constructive obligation that results in an entity having no realistic alternative but to settle that obligation.

- **Legal Obligation:**

A legal obligation is an obligation that derives from:

a) A contract (through its explicit or implicit terms);
b) Legislation; or
c) Other operations of law.

- **Constructive Obligation:**

A constructive obligation is an obligation that derives from an entity's actions where:

a) By an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities.
b) As a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

Contingent Liability:

A contingent liability is:

a) A possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or
b) A present obligation that arises from past events but is not recognized because:

    i. It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation.
    ii. The amount of the obligation cannot be measured with sufficient reliability;

Contingent Assets:

A contingent asset is a possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

Treatment of Liabilities, Accruals & Provisions:

Liabilities can be categorized as:

1. Certain liability — example is Creditors against supplies
2. Virtually certain liability — example is Accruals against expenses
3. Uncertain liability — example is Provision against expected losses

	Liabilities (certain)	***Accruals (virtually certain)***	***Provisions (uncertain)***
Status	Present obligation	Present obligation	Present obligation
Arising from	Past events	Past events	Past events
Outflow of resources embodying economic benefits	Probable	Probable	Probable
Measurement of amount	Certain	Virtually certain	Uncertain (However a reliable estimate can be made)
Accounting treatment	Dr. Purchases Cr. Creditors	Dr. Expense Cr. Accrual/Owings	Dr. Loss (Expenses) Cr. Provision for the Loss

Virtually certain:

Something that involve a minor degree of estimation. An example of such would be the amount payable in Utility Bills. The expense on the bill is for one month; however the meter is read a couple of days after the month including charges for those extra days as well.

Identifying Contingent Liabilities:

Following table will help to identify whether the obligation is a contingent liability or not in accordance with the definition of IAS 37.

	Case 1	***Case 2***	***Case 3***
Status	Possible obligation	Present obligation	Present obligation
Arising from	Past events	Past events	Past events
Outflow of resources embodying	Will be confirmed upon the occurrence or	Probable	Not probable

economic benefits	non-occurrence of future events, not in the control of the entity		
Amount	a] Future events are not remote b] Future events are remote	Cannot be measured reliably	a] Probability is not remote b] Probability is emote
Accounting treatment	a] Disclosed in notes b] Not disclosed in notes	Disclosed in notes	a] Disclosed in notes b] Not disclosed in notes

Accounting Requirements for recognizing Liabilities and Assets:

Recognizing liabilities and assets means to record relevant accounting heads in the books of accounts. IASB frame work and relevant Accounting Standards provide guidelines for recognizing liabilities and assets at different stages.

Following table will explain that which type of liabilities and assets will be treated in what way.

Stage	***Liabilities***	***Assets***
Certain	Recognize	Recognize
Virtually certain (Accruals/Owings)	Recognize	Recognize
Uncertain (Probable/Provision)	Recognize	Do not recognize Disclose only
Contingent	Do not recognize Disclose only	Do nothing
Remote	Do nothing	Do nothing

Do nothing:

'Do nothing' means that the event is to be ignored while preparing the financial statements. Even a disclosure of the same is not required in the notes to the accounts.

Recognizing different transactions/events in Accordance with IAS 37:

Expense/Loss (Status)	*Measurement of amount*	*Status/Recognize as*	*Accounting entry*
Identified as present obligation	Certain (Invoice/supporting documents based)	Liability	Dr. Expense Cr. Payable
Identified as present obligation	Virtually certain (Invoice/supporting documents based)	Accrued liability	Dr. Expense Cr. Accrual/Owings
Identified as present obligation	Uncertain (amount can be estimated reliably with probable outflow of resources)	Provision liability	Dr. Expense (Loss) Cr. Provision for loss
Identified as present obligation	Uncertain (amount can not be estimated reliably although there is a probability of outflow of resources)	Contingent liability	No entry. Disclose only
Identified as present obligation	Uncertain (without any probability of outflow resources)	Contingent liability	No entry. Disclose only
Unidentified ***(possible obligation)***	Uncertain (possible outflow of resources are based on future events not in control of the entity)	Contingent liability	No entry. Disclose only
Unidentified ***(remote obligation)***	Uncertain	No recognition	No entry. No disclosure

Liability	Creditors	Accrued Expense	Provision liability	Contingent liability	Contingent liability	Contingent liability
	Certain	Virtually certain	Uncertain	Uncertain	Uncertain	Possible
1: Present obligation	✓	✓	✓	✓	✓	X
2: Arising from past events	✓	✓	✓	✓	✓	✓
3: Probable outflow of resources embodying economic benefit in future	✓	✓	✓	✓	X	✓
4: Reliable estimation of the amount (can be measured reliably)	As per Invoice received	As per previou s Invoice	✓	X	-	-/ ✓ X/
5: Accounting treatment	Expense/Resources Payable A/C	Expense A/C Accrual A/C	Losses against warranty Dr. Provision for Warranty Cr.	No entry only disclosure is required	No entry only disclosure is required	No entry only disclosure is required

Provisions and Other Liabilities:

Provisions can be distinguished from other liabilities such as trade payables and accruals because there is uncertainty about the timing or amount of the future expenditure required in settlement. By contrast:

a) Trade payables are liabilities to pay for goods or services that have been received or supplied and have been invoiced or formally agreed with the supplier; and

b) Accruals are liabilities to pay for goods or services that have been received or supplied but have not been paid, invoiced or formally agreed with the supplier, including amounts due to employees (for example amounts relating to accrued vacation pay).

Although it is sometimes necessary to estimate the amount or timing of accruals, the uncertainty is generally much less than for provisions. Accruals are often reported as part of trade and other payables, whereas provisions are reported separately.

Relationship between Provisions and Contingent Liabilities:

This Standard distinguishes between:

a) Provisions – which are recognized as liabilities (assuming that a reliable estimate can be made) because they are present obligations and it is probable that an outflow of resources embodying economic benefits will be required to settle the obligations; and
b) Contingent liabilities – which are not recognized as liabilities because they are either:

    i. Possible obligations, as it has yet to be confirmed whether the entity has a present obligation that could lead to an outflow of resources embodying economic benefits; or
    ii. Present obligations that do not meet the recognition criteria in this Standard (because either it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation, or a sufficiently reliable estimate of the amount of the obligation cannot be made).

RECOGNITION:

Provisions:

A provision shall be recognized when:

a) An entity has a present obligation (legal or constructive) as a result of a past event;
b) It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
c) A reliable estimate can be made of the amount of the obligation.

If these conditions are not met, no provision shall be recognized.

Present Obligation:

In rare cases it is not clear whether there is a present obligation. In these cases, a past event is deemed to give rise to a present obligation if, taking account of all available

evidence, it is more likely than not, that a present obligation exists at the balance sheet date.

In almost all cases it will be clear whether a past event has given rise to a present obligation. In rare cases, for example in a law suit, it may be disputed either whether certain events have occurred or whether those events result in a present obligation. In such a case, an entity determines whether a present obligation exists at the balance sheet date by taking into account of all available evidence, including for example, the opinion of experts. The evidence considered includes any additional evidence provided by events after the balance sheet date. On the basis of such evidence:

a) Where it is more likely than not, that a present obligation exists at the balance sheet date, the entity recognizes a provision (if the recognition criteria are met); and
b) Where it is more likely that no present obligation exists at the balance sheet date, the entity discloses ability, unless the possibility of an outflow of resources embodying economic benefits is remote.

Past Events:

A past event that leads to a present obligation is called an obligating event. For an event to be an obligating event, it is necessary that the entity has no realistic alternative to settling the obligation created by the event. This is the case only:

a) Where the settlement of the obligation can be enforced by law; or
b) In case of a constructive obligation, the event creates valid expectations in other parties that the entity will discharge the obligation.

Probable Outflow of Resources Embodying Economic Benefits:

For a liability to qualify for recognition there must be not only a present obligation but also the probability of an outflow of resources embodying economic benefits to settle that obligation. For the purpose of this Standard, an outflow of resources or other event is regarded as probable if the event is more likely than not to occur i.e. the probability that the event will occur is greater than the probability that it will not. Where it is not probable that a present obligation exists, an entity discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote.

Reliable Estimate of the Obligation:

The use of estimates is an essential part of the preparation of financial statements and does not undermine their reliability. This is especially true in the case of provisions, which by their nature are more uncertain than most other balance sheet items.

Contingent Liabilities:

An entity shall not recognize a contingent liability. A contingent liability is disclosed unless the possibility of an outflow of resources embodying economic benefits is remote.
Contingent liabilities may develop in a way not initially expected. Therefore, they are assessed continually to determine whether an outflow of resources embodying economic benefits has become probable. If it becomes probable that an outflow of future economic benefits will be required for an item previously dealt with as a contingent liability, a provision is recognized in the financial statements of the period in which the change in probability occurs (except in the extremely rare circumstances where no reliable estimate can be made).

Example-1:

Extract from Notes to the Accounts:

a) Guarantees issued by banks on behalf the company;
b) Claims against the company were not acknowledged as debt by the company. As the management is confident that the matter would be settled in her favor; consequently no provision has been made in the financial statements in respect of the disputed liabilities.

Contingent Assets:

An entity shall not recognize a contingent asset. Contingent assets usually arise from unplanned or other unexpected events that give rise to the possibility of an inflow of economic benefits to the entity. An example is a claim that an entity is pursuing through legal processes, where the outcome is uncertain.
Contingent assets are not recognized in financial statements since this may result in the recognition of income that may never be realized. However, when the realization of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate.
A contingent asset is disclosed where an inflow of economic benefits is probable.

Example-2:

The company has filed a suit against SA Ltd. claming damages amounting to Rs. 600,000. The legal advisors of the company are of the opinion that the company will win the case.

MEASUREMENT:

Best Estimate:

The amount recognized as a provision shall be the best estimate of the expenditure required to settle the present obligation at the balance sheet date.
The estimates of outcome and financial effect are determined by the judgment of the management of the entity, supplemented by experience of similar transactions and in some cases, reports from independent experts. The evidence considered includes any additional evidence provided by events after the balance sheet date.

Example-3:

An entity sells goods with a warranty under which customers are covered for the cost of repairs of any manufacturing defects that become apparent within the first six months after purchase. If minor defects were detected in all products sold, repair costs of Rs. 1 million would result. If major defects were detected in all products sold, repair costs of Rs. 4 million would result. The entities past experience and future expectations indicate that, for the coming year, 75 percent of the goods sold will have no defects, 20 percent of the goods sold will have minor defects and 5 percent of the goods sold will have major defects. In accordance with 3.1.4.2, an entity assesses the probability of an outflow for the warranty obligations as a whole.

The expected value of the cost of repairs is:
(75% of Nil) + (20% of Rs. 1 m) + (5% of Rs. 4 m) = Rs. 400,000.

CHALLANGES IN PROVISION:

Provision shall be reviewed at each balance sheet date and adjusted to reflect the current best estimate. If it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision shall be reversed.

USE OF PROVISIONS:

A provision shall be used only for expenditures for which the provision was originally recognized.
Only expenditures that relate to the original provision are set against it. Setting expenditures against a provision that was originally recognized for another purpose would conceal the impact of two different events.

Example-8:

A damage claim of Rs. 15 million for breach of contract has been served on the company. The company's legal counsel is of the view that it is probable that the damages will be awarded to plaintiff. So, the company makes a provision. In the next

year the case is decided in the favor of the plaintiff. The company has to pay Rs. 12 million. Another suit filed against the company is also decided in this year. The company has to pay Rs. 2 million in respect of this case.

Required: How will you account for above two payments?

Solution:

i. The first payment of Rs. 12 million shall be charged to provision and remaining provision should be reversed.

	Debit	Credit
Provision for claim	15,000,000	
Cash		12,000,000
Profit & Loss (Reversal of provision)		3,000,000

ii. The second payment of Rs. 2 million shall be charged to P & L Account separately.

	Debit	Credit
Damages Expenses (P & L A/c)	2,000,000	
Cash		2,000,000

Application of the Recognition and Measurement Rules:

Future Operating Losses:

a) Provisions shall not be recognized for future operating losses.
b) Future operating losses do not meet the definition of a liability and the general recognition criteria set out for provisions.
c) An expectation of future operating losses is an indication that certain assets of the operation may be impaird. An entity tests these assets for impairment under IAS-36 Impairment of Assets.

Onerous Contracts:

If an entity has a contract that is onerous, the present obligation under the contract shall be recognized and measured as a provision.

LESSON # 29

IAS 8
ACCOUNTING POLICIES, CHANGES IN ACCOUNTING ESTIMATES AND ERRORS

This standard shall be applied in selecting and applying accounting policies, and accounting for changes in accounting policies, changes in accounting estimates and corrections of prior period errors.

DEFINITIONS:

The following terms are used in this standard with the meanings specified:

Accounting policies:

These are the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements.

Change in accounting estimate:

It is an adjustment of the carrying amount of an asset or a liability, or the amount of the periodic consumption of an asset, that results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities. Changes in accounting estimates result from new information or new developments and, accordingly, are not corrections of errors.

Example-1:

English Limited acquired an asset. The company estimates its useful life 5 years i.e. future economic benefits shall be drawn from the asset in next 5 years.

This is an accounting estimate.

After 2 years, the company estimates its remaining useful life 4 years. There is a change in total useful life of the asset in third year.

This change is a change in accounting estimate.

Material:

a) Omissions or misstatements of items are material if they could, individually or collectively; influence the economic decisions of users taken on the basis of the financial statements.
b) Materiality depends on the size and nature of the omission or misstatement judged in the surroundings circumstances.
c) The size or nature of the item, or a combination of both, could be the determining factor.
d)

Example-2:

Ihsan Sports Private Limited is in the course of finalizing its financial statement for the year ended 30th June. 2004.

The following information is available from draft financial statements: -

Sales Rs. 200,000,000

Gross profit Rs. 50,000,000

Net profit Rs. 20,000,000

a) Sales made during the month of June are omitted from above records amounting to Rs. 10,000,000.
b) Purchase of stationery on 30th June amounting to Rs. 5,000 is also omitted from above records.

Required: Which items are materials with respect to the above drafts of financial statements?

Solution:

- Sale omitted are 5% of total sales recorded, while stationery purchased is 0.0025%
- Sales omitted are 50% of net profit while stationery purchased is 0.025%.

So, sales omitted are material, which could influence the economic decisions of users. But stationery is not a material because the amount is immaterial with respect to sales and net profit.

Prior period errors:

These are omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that was available when financial statements for those periods were authorized for issue; and could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.

Such errors include the effects of:-

a) Mathematical mistakes;
b) Mistakes in applying accounting policies;
c) Oversights; or
d) Misinterpretations of facts; and
e) Fraud

Retrospective application:

This application is applying a new accounting policy to transactions, other events and conditions as if that policy had always been applied i.e. effect of change in accounting policy regarding previous period is to be calculated.

Retrospective restatements:

Retrospective restatements is correcting the recognitions, measurement and disclosure of amounts of elements of financial statements as if a prior period error had never occurred i.e. correction of error is to be made by restating the previous income statement and opening balance of previous periods' retained earnings.

Prospective application:

It is change in accounting policy and of recognizing the effect of a change in an accounting estimate, respectively, is:

a) Applying the new accounting policy to transactions, other events and conditions occurring after the date as at which the policy is changed; and
b) Recognizing the effect of change in the accounting estimates in the current and future periods affected by the change.

ACCOUNTING POLICIES:

Selection and Application of Accounting Policies:

When a Standard or an Interpretation specifically applies to a transaction, other event or condition, the accounting policy or policies applied to that item shall be determined by applying the Standard or Interpretation and considering any relevant Implementation Guidance issued by the IASB for the standard or interpretation.

In the absence of a Standard or an Interpretation that specifically applies to a transaction, other event or condition, management shall use its judgment in developing and applying an accounting policy that results in information that is:

a) Relevant to the economic decision-making needs of users; and
b) Reliable i.e. the financial statements:

    i. Represent faithfully the financial position, financial performance and cash flows of the entity. Reflect the economic substance of transactions, other events and conditions, and not merely the legal form;
    ii. Are neutral, i.e. free from bias;
    iii. Are prudent; and
    iv. Are complete in all material respect.

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Accounting policies are selected and applied in accordance with a particular standard e.g. FIFO or Weighted Average for inventory measurement. If there is no specific policy in the standard, interpretation or any guidance issue by IASB, the policy selected should fulfill the requirements given in the above paragraph.

In making the judgment described in above paragraph, the management shall refer to, and consider the applicability of, the following sources in descending order:

a) The requirements and guidance in Standards and Interpretations dealing with similar and related issues; and
b) The definitions, recognition criteria and measurement concepts for assets; liabilities, income and expenses in the Framework.

Consistency of Accounting Policies:

a) An entity shall select and apply its accounting policies consistently for similar transactions, other events and conditions, unless a Standard or an Interpretation specifically requires or permits categorization of items for which different policies may be appropriate.
b) If a Standard or an Interpretation requires or permits such categorization, an appropriate accounting policy shall be selected and applied consistently to each category.

CHANGES IN ACCOUNTING POLICIES:

An entity shall change an accounting policy only if the change:

a) Is required by Standard or an Interpretation; or
b) Result in the financial statements providing reliable and more relevant information.

Example-4:

i. Lasani Private Limited have been following LIFO (an allowed alternative treatment of previous IAS-2) for Inventory measurement. Now the entity is required to adopt FIFO or weighed Average method for Inventory measurement (as per the revised IAS-2).

This is a change in accounting policy required by standard.

ii. Pak Limited has been recognizing revenue on dispatch of goods to customers. The company has now decided to recognize revenue on approval of goods by the customer. This change was due to unreliable courier service. The products delivered were not received in good condition by the customers and the company used to take back these damaged goods.

This is a change in accounting policy, which provides more reliable and relevant information about the effects of the transactions.

The following are not considered as changes in accounting policies:-

a) The application of an accounting policy for transactions, other events or conditions that differ in substance from those previously occurring; e.g. loans were used for qualifying assets first time in current year. Previously loans were used for purchase of vehicles and furniture etc.
b) The application of a new accounting policy for transactions; other events or conditions that did not occur previously or were immaterial e.g. policy for borrowing costs, loan taken in current year first time.

The initial application of a policy to revalue assets in accordance with IAS 16 Property, Plant and Equipment or IAS 38 Intangible Assets is a change in an accounting policy to be dealt with as a revaluation in accordance with IAS 16 or IAS 38, rather than in accordance with this Standard.

APPLYING CHANGES IN ACCOUNTING POLICES:

a) An entity shall account for a change in accounting policy, if the change is required by a standard, as per transitional provision, if any, given in the Standard.
b) An entity shall account for a change in accounting policy retrospectively if:

    i. The change is required by a Standard and where no specific transitional provision given in Standard, or
    ii. Change in accounting policy is voluntary.

***Retrospective application**:*

When a change in accounting policy is applied retrospectively, the entity shall adjust.

a) The opening balance of each affected component of equity for the earliest prior period presented; and
b) The other comparative amounts disclosed for each prior period presented as if the new accounting policy had always been applied.

<u>Example-5:</u>

During 2004, Aslam Engineering Ltd changed its accounting policy for the treatment of borrowing costs that are directly attributable to the construction of commercial building to serve as their head office power station. In previous periods, Aslam Engineering Ltd had capitalized such costs. Aslam Engineering Ltd has now decided to treat these costs as an expense, rather than capitalize them. Management judges that the new policy is preferable because it results in a more transparent treatment of

finance costs and is consistent with local industry practice, making Aslam Engineering Ltd financial statements more comparable.

Aslam Engineering Ltd capitalized borrowing costs incurred of Rs. 2,600 during 2003 and Rs. 5,200 in periods before 2003. All borrowing costs incurred in previous years in respect of the building under construction were capitalized.

Aslam Engineering Ltd accounting records for 2004 show profit before interest and income taxes of Rs. 30,000, interest expense of Rs. 3,000 (which relates only to 2004); and income taxes of Rs. 8,100.

Aslam Engineering Ltd has not yet recognized any depreciation on the building under construction because it is not yet in use. In 2003, Aslam Engineering Ltd reported:

	Rs.
Profit before interest and income taxes	18,000
Interest expense	-
Profit before income taxes	18,000
Income taxes	(5,400)
Profit	12,600

2003 opening retained earnings was Rs. 20,000.and closing retained earnings was Rs.32, 600

Aslam Engineering Ltd tax rate was 30 percent for 2004, 2003 and prior periods.

Aslam Engineering Ltd had Rs. 10,000 of share capital throughout, and no other components of equity except for retained earnings.

Solution:

Aslam Engineering Ltd
Extract from the Income Statement

		(Restated)
	2004	**2003**
	Rs.	**Rs.**
Profit before interest and income taxes	30,000	18,000
Interest expense	(3,000)	(2,600)
Profit before income tax	27,000	15,400
Income tax	(8,100)	(4,620)
Profit	18,900	10,780

Aslam Engineering Limited
Statement of Retained Earnings

	(Restated) Retained Earnings Rs.
Balance at 31 December 2002	20,000
Effect of change in accounting policy (Note)	(3,640)
Balance at 31 December 2002 (restated)	16,360
Profit for the year ended 31 December 2003 (restated)	10,780
Balance at 31 December 2003	27,140
Profit for the year ended 31 December 2004	18,900
Balance at 31 December 2004	46,040

Note:

Effect of change in accounting policy is the de-capitalization of interest (net of income taxes of Rs. 1,560).

Example-6:

Servis Shoes Limited has prepared the following information for the year ended 31

March 2005.

Profit & Loss Account

	2005 Rs	2004 Rs.
Sales	75,000	72,750
Cost of sales	(50,000)	(48,500)
Gross profit (1/3 of sales)	25,000	24,250
Operating expenses	(7,500)	(7,750)
	17,500	16,500
Income tax @ 30%	(5,250)	(4,950)
Net Profit	12,250	11,550

Statement of Retained Earnings

	2005 Rs.	2004 Rs.
Balance as at opening date	11,000	7,500
Profit for the year	12,250	11,550
	23,250	19,050
Dividend	10,250	(8,050)
Balance as at closing date	**13,000**	**11,000**

The company used to account for revenue on dispatch of goods. The company observes that the sales returns are increasing year by year. Due to a dishonest employee, quantity received by customers was often less than quantity dispatched.

Along-with administrative action the company also changed its policy for recognition of revenue and decided to account for revenue after receiving acknowledgment from customer.

Relevant amounts for the previous years; since the changed policy was adopted is Rs. 9,000 decrease in sales, resulting in a decrease of Rs. 3,000 in profit before tax.
For the current year 2005, goods dispatched by the company amounted to Rs. 1,500 which were acknowledged in next period, are included in profit & loss account already prepared. For previous year 2004, this amount was Rs. 1,000.

Required: Account for the above change in Accounting policy.

Solution:

Service Shoes Limited
Profit & Loss Account
For the year ended 31 March 2005

	2005	**(Restated) 2004**
	Rs.	**Rs.**
Sales (W-1)	74,500	71,750
Cost of sales - Balancing figure	(49,667)	(47,833)
Gross profit (1/3 of sales)	24,833	23,917
Operating expenses	(7,500)	(7,750)
	17,333	16,167
Income Tax @ 30%	(5,200)	(4,850)
Net profit	12,133	11,317

Service Shoes Limited
Statement of Retained Earnings (Extract)
For the year ended 31 March

	(Restated)
	Rs.
Balance as at 31.3.2003 (W-2)	5,400
Profit for the year 2004 (restated)	11,317
	16,717
Dividend	(8,050)
Balance as at 31.3.2004	8,667
Profit for the year 2005	12,133
	20,800
Dividend	(10,250)
Balance as at 31.3.2005	10,550

Workings:

(W-1) Adjusted sales for:

	2005	2004
	Rs.	Rs.
Sales before change in Accounting policy	75,000	72,750
(Decrease) in sales	(1,500)	(1,000)
Increase in sales	1,000	-
Adjusted sales	74,500	71,750

(W-2)

Adjustment in opening retained profits as on 31.3.2003		7,500
Profit before tax	3,000	
Income Tax effect 30%	(900)	(2,100)
		5,400

If retrospective application is impracticable then change in accounting policy will be applied prospectively from the year when it is practicable to change.

LESSON # 30

IAS 8
ACCOUNTING POLICIES, CHANGES IN ACCOUNTING ESTIMATES AND ERRORS

CHANGES IN ACCOUNTING ESTIMATES:

As a result of the uncertainties inherent in business activities, many items in financial statements cannot be measured with accuracy but can only be estimated. Estimation involves judgments based on the latest available and reliable information. For example, estimates may be required for:

a) Doubtful debts,
b) Inventory obsolescence;
c) The fair value of financial assets or financial liabilities;
d) The useful lives of, and expected pattern of consumption of the future economic benefits embodied in depreciable asset, and
e) Warranty obligations.

The effect of a change in an accounting estimate, other than a change to which following paragraph applies, shall be recognized prospectively by including it in profit or loss in:

a) The period of the change, if the change affects that period only; or
b) The period of the change and future period, if the change affects both.

To the extent that a change in an accounting estimate gives rise to changes in assets and liabilities, or relates to an item of equity it shall be recognized by adjusting the carrying amount of the related asset, liability or equity item in the period of the change.

a) Prospective recognition of the effect of a change in an accounting estimate means that the change is applied to transactions, other events and conditions from the date of the change in estimate.
b) A change in an accounting estimate may affect only the current period's profit or loss, or the profit or loss of both the current period and future periods.

For example, a change in the estimate of the amount of bad debts affects only the current period's profit or loss and therefore is recognized in the current period only. However, a change in the estimated useful life of, or the expected pattern of future economic benefits embodied in a depreciable asset affects depreciation expense for the current period and future periods during the asset's remaining useful life. In both cases, the effect of the change relating to the current period is recognized as income or expense in the current period. The effect, if any, on future periods is, recognized as income or expense in those future periods.

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Example-8:

Idrees Sports Private Limited purchased an asset with followings details:

Cost Price	=	Rs. 2,500,000
Estimated useful life	=	10 years
Estimated residual value	=	Rs. 100,000

In third year, the company estimates the useful life of its asset at 6 years with residual value of Rs. 220,000. The company depreciates its asset on straight line method.

Required: Account for the above Accounting Estimates in the Financial Statements of Idrees Sports Private limited, in the third year.

Solution:

Idress Sports Private Limited
Extract from cost of goods sold statement

	Rs	*Rs*
Manufacturing Expenses		
Depreciation (W-2)	300,000	

Note: This change in Accounting Estimate has been accounted for prospectively.

Working:

(W-1)

Year	*Cost*	*Depreciable Amount*	*Depreciation Rate (W-3)*	*Depreciation Amount*	*Book Value*
	(Rs)	(Rs)	%	(Rs)	(Rs)
1	2,500,000	2,400,000	10%	240,000	2,260,000
2.		2,400,000	10%	240,000	2,020,000

(W-2)

Year	**Carrying Amount**	**Depreciable Amount**	**Depreciable Rate**	**Depreciation**	**Book Value**
	Rs	***Rs***	***%***	***Rs***	***Rs***
	(2,020,000 – 220,000)				
3	2,020,000	1,800,000	16.67%	300,000	1,720,000
4			16.67%	300,000	1,420,000
5			16.67%	300,000	1,120,000
6.			16.67%	300,000	820,000
7.			16.67%	300,000	520,000
8			16.67%	300,000	220,000

(W-3) <u>Depreciation rate in first two years</u>

$$\text{Depreciation Rate} = \frac{1}{\text{Estimated useful life}} \times 100$$

$$\text{Depreciation Rate} = \frac{1}{10} \times 100$$

$$\text{Depreciation Rate} = 10\%$$

(W-4) <u>Depreciation rate from third year</u>

$$\text{Depreciation Rate} = \frac{1}{\text{Estimated useful life}} \times 100$$

$$\text{Depreciation Rate} = \frac{1}{6} \times 100$$

$$\text{Depreciation Rate} = 16.67\%$$

Disclosure:

An entity shall disclose the nature and amount of change in an accounting estimate that has an effect in the current period or is expected to have an effect in future periods, except for the disclosure of the effect on future periods when it is impracticable to estimate that effect.

If the amount of the effect in future periods is not disclosed because it is impracticable, an entity shall disclose that fact.

Errors:

a) Errors can arise in respect of the recognition, measurement, presentation or disclosure of elements of financial statements.
b) Financial statements do not comply with IFRSs if they contain either material errors or immaterial errors made intentionally to achieve a particular presentation of an entity's financial position, financial performance or cash flow.
c) Potential current period errors discovered in that period are corrected before the financial statements are authorized for issue. However, material errors are sometimes not discovered until a subsequent period, and these prior period errors are corrected in the comparative information presented in the financial statements for that subsequent period.

If it is not impracticable, an entity shall correct prior period errors retrospectively in the first set of financial statements authorized for issue after their discovery by:

a) Restating the comparative amounts for the prior period(s) presented in which the error occurred; or
b) If the error occurred before the earliest prior period presented, and then restating the opening balances of assets, liabilities and equity for the earliest prior period presented.

Example-9:

During 2008, Saleem Co discovered that some products that had been sold during 2007 were incorrectly included in inventory at 31 December 2007 at Rs. 6,500.

Saleem Co's accounting records for 2008 show sales of Rs. 104,000, cost of goods sold of Rs.86,500 (including Rs. 6,500) for the error in opening inventory), and income taxes of Rs. 5,250.

In 2007, Saleem Co's reported:

	2007
	Rs.
Sales	73,500
Cost of goods sold	(53,500)
Profit before income taxes	20,000
Income taxes	(6,000)
Profit	14,000

2007 opening retained earnings was Rs. 20,000 and closing retained earning was Rs.34, 000.

Saleem Company's income tax rate was 30 percent for 2008 and 2007. It had no other income or expenses

Saleem Company's had Rs. 50,000 of share capital throughout and no other components of equity except for retained earnings.

Solution:

Saleem Co's

Extract from the Income Statement

		(Restated)
	2008	**2007**
	Rs.	**Rs.**
Sales	104,000	73,500
Cost of goods sold	(80,000)	(60,000)
Profit before income taxes	24,000	13,500
Income taxes	(7,200)	(4,050)
Profit	16,800	9,450

Saleem Co's

Statement of Changes in Equity

		2008	2007
	Rs.	Rs.	Rs.
Opening Balance (Retained Profit b/f)		34,000	20,000
Adjustment in opening retained profit	6,500		
Income tax effect at 30%	(1,950)	4,550	
Adjusted Retained profit		29,950	
Profit after tax for the current year		16,800	9,450
Closing Balance at (Retained Profit c/f)		46,250	29,450

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LESSON # 31

BORROWING COST (IAS 23)

This standard deals with the cost (interest/financial charges) of such borrowings that are made for purchase, acquisition or construction/production of assets.

DEFINITIONS:

Two very important terminologies of this standard need explanation, before going into the further details.

1) **Borrowing Costs:**

These are interest and other costs incurred by an entity in connection with the borrowing of funds.

Examples of Borrowing Costs:

(a) Interest on bank overdrafts and short-term and long term borrowings;
(b) Amortization of discounts or premiums relating to borrowings;
(c) Amortization of ancillary costs incurred in connection with the arrangement of borrowings (*e.g. processing fee, lawyer's consultation etc.*);
(d) finance charges in respect of finance leases recognized in accordance with IAS 17, Leases; and
(e) Exchange difference arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest cost.

2) **A qualifying asset:**

It is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

Examples of Qualifying Assets:

a) Manufacturing plants
b) Power generation facilities
c) Investment properties
d) Those inventories which are routinely manufactured or produced in large quantities on a repetitive basis and assets ready for their intended use or sale when acquired are not qualifying assets.

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Solved Problem #1:

Identify which of the followings are qualifying assets:

(a) Power plant being in the process of manufacturing.
(b) Inventories routinely manufactured;
(c) Asset ready for use;

(d) Inventories requiring a substantial period for manufacturing.
(e) Special order for a special inventory that will be manufactured in 5 months.

Solution:

(a) Qualifying Asset;
(b) Not Qualifying Asset;
(c) Not Qualifying Asset;
(d) Qualifying Asset;
(e) Qualifying Asset.

Accounting for borrowing costs:

1) **Benchmark Treatment:**

Recognition:

Under the benchmark treatment borrowing costs are recognized as an expense in the period in which they are incurred regardless of how the borrowings are applied.

Disclosure:

The financial statements shall disclose the accounting policy adopted for borrowing costs (*e.g. Interest, markup, profit and other charges on borrowings are charged to income*).

2) **Allowed Alternate Treatment:**

Recognition:

Borrowing costs shall be recognized as an expense in the period in which they are incurred, except to the extent that borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset shall be capitalized as part of the cost of that asset.

Borrowing costs eligible for capitalization:

The borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are those borrowing costs that would have been

avoided had the expenditure on the qualifying asset not been made. When an entity borrows funds specifically for the purpose of obtaining a particular qualifying asset, the borrowing costs that directly relate to that qualifying asset can be readily identified.

Solved Problem #2:

Mega Limited is engaged in the production of power generation plants, which is to be used by the company.
The company borrows Rs.20, 000,000 @ 10% for construction of the plant.
The company wants to adopt the policy for accounting treatment of interest expense on such borrowings.

What options are available to the company under IAS-23, Borrowing Costs.

Solution:

Benchmark Treatment:

Interest expense is recognized as an expense in the period in which it is incurred. Therefore, the company under benchmark treatment should recognize the interest of Rs. 2,000,000 as an expense.

Allowed Alternative Treatment:

Under allowed alternative treatment, the interest expense of Rs. 2,000,000 shall be capitalized in the cost of the asset.

Specific Borrowings:

Where funds are borrowed specifically for a qualifying asset, the amount of borrowing cost (less temporary investment income if any) shall be capitalized as a cost of such asset.

Temporary Investment Income:

When all of the borrowed funds are not utilized at once for acquisition, development or construction of qualifying asset, the unutilized amount of the borrowed fund is invested temporarily(for a little time period) in some securities. The return on such investments is known as temporary investment income.

Solved problem #3:

Swan Limited borrowed a loan from bank @ 12% per annum amounting to Rs.1, 000,000 for the construction of power generation facilities of the company. The loan was received on January 01 and utilized Rs. 300,000 on Qualifying Asset. On January

01, the company deposited the remaining amount in a bank yielding interest @ 6%. Whole of the amount is withdrawn and paid to contractor on March 01. The company returned the loan to bank after 9 months i.e. on October 01. You are required to calculate the amount of borrowing cost eligible for capitalization.

Hint:

Borrowing period 9 months
Investment period 2 months

Solution:

	Rs.
Interest paid to bank	
$1,000,000 \times 12\% \times \frac{9}{12}$	90,000
Less: Interest income	
$700,000 \times 6\% \times \frac{2}{12}$	(7,000)
Borrowing cost eligible for capitalization	83,000
Capital expenditure (Rs. 1,000,000 + 83,000)	**1,083,000**

General Borrowings:

The amount to be capitalized shall be computed on the basis of capitalization rate, which shall be the weighted average of the borrowing costs applicable to the outstanding borrowing during the period, i.e.

$$\text{Capitalization rate} = \frac{\text{Total Borrowing Cost incurred}}{\text{Weighted Borrowings Outstanding}} \times 100$$

This rate when applied on the expenditure incurred on Qualifying Asset on a time basis gives the amount of borrowing cost to be capitalized.
The capitalization should not exceed the amount of borrowing costs actually incurred,

Solved problem #4:

MCQ (Private) Limited has the following loans outstanding as at December 31, 2005.

	Rs.
Loan – 1 @ 6% (Due since opening date)	300,000
Loan – 2 @ 8% (Taken on 1 April, 2005)	200,000
Loan – 3 @ 9% (Taken on 1 July, 2005)	150,000

The company spent following amounts on construction of an asset.

January 31, 2005	70,000
April 1, 2005	80,000
December 1, 2005	10,000

Calculate

(i) Capitalization Rate
(ii) Borrowing cost eligible for capitalization.

Solution:

(i) Capitalization rate 7% (W-1)
(ii) Borrowing cost eligible for capitalization Rs.9, 136 (W-2)

Working:

(W-1) Capitalization Rate.

Loan	Amount Rs.		W Avg. Rs.	Rate	Interest Rs.
Loan – 1	300,000		300,000	6%	18,000
Loan – 2	200,000	(9/12)	150,000	8%	12,000
Loan – 3	150,000	(6/12)	75,000	9%	6,750
	650,000		525,000		36,750

$$\text{Capitalization rate} = \frac{\text{Total Interest}}{\text{Weighted Average Loan}} \times 100$$

$$= \frac{36,750}{525,000} \times 100$$

Capitalization rate = 7%

(W-2) Borrowing cost eligible for capitalization.

Expenditure	Incurred on	Rate	Period	Capitalization
70,000	January 31, 2005	7%	11/12	4,492
80,000	April 01, 2005	7%	9/12	4,200
10,000	December 01, 2005	7%	1/12	58
160,000				8,750

	Rupees
Total borrowing cost	**36,750**
Borrowing cost eligible for capitalization	**(8,750)**
Borrowing cost chargeable as expense	**28,000**
Capital Expenditure	
Incurred cost	**160,000**
Borrowing cost eligible for capitalization	**8,750**
Total	**168.750**

Solved problem #5:

MCQ (Private) Limited has the following loans outstanding as at December 31, 2005.

	Rs.
Loan – 1 @ 6% (Due since opening date)	300,000
Loan – 2 @ 8% (Due since opening date)	200,000
Loan – 3 @ 9% (Due since opening date)	150,000

The company spent following amounts on construction of an asset.

January 31, 2005	70,000
April 1, 2005	80,000
December 1, 2005	10,000

Calculate (i) Capitalization Rate
(ii) Borrowing cost eligible for capitalization.

Solution:

(i)	Capitalization rate	7.31% (W-1)
(ii)	Borrowing cost eligible for capitalization	Rs.9, 136 (W-2)

Working:

(W-1)

Loan	**Amount Rs.**	**Rate**	**Interest Rs.**
Loan – 1	300,000	6%	18,000
Loan – 2	200,000	8%	16,000
Loan – 3	150,000	9%	13,500
	650,000		47,500

$$\text{Capitalization rate} = \frac{\text{Total Interest}}{\text{Total Loan}} \times 100$$

$$= \frac{47{,}500}{650{,}000} \times 100$$

Capitalization rate = 7.31%

(W-2) *Borrowing cost eligible for capitalization.*

Expenditure *Rupees*	**Incurred on**	**Rate**	**Period**	**Capitalization** *Rupees*
70,000	January 31, 2005	7.31%	11/12	4,689
80,000	April 1, 2005	7.31%	9/12	4,386
10,000	December 1, 2005	7.31%	1/12	61
160,000				9,136

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	Rupees
Total borrowing cost	**47,500**
Borrowing cost eligible for capitalization	**(9,136)**
Borrowing cost chargeable as expense	**38,364**
Capital Expenditure	
Incurred cost	**160,000**
Borrowing cost eligible for capitalization	**9,136**
Total	**169,136**

Solved problem #6:

Sublime Sports Limited is currently manufacturing its power plants.
Up-to December 31, 2003, the company has incurred costs totaling Rs.500, 000 on production of one of its plant.
The following loans are outstanding:

	Rs.
Loan from MCB @ 9%	500,000
Loan from HBL @ 10%	625,000
Loan from UBL @ 11%	375,000

Loan from HBL was taken on July 1, 20x3 other loan were brought forward from previous year.

Expenditure on plant incurred as follows:

	Rs.
May 31, 2003	300,000
July 31, 2003	200,000

You are required to calculate:
(a) Capitalization rate of the company;
(b) Total borrowing cost to be capitalized for the year 2003.

Solution:

(a)	Capitalization rate	9.8947% (W-1)
(b)	Total borrowing cost eligible for capitalization	Rs. 25,562 (W-2)

Workings:

(W-1)	**Principal**		**W Avg. Loan**	**Rate**	**Interest**
Loan from MCB	500,000	12/12	500,000	9%	45,000
Loan from HBL	625,000	6/12	312,500	10%	31,250
Loan from UBL	375,000	12/12	375,000	11%	41,250
			1,187,500		117,500

$$\text{Capitalization rate} = \frac{\text{Total interest}}{\text{Weighted average loan}} \times 100$$

$$= \frac{117{,}500}{1{,}187{,}500} \times 100$$

Capitalization rate = 9.8947%

(W-2) Total borrowing cost to be capitalized.

Expenditure	Incurred on	Rate	Period	Capitalization
300,000	May 31, 2003	9.8947%	7/12	17,316
200,000	July 31, 2003	9.8947%	5/12	8,246
500,000				25,562

LESSON # 32

EXCESS OF THE CARRYING AMOUNT OF THE QUALIFYING ASSET OVER RECOVERABLE AMOUNT

When the carrying amount or the expected ultimate cost of the qualifying asset exceeds its recoverable amount or net realizable value, the carrying amount is written down or written off in accordance with the requirements of other Standards. In certain circumstances, the amount of the write down or write-off is written back in accordance with those other Standards.

Commencement of capitalization:

The capitalization of borrowing costs as part of the cost of a qualifying asset shall commence when:

(a) Expenditures on the asset are being incurred;
(b) Borrowing costs are being incurred; and
(c) Activities that are necessary to prepare the asset for its intended use or sale are in progress.

Solved problem #7:

Silver Star (Private) Limited engaged in manufacturing of surgical items.
Currently the company is manufacturing its power plant. The company started the project on February 01, with its own funds. Later on due to shortage of funds, the company takes a loan to sponsor the project on May 01. The first payment out of the loan on the plant is made on June 01.

Required:

When should the company commence capitalization of borrowing cost on the plant?

***Solution*:**

The necessary three conditions for commencement of capitalization are fulfilled on June 01, so capitalization should commence on **June 01**.

Treatment of Subsidies by the Government:
Expenditures on a qualifying asset include only those expenditures that have resulted in payments of cash, transfers of other assets or the assumption of interest bearing liabilities. Expenditures are reduced by any progress payments received and grants received in connection with the asset. The average carrying amount of the asset during a period, including borrowing costs previously capitalized, is normally a reasonable approximation of the expenditures to which the capitalization rate is applied in that period.

Solved problem #8:

Pak Solutions Limited is engaged in the production of plants. The company is currently manufacturing a plant for internal use.
Following expenditures were made:

	Rupees
Payment to vendors for material	500,000
Depreciation of equipment used for manufacturing of plant	20,000
Wages paid	300,000
Utilities to be paid	80,000

Government granted a subsidy to the company for manufacturing of plant amounting to Rs.200, 000.

Required:

Assuming that the company funds the project by obtaining a loan, calculate the amount to be used as cost of the asset for computing the borrowing cost eligible for capitalization.

Solution:

Amount on which capitalization should be made:

	Rs.
Payment to vendors for materials	500,000
Wages paid	300,000
Depreciation of equipment	20,000
Utilities to be paid	80,000
	900,000
Less: Govt. subsidy	(200,000)
	700,000

The activities necessary to prepare the asset for its intended use or sale encompass more than the physical construction of the asset. They include technical and administrative work prior to commencement of physical construction, such as the activities associated with obtaining permits prior to the commencement of the physical construction.

Suspension of capitalizing borrowing cost:

Capitalization of borrowing costs shall be suspended during extended periods in which active development is interrupted.
Capitalization is not suspended when a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale e.g. the extended period during which high water level delay construction of a bridge.

Solved problem # 9:

Shahid and company is constructing an asset for their own use in the business.
The production of asset started on September 30, 2006. Due to some internal problems of the company, the construction remained suspended from November 01 to November 31. The asset was completed on December 31. The asset was constructed by utilizing the borrowed funds.

Required:

Calculate the period for which capitalization should be made.

Solution:

The active development started on September 30, and continued till October 31, and then after stoppage construction again started on December 1 till December 31.
Therefore, the borrowing cost should be capitalized for two months and shall remain suspended for one month.

Cessation of Capitalization:

Capitalization of borrowing costs shall cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

Solved problem #10:

Haroon Limited is constructing an asset for its internal use. The construction started on March 01, 2009. The asset was completed on July 31, 2009. It was put into use on September 15. The production was started from such asset on November 1.

Required:

You are required to state when capitalization of borrowing cost should be ceased.

Solution:

The asset was completed on July 31, 20x9. It was ready for use although the production from such asset was not started. Thus capitalization of borrowing cost should cease on July 31, 2009.

Modification work after completion:

An asset is normally ready for its intended use or sale when the physical construction of the asset is complete even though routine administrative work might still continue. If minor modifications, such as the decoration of a property to the purchaser's or

user's specification, are all that are outstanding, this indicates that substantially all the activities are complete.

Solved problem #11:

Zeshan Limited is engaged in production of an asset. The production started on July 31, 2007. The production completed on July 31, 2008.
The works manager checked the asset and requested some minor modifications. These modifications were completed on August 30, 2008. The asset delivered to works manager on September 10, 2008. The production started from such asset on October 01, 2008.

Required:

When should capitalization cease.

Solution:

The capitalization should cease on July 31, 2008, as substantially the activities have been completed on this date.

Completion of work in parts:

When the construction of qualifying asset is completed in parts and each part is capable of being used separately while construction continues on other parts, capitalization of borrowing costs shall cease when substantially all the activities necessary to prepare that part for its intended use or sale are completed.
A business centre comprising several buildings, each of which can be used individually is an example of a qualifying asset for which each part is capable of being used while construction continues on other parts.
An example of a qualifying asset that needs to be completed in full, before any other part can be used, is an industrial plant involving several processes which are carried out in sequence at all parts of the plant within the same site, such as a steel mill.

Solved problem #12:

Sialkot (Pvt.) Limited contracted with B Limited to build a group of factory buildings. Each building is capable of being used separately.
Sialkot (Pvt.) Limited capitalizes its borrowing costs in accordance with Allowed Alternative Treatment of IAS-23, Borrowing Costs.

Required:

Advice the company to capitalize its borrowing costs based on the period when all the buildings are ready for use or based on the period when each building is ready for use.

Solution:

As each component of the contract is capable of being used separately, the borrowing costs should be capitalized based on the period of construction of each building.

Disclosures:

Following should be disclosed in the financial statements:

(a) The accounting policy adopted for borrowing costs;
(b) The amount of borrowing costs capitalized during the period; and
(c) The capitalization rate used to determine the amount of borrowing costs eligible for capitalization.

Solved problem # 13:

Disclosure:

(i) Borrowing costs are recognized as an expense in the period in which these are incurred, except to the extent that borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset is capitalized as part of the cost of that asset.
(ii) The amount of borrowing costs capitalized during the period is Rs. 75,145.
(iii) Capitalization rate for the year used to capitalize borrowing costs is 9.15%.

PRACTICE QUESTIONS

QUESTION #1:

On 1st Jan 2006, Sparkle Co borrowed Rs. 1.5 million to finance the production of two assets both of which were expected to take a year to build. Production started during 2006. The loan facility was drawn down on 1 Jan 2006 and was utilized as follows, with the remaining funds invested temporarily

	Asset A	Asset B
1 Jan 2006	250,000	500,000
1 Jul 2006	250,000	500,000
	500,000	1,000,000

The loan rate was 8 % and Sparkle Co can invest surplus funds at 5 %.

Required:

Calculate the borrowing costs which may be capitalized for each of the asset and consequently the cost of each asset as at 31 Dec 2006.

QUESTION #2:

AUM engineering limited has been engaged in construction business and wins a contract to construct Kalabhag Dam work Rs. 120 million with a completion period of one year.

Progress payments made by the government are as under

1st April	30 M
1st July	30 M
31st December	60 M

The company's bankers agree to finance the project @ 9 % mark up per annum as per following schedule.

1st January	40 M
1st April	40 M
1st July	40 M

The company realizes at the end of third month that second installment of disbursement by the bankers needs to be paid to the company's creditors a month later. Therefore, on receipt of second installment, it is temporarily invested to fetch return of 2 % per month to the company.

Required:

Compute the amount of borrowing cost to be capitalized as per IAS-23.

QUESTION #3:

Loan worth of Rs. 300,000 taken on 1st January 2006 for construction of X and Y blocks. Interest Rate is 10% per annum and surplus funds are invested @ 7% per annum.

Detail of Expenditure

Year 2006	**X**	**Y**
1st January	100,000	50,000
30th June	0	60,000
	100,000	110,000

Block X was completed on June 30, 2006.

Required:

Calculate total expenditure on X and Y Blocks as on December 31, 2006, applying allowed alternative treatment under IAS-23 is adopted.

LESSON # 33

EARNINGS PER SHARE (IAS – 33)

Earning per share is an accounting ratio that improves comparison of the performance of different entities in the same period and of the same entity in different accounting periods.
International Accounting Standard (IAS) 33 provides complete guidelines regarding calculation and presentation of EPS. Only listed companies need to present EPS. Where a non listed company chooses to present EPS in its financial statements, it must do so in accordance with IAS 33.

Basic Earnings per Share (EPS)

Apparently EPS is the outcome of current year's earnings divided by the number of ordinary shares. IAS 33 guides to use following formula for calculation of basic EPS:

$$\frac{\text{Profits available for distributions to ordinary shareholders}}{\text{Weighted average number of ordinary shares outstanding during the year}} = \text{EPS}$$

Profits available for distribution to ordinary shareholders:

This is the current year's profit figure which is obtained after subtracting all types of expenses (cost of goods sold, administrative, selling, financial and income tax expenses) out of all the incomes (revenues and gains) recognized during the year. This is also known as the profit after tax.

Weighted average number of ordinary shares outstanding during the year:

This is the figure that needs calculation; these are the weighted average of ordinary shares that remained outstanding during the year. This figure is obtained after making certain adjustments concerning increase or decrease in the number of ordinary shares in accordance with the time period due.
The time-weighting factor is the number of days the shares were outstanding compared with the total number of days in the period.

A very simple example to understand the concept of weighted average is as under:

FS Company Limited

		Number of Ordinary Shares
January 1, 2007	Opening Balance b/f	200,000
September 30, 2007	Issue of ordinary share capital	200,000
December 31, 2007	Closing Balance c/f	**400,000**

Weighted Average number of ordinary share capital outstanding during the year:

200,000	(outstanding for full year)	200,000
200,000 x 3/12	(outstanding for Oct. Nov. & Dec.)	50,000
Weighted average number of ordinary share capital outstanding		**250,000**

Another example to understand weighted average calculations:

Jubilation Co., a listed company, has the following share transactions during the year ending on December 31, 2007.

Date	Details	Shares Issued	Treasury shares*	Shares Outstanding
Jan 1, 2007	Balance b/f	200,000	30,000	170,000
May 31, 2007	Fresh Issue	80,000	-	250,000
Dec 1, 2007	Treasury shares		25,000	225,000
Dec 31, 2007	Balance c/f	**280,000**	**55,000**	**225,000**

**Treasury shares are the company's own shares held by the company itself*

Weighted average number of shares

Shares Outstanding	weight in months	weighted average
170,000	5/12	70,833
250,000	6/12	125,000
225,000	1/12	18,750
		214,583

Alternative calculation:

Number of shares	weight in months	weighted average
170,000	12/12	170,000
80,000	7/12	46,666
(25,000)	1/12	(2,083)
		214,583

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Shares are usually included in the weighted average number of shares from the date on which the consideration is receivable which is usually the date of issue.
Ordinary shares issued as purchase consideration in an acquisition should be included as of the date of acquisition because the acquired entity's results will also be included from that date.

Solved problem # 1:

Famous Co. is a company with an issued and paid up capital of 100,000 ordinary shares of Re. 1 each and 20,000 10% debentures of Re. 1 each. The company manufactures electrical appliances.
During its accounting year ending on December 31, 2007 the company had operating expenses of Rs. 50,000 the gross profit was Rs. 200,000. The company paid the 10% interest on debentures and declared an ordinary dividend of 40 paisa per share.
Assuming an income tax rate of 30% on the given figures show the trading results and EPS of the company.

Solution:

Famous Co
Income Statement
For the year ended December 31, 2007

	Rupees
Gross profit	200,000
Operating expenses	(50,000)
Profit from operations	150,000
Interest on debentures	(2,000)
Profit before tax	148,000
Income tax	(44,400)
Profit after tax	**103,600**

Earnings per share

$$\frac{\text{Rs. } 103{,}600}{100{,}000} = \text{Rs. } 1.036 \text{ per share}$$

Solved problem # 2:

In addition to the information given in the above problem assume the Famous Co also issued further 40,000 ordinary shares on July 1, 2007.

Solution:

Weighted average number of ordinary shares

Balance on Jan 1, 2007		100,000
Issued on July 1, 2007	40,000 x 6/12	20,000
Weighted average		**120,000**

Earnings per share

Rs. 103,600 = Rs. 0.863 per share
120,000

Solved problem # 3:

On September 30, 2008, Blue-moon Co made an issue at full market price of 1,000,000 ordinary shares. The company's accounting year runs from January 1 to December 31. Relevant information for the year 2007 and 2008 is as follows:

	2008	**2007**
Shares in issue as on December 31	9,000,000	8,000,000
Profits after tax (in Rupees)	3,300,000	3,280,000

Required:

Calculate EPS for the year 2008 and corresponding figure for 2007

Solution:

Weighted average number of shares

		2008	**2007**
Shares in issue on opening date		8,000,000	8,000,000
Fresh issue	1,000,000 x 3/12	250,000	
Weighted average		**8,250,000**	**8,000,000**
Earnings		**3,300,000**	**3,280,000**
Earnings per share		Rs. 3,300,000 / 8,250,000	Rs. 3,280,000 / 8,000,000
		40 paisa	41 paisa

Despite an increase in total earnings by Rs. 20,000 in the year 2008, the EPS is not as good as in the year 2007, because there was extra capital employed for the last 3 months of the year 2008.

LESSON # 34

Earnings per Share (IAS 33)

There are few events that cause a change in number of ordinary shares in issue other than because of the issue of share against inflow of resources. These include:

- Capitalization of reserves or issue of bonus shares.
- Bonus element in rights issue of share capital to the existing share holders.

In these events it is necessary to make adjustments in the denominator of the EPS formula so that the current and comparative EPS figures are meaningful.

Bonus Issue of Share Capital:

Bonus issue of share capital causes an increase in the number of ordinary shares without corresponding increase in the financial resources of the entity. Bonus shares are issued against capitalization of the reserves kept in the owners' equity. Because of the bonus issue the total amount of net assets of owners' equity remains the same as it was prior to the issue.

As the increase in ordinary share capital does not bring financial resources in the business, and this change in share capital causes a decrease in the EPS comparing with the previous year's EPS, therefore this problem is solved by adjusting the number of ordinary shares outstanding before the event for the proportionate change in the number of shares outstanding as if the event had occurred at the beginning of the earliest period reported.

Solved problem # 1:

Great Master Co had 400,000 shares in issue, until on September 30, 2009 it made a bonus issue of 100,000 shares. Calculate the EPS for the year 2009 and the corresponding figure for the year 2008 if total earnings were Rs. 80,000 in the year 2009 and Rs. 75,000 in the year 2008. The company's accounting year runs from January 1 to December 31.

Solution:

	2009	***2008***
Earnings (in Rupees)	**80,000**	**75,000**
Number of share on January 1	400,000	400,000
Bonus Issue during the year 2009	100,000	100,000
Total number	**500,000**	**500,000**
EPS	**16 paisa**	**15 paisa**

The number of shares in the year 2008 must also be adjusted if the figures for EPS are to remain comparable.
Because if the number of shares in the year are not adjusted with the number of bonus share issued in the year 2009 then the results will be very much distorted.

Like the EPS in the year 2008 will then be $\frac{\text{Rs. } 75{,}000}{400{,}000}$ = 18.75 paisa

This working shows that the company's earnings were more than the current year's earnings, which is not true in fact. The company earned Rs. 80,000 profit with the same amount of financial resources in terms of the share capital which it had in the year 2007, when the profits were Rs. 75,000, therefore how come it can be said that the year 2007 was better than the year 2008.
To fix this problem there are two alternatives, either to calculate EPS in both years with a denominator of 400,000 number of shares it will give comparable results, or to calculate EPS in both years with a denominator of 500,000 number of shares. Later approach is recommendable because doing this will not require further adjustments in the subsequent years when the actual number of ordinary share are 500,000.

Rights Issue of Share Capital:

A rights issue of share capital is an issue of new shares to existing shareholders at a price below the current market value. The offer of new shares is made on the basis of a number of new shares for every number of shares currently held, e.g. a 1 for 3 rights issue is an offer of 1 new share at the offer price for every 3 shares currently held. This means that there is a bonus element included in the rights issue.
To arrive at figures for EPS when a rights issue is made, we need to calculate first of all the *theoretical ex-rights price*. This is a weighted average value per share; concept of theoretical ex-right price will become clear after doing the following problem.

Solved problem # 2:

On January 1, 2008, Egg Co has 10,000 shares in issue. On June 30, 2008 it proposes to make a 1 for 4 rights issue at a price of Rs. 3 per share. The market value of existing shares on June 30, 2008, before the issue is made is Rs. 5 (this is cum right value also known as with right value). Calculate the theoretical ex-rights price per share.

Solution:

Number of shares held @ Market price	4 x Rs. 5	20
Number of shares offered @ Offer price	1 x Rs. 3	3
Theoretical price of 5 shares		23

Theoretical ex-right price per share $\frac{23}{5}$ = Rs. 4.60/sh

This calculation can alternatively be performed as under

Number of shares held @ Market price	10,000 x Rs. 5	50,000
Number of shares offered @ Offer price	2,500 x Rs. 3	7,500
Theoretical price of 12,500 shares		57,500

Theoretical ex-right price per share $\frac{57,500}{12,500}$ = Rs. 4.60/sh

Procedure to calculate EPS:

1. Calculate theoretical ex-rights price
2. Determine the bonus element in rights issue
3. Add the bonus element in the outstanding number of ordinary shares of current year and also add the same figure in the outstanding number of ordinary shares of the previous year
4. Calculate the weighted average number of shares representing the resources element in the rights issue and add this figure in the current year's outstanding number of ordinary shares
5. Calculate EPS

Solved problem # 3:

Continuing the above example in solved problem # 2, earnings of the Egg Co for the years 2007 and 2008 were Rs. 20,000 and Rs. 22,000 respectively.
Calculate EPS for the year 2008 and its corresponding figure for 2007.

Solution:

Rights issue	2,500 shares
Offer price	Rs. 3 per share
Market price	Rs. 5 per share
Theoretical ex-right price	Rs. 4.60 per share
Total amount of investment	2,500 @ Rs. 3 = Rs. 7,500
Consideration element	Rs. 7,500/Rs. 4.60 = 1,630 shares
Bonus element	2,500 – 1,630 = 870 shares

Schedule of weighted average number of shares outstanding during the year

	2008	2007
Opening balance	10,000	10,000
Rights issue		
Bonus element	870	870
Consideration/resource element		
1,630 x 6/12	815	

Weight average	**11685**	**10,870**
Earnings per share	22,000 / 11,685	20,000 / 10,870
EPS	**Rs. 1.88**	**Rs. 1.84**

Solved problem # 4:

A company produced the following net profit figures for the years ending December 31;

	Rs.
2006	110,000
2007	150,000
2008	180,000

On January 1, 2007 the number of shares outstanding was 500,000. During 2007 the company announced a rights issue with the following details.

Rights:	1 new share for each 5 outstanding
Exercise price	Rs. 5 per share
Last date to exercise rights	March 1, 2007 (10 months outstanding)
Market price on March 1, 2007	Rs. 11

Required:

Calculate EPS for the years 2006, 2007 and 2008.

Solution:

Theoretical ex-right price	Shares	Value Rs.
Number of shares held @ market price	500,000 @ Rs. 11	5,500,000
Number of shares offered @ offer price	100,000 @ Rs. 5	500,000
Theoretical value of	600,000	6,000,000

Theoretical ex-right price $\frac{\text{Rs. } 6{,}000{,}000}{600{,}000}$ = Rs. 10 per share

Bonus element

Total investment	Rs. 500,000
Number of shares out of the market at offer price	Rs. 500,000/Rs, 10
Consideration element	50,000 shares
Bonus element	
(Total rights issue – consideration element)	50,000 shares

Schedule of weighted average number of shares outstanding during the year

Outstanding number on opening date	500,000	500,000	600,000
Bonus element	50,000	50,000	
Consideration/resources element (50,000 x 10/12)			41,667
Weighted average	**550,000**	**591,667**	**600,000**
EPS	110,000	150,000	180,000
	550,000	591,667	600,000
	Rs. 0.20	**Rs. 0.2535**	**Rs. 0.30**

LESSON # 35

DILUTED EARNINGS PER SHARE

At the end of an accounting period, a company may have in issue some securities which do not (at present) have any claim to a share of equity earnings, but may give rise to such a claim in the future. These securities include:

a) A separate class of equity shares which at present is not entitled to any dividend, but will be entitled after some future date
b) Convertible Debentures or convertible preferred shares which give their holders the right at some future date to exchange their securities for ordinary shares of the company, at a pre-determined conversion rate
c) Option or warrants

In such circumstances, the future number of ordinary shares in issue might increase. This in turn results in a fall in the EPS. In other words, a future increase in the number of ordinary shares will cause a dilution of equity, and it is possible to calculate diluted earnings per share (i.e. the EPS that would have been obtained during the financial period if the dilution had already taken place). This will indicate to investors the possible effects of a future dilution.

Earnings:

The earnings calculated for basic EPS should be adjusted by the post-tax (including deferred tax) effect of

a) Any dividends on dilutive potential ordinary shares that were deducted to arrive at earnings for basic EPS
b) Interest recognized in the period for the dilutive potential ordinary shares
c) Any other changes in income or expenses (fee and discount, premium accounted for as yield adjustments) that would result from the conversion of the dilutive potential ordinary shares

The conversion of some potential ordinary shares may lead to changes in other income or expenses. For example, the reduction of interest expense related to potential ordinary shares and the resulting increase in net profit for the period may lead to an increase in the expense relating to non-discretionary employee profit sharing plan. When calculating diluted EPS, the net profit or loss for the period is adjusted for any such consequential changes in income or expense.

Per Share:

The number of ordinary shares is the weighted average number of ordinary shares calculated for basic EPS plus the weighted average number of shares that would be issued on the conversion of all the dilutive potential ordinary shares into ordinary shares.

It should be assumed that diluted ordinary shares were converted into ordinary shares at the beginning of the period or, if later, at the actual date of issue.

Solved problem # 1:

Basic EPS of a company is Rs. 1.05 per share based on earnings of Rs. 105,000 and 100,000 ordinary Re. 1 shares. It also had in issue Rs. 40,000 15% Convertible Debentures which is convertible in two years' time at the rate of 4 ordinary shares for every Rs. 5 of debenture. The rate of tax is 30%. In 2007 gross profit of Rs. 200,000 and expenses of Rs. 50,000 were recorded, including interest payable of Rs. 6,000

Income Statement before conversion of debentures into the ordinary shares

	Rupees
Gross profit	200,000
Operating expenses	(44,000)
Profit from operations	156,000
Financial expenses	(6,000)
Profit before tax	150,000
Income tax 30%	(45,000)
Profit after tax (earnings)	**105,000**

Diluted earnings per share

a) Conversion of debentures into the ordinary number of shares
Rs. 40,000 x 4/5 = 32,000 number of ordinary shares

b) Adjustment of profits after the conversion of debentures into the ordinary shares

c)

	Rupees
Gross profit	200,000
Operating expenses	(44,000)
Profit from operations	156,000
Income tax 30%	(46,800)
Profit after tax (earnings)	**109,200**

d) Diluted EPS

$\frac{\text{Rs. } 109{,}200}{132{,}000}$ = Rs. 0.827 per share

e) Dilution:

The dilution in earnings would be Rs. 1.05 less 0.827 = Rs. 0.223/share.

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Dilutive potential ordinary shares

Those convertible debentures or securities that will cause an increase in Basic EPS had these would have been converted in the current year are anti-dilutive potential ordinary shares.

According to IAS 33, potential ordinary shares should be treated as dilutive when, and only when, their conversion to ordinary shares would decrease net profit per share from continuing operations. This point is illustrated in the following example:

Profit from operations	156,000
Financial charges (interest @ 25%of Rs. 40,000 debentures)	(10,000)
Profit before tax	146,000
Income tax (@ 30%)	(43,800)
Profit after tax	**102,200**
Ordinary number of shares	100,000

Basic EPS

Rs. 123,300 = Rs. 1.022 per shares
100,000 shares

Diluted EPS

Conversion rate is 3 ordinary shares will be issued against each Rs. 20 debentures in issue

Rs. 40,000 x 3/20 = 6,000 number of shares

Revised Income statement after conversion

	Rupees
Profit from operations	156,000
Financial charges	0
Profit before tax	156,000
Income Tax @ 30%	(46,800)
Profit after tax	**109,200**

Revised earnings per share after conversion

Rs. 109,200 = Rs. 1.030 per share
106,000shares

There is no dilution as the post conversion EPS is greater than the basic EPS.

This can also be understood by calculating individual EPS of the security/debenture. If the individual EPS of the security is lesser than the basic EPS then it is a dilutive potential shares, whereas, if the individual EPS of the security is greater than the basic EPS then it is a non dilutive potential shares.

Like is this case:	***Rupees***
Savings of financial charges	10,000
Income tax impact @ 30%	(3,000)
Impact on the earnings to the extent of the security	**7,000**

Individual EPS $\frac{\text{Rs. } 7{,}000}{6{,}000 \text{ shares}}$ = Rs. 1.667

This individual EPS is greater than the basic EPS i.e. 1.022 per share therefore this security is anti-dilutive potential share and should not be converted into the ordinary shares before calculating the diluted earnings per share.

Solved problem # 2:

Ali Imran Co has 5,000,000 ordinary shares in issue, and also had in issue in 2004:

a) Rs. 1,000,000 of 14% convertible debentures, convertible in three years' time at the rate of 2 shares peer Rs. 10 of debentures
b) Rs. 2,000,000 of 10% convertible debentures, convertible in one year's time at the rate of 3 shares per Rs. 5 of debenture.

- The total earnings in 2004 were Rs. 1,750,000
- The rate of income tax is 35%

Requited: Calculate the basic EPS and the diluted EPS

Solution:

Basic EPS = $\frac{\text{Rs. } 1{,}750{,}000}{5{,}000{,}000}$ = 35 paisa

Diluted EPS:

Before calculating diluted EPS we must decide which of the potential ordinary shares (the convertible debentures) are dilutive.

a) Conversion into ordinary shares Rs. 1,000,000 x 2/10 = 20,000 ordinary shares

Savings of financial charges Rs. 1,000,000 x 14%	140,000
Income tax impact @ 35%	(49,000)
Impact on the earnings to the extent of the security	**91,000**

Individual EPS $\frac{\text{Rs. } 91{,}000}{20{,}000}$ = 45.5 paisa (greater than the basic EPS)

b) Conversion into ordinary shares Rs. 2,000,000 x 3/5 = 1,200,000 ordinary shares

Savings of financial charges Rs. 2,000,000 x 10%	200,000
Income tax impact @ 35%	(70,000)
Impact on the earnings to the extent of the security	**130,000**

Individual EPS $\frac{\text{Rs. } 130{,}000}{1{,}200{,}000}$ = 10.8 paisa (lesser than the basic EPS)

Therefore the diluted EPS will be calculated after converting the 10% debentures.

$$\frac{\text{Rs. } 1{,}750{,}000 + \text{Rs. } 130{,}000}{5{,}000{,}000 + 1{,}200{,}000} = \frac{\text{Rs. } 1{,}880{,}000}{6{,}200{,}000} = 30.30 \text{ paisa}$$

Dilution is equal to

Basic EPS	35.00
Diluted EPS	30.30
Dilution	**4.70**

LESSON # 36

GROUP ACCOUNTS

It is obvious from the name that group accounts will be demonstrating financial status of more than one entity. Group accounts are the financial statements of different entities operating in a group. Group of companies is established in order to obtain benefits of synergy, better management of resources, and to avoid competitive business environment.
Formation of a group of companies takes place when one company establishes its control over another company. This creates a relationship of parent and subsidiary. The company that enjoys control is named as parent company and the company that is controlled is known as subsidiary company. In a group there will be one parent company with its one ore more than one subsidiary companies. Therefore, *Group means a parent and all its subsidiaries.*

Control:

According to IFRS 3 and IAS 27, *Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities*.
Normally control is assumed to exist when the parent company acquires majority number of ordinary share capital. But according to the above referred accounting standards control exists when any of the following situation crops up.

When the parent company:

1. Has owned more than 50% of the voting rights of subsidiary company (Each ordinary share capital has one voting right)
2. Has power over more than 50% of the voting rights of subsidiary company by virtue of agreement with other share-holders of it.
3. Has power to govern the financial and operating policies of subsidiary company by statute or under an agreement.
4. Has power to appoint or remove a majority of the directors of subsidiary company.
5. Has power to cast the majority of votes at meetings of the board of directors of subsidiary company.

Consolidated Financial Statements:

A single set of financial statements that combine the assets, liabilities, incomes and expenses of a parent company and its subsidiaries. In our syllabus we shall learn how to prepare:

1. Consolidated Balance Sheet
2. Consolidated Income Statement

Group Accounts

Example - [Case i] Simple Consolidation

Balance Sheet as on 31st December 2008

	P	**S**
	Rs	Rs
Fixed Assets	1,000	400
Investment in S.	500	
Current Assets	400	200
	1,900	**600**
Share Capital	1,200	300
Reserves	500	200
Current Liabilities	200	100
	1,900	**600**

The Parent Co. (P) acquired 100% shares of the Subsidiary Co. (S) on 31st December 2008.

Required:
Prepare the Consolidated Balance Sheet as on the same date.

Solution - [Case i]

Consolidated Balance Sheet
As at 31 December 2008

	Rs
Fixed Assets	1,400
Current Assets	600
	2,000
Share Capital	1,200
Reserves	500
Current Liabilities	300
	2,000

The above example covers simple consolidation of balance sheet that explains how the assets and liabilities of subsidiary company are consolidated with the assets and liabilities of the parent company. This also explains that the cost of investment appearing in the parent company gets cancelled with the amount of the owner equity

of the subsidiary company. This cost of investments is asset of the parent company made up from its own sources therefore in the consolidated balance sheet we have to replace the cost of investment in subsidiary company with net assets of it. The only care is to be taken is to consolidate all assets and liabilities individually and remember do not confuse why we are not consolidating the owner equity of the subsidiary company in the parent company's owners' equity.

Example - [Case ii] Goodwill

Balance Sheet as on 31st December 2008

	P	**S**
	Rs	Rs
Fixed Assets	1,000	400
Investment in S.	500	
Current Assets	400	200
	1,900	**600**
Share Capital	1,200	300
Reserves	500	150
Current Liabilities	200	150
	1,900	**600**

The Parent Co. (P) acquired 100% shares of the Subsidiary Co. (S) on 31st December 2008.

Required:
Prepare the Consolidated Balance Sheet as on the same date.

Solution - [Case ii]

Working for Calculation of Good will:

Cost of investment	500
Net assets of S Co acquired	450
Good will	50

Consolidated Balance Sheet
As at 31 December 2008

	Rs
Fixed Assets	1,400
Goodwill	50
Current Assets	600
	2,050
Share Capital	1,200
Reserves	500
Current Liabilities	350
	2,050

Good Will:
Good will is the excess of the cost of investment made in the subsidiary company over the fair value of the net assets of the subsidiary company acquired.

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LESSON # 37

GROUP ACCOUNTS (Cont.)

Example - [Case iii] Pre-acquisition Reserves, Goodwill

Balance Sheet as on 31st December 2008

	P	S
	Rs	Rs
Fixed Assets	1,000	400
Investment in S.	500	
Current Assets	400	200
	1,900	**600**
Share Capital	1,200	300
Reserves	550	150
Current Liabilities	150	150
	1,900	**600**

The Parent Co. (P) acquired 100% shares of the Subsidiary Co. (S) on 1st January 2008 when the reserves of the company were worth Rs100.

Required:
Prepare the Consolidated Balance Sheet as on 31/12/2008. (Ignore impairment of Goodwill).
Solution - [Case iii]
Analysis of Equity of Subsidiary Company

	Pre-acquisition Rs	**Post-acquisition** Rs
Share Capital of subsidiary company	300	
Reserves of subsidiary company	100	50
Total	**400**	
Calculation of Goodwill		
Cost of Investment	500	
Pre acquisition owners' equity of the subsidiary Co.	(400)	
Goodwill	**100**	
Calculation of Group Reserves		
All reserves of parent company		550
Post acquisition of the subsidiary company		50
Total		**600**

Consolidated Balance Sheet
As at 31 December 2008

	Rs
Fixed Assets	1,400
Goodwill	100
Current Assets	600
	2,100
Share Capital	1,200
Reserves	600
Current Liabilities	300
	2,100

Example - [Case IV] Goodwill Impairment, Pre-acquisition Reserves:

Balance Sheet as on 31st December 2008

	P	**S**
	Rs	Rs
Fixed Assets	1,000	400
Investment in S.	500	
Current Assets	400	200
	1,900	**600**
Share Capital	1,200	300
Reserves	550	150
Current Liabilities	150	150
	1,900	**600**

The Parent Co. (P) acquired 100% shares of the Subsidiary Co. (S) on 1st January 2008 when the reserves of the company were worth Rs100. Goodwill, has been impaired by Rs. 20

Required:

Prepare the Consolidated Balance Sheet as at 31/12/2008.

Solution - [Case IV]

Analysis of Equity of Subsidiary Company

	Pre-acquisition Rs	**Post-acquisition** Rs
Share Capital of subsidiary company	300	
Reserves of subsidiary company	100	50
Total	**400**	
Calculation of Goodwill		
Cost of Investment	500	
Pre acquisition owners' equity of the subsidiary Co.	(400)	
	100	
Impairment of goodwill	(20)	
Goodwill	**80**	
Calculation of Group Reserves		
All reserves of parent company		550
Post acquisition of the subsidiary company		50
Impairment loss of good		(20)
Total		**580**

Consolidated Balance Sheet
As at 31 December 2008

	Rs
Fixed Assets	1,400
Goodwill	80
Current Assets	600
	2,080
Share Capital	1,200
Reserves	580
Current Liabilities	300
	2,080

Example - [Case v] Impairment of Goodwill, Inter Co. Dividends & Loans

Balance Sheet as on 31st December 2008

	P	S
	Rs	Rs
Fixed Assets	1,000	600
Investment in S	500	
Dividend Receivable	100	
Other Current Assets	300	
Current Assets	400	200
Loan to S	200	
	2,100	800
Share Capital	1,200	300
Reserves	700	150
Loan from P		200
Dividend Payable		100
Other Current Liabilities		50
Current Liabilities	200	150
	2,100	800

The Parent Co. (P) acquired 100% shares of the Subsidiary Co. (S) on 1st January 2007 when the reserves of the company were worth Rs70. Goodwill has been impaired by Rs. 52

Required:
Prepare the Consolidated Balance Sheet as at 31/12/2008.

Solution - [Case v]

Analysis of Equity

	Pre	Post
	Rs	Rs
S		
Share Capital	300	
Reserves	70	80
	370	
P		
Investment	500	
Reserves		700
Goodwill	130	
Impairment of Goodwill	(52)	(52)
Group Goodwill	78	
Group Reserves		728

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	P	S
	Rs	Rs
Fixed Assets	1,000	600
Investment in S	500	
Dividend Receivable	~~100~~	
Other Current Assets	300	
Current Assets	400	200
Loan to S	~~200~~	
	2,100	800
Share Capital	1,200	300
Reserves	700	150
Loan from P		~~200~~
Dividend Payable		~~100~~
Other Current Liabilities		50
Current Liabilities	200	150
	2,100	800

Consolidated Balance Sheet
As at 31 December 2008

	Rs
Fixed Assets	1,600
Goodwill	78
Current Assets	500
	2,178
Share Capital	1,200
Reserves	728
Current Liabilities	250
	2,178

LESSON # 38

GROUP ACCOUNTS (Cont.)

Example - [Case vi] Minority Interest

Balance Sheet as on 31st December 2008

	P	S
	Rs.	Rs.
Fixed Assets	1,000	450
Investment in S.	550	
Current Assets	350	150
	1,900	**600**
Share Capital	1,200	300
Reserves	600	200
Current Liabilities	100	100
	1,900	**600**

The Parent Co. (P) acquired 80% shares of the Subsidiary Co. (S) on 31st December 2008

Required:
Prepare the Consolidated Balance Sheet as at 31/12/2008.

Solution - [Case vi]

Working

Calculation of Goodwill

-	Rs.	Rs.
Investment		550
Share Capital	300	
Reserves	200	
Owners equity	**500**	
Less: 500 x 80%		400
Good will		**150**

Simple calculation of Minority Interest is as under

Owners' equity of Subsidiary Company @ MI% =500 x 20% = 100

Alternatively we may split the Balance sheet of S Co. into the share of parent company and the share of minority interest. Net amount of the column of MI will be the amount of minority interest.

	H%	**MI%**
Fixed Assets	360	90
Current Assets	120	30
Current Liabilities	(80)	(20)
		100

Minority interest is the figure that represents the owners' equity of the minority share holders in the group. Therefore it is shown separately but within the owners' equity class consolidated balance sheet.

Consolidated Balance Sheet
As at 31 December 2008

		Rs.
Fixed Assets		1,450
Goodwill		150
Current Assets		500
		2,100
Share Capital	1,200	
Reserves	600	
	1,800	
Minority Interest	100	1,900
Current Liabilities		200
		2,100

Example - [Case vii] Minority Interest, Pre-acquisition Reserves, Goodwill

Balance Sheet as on 31st December 2008

	P	S
	Rs.	Rs.
Fixed Assets	1,000	450
Investment in S.	500	
Current Assets	400	150
	1,900	**600**
Share Capital	1,200	300
Reserves	600	200
Current Liabilities	100	100
	1,900	**600**

The Parent Co. (P) acquired 80% shares of the Subsidiary Co. (S) on 1st January 2008 when its reserves were worth Rs.120. Goodwill impaired with Rs. 33 during the year.

Required:

Prepare the Consolidated Balance Sheet as at 31/12/2008.

Solution - [Case vii]

W-1

H%	80%	Determine the % of holding by dividing the number of equity shares acquired with the total number of shares of the subsidiary company
MI%	20%	%age representing the minority interest is very simple to calculate, just subtract H% from 100

W-2

Analysis of Equity of S Co.

	Pre-Acquisition	Post-acquisition
Share Capital	300	Nil
Reserves	120	80
	420	**80**

W-3

Calculation of goodwill

		Rupees
Cost of investment		500
Pre acquisition equity of S Co.	420 x 80%	(336)
		164
Impairment loss		(33)
Goodwill		131

W-4
Group Reserves

All reserves of P Co	600
Post acquisition reserves of S Co. (Rs.80 x 80%)	64
Impairment loss	(33)
	631

W-5
Minority Interest

Owners' equity of Subsidiary Company @ MI% =500 x 20%
= 100

<u>Detailed working</u>

	Total	Pre-acquisition	Post-acquisition
Owners' equity of S Co.	500	420	80
Holding - 80%	(400)	(336)	(64)
Minority Interest - 20%	100	84	16

Consolidated Balance Sheet
As at 31 December 2008

		Rs.
Fixed Assets		1,450
Goodwill		131
Current Assets		550
		2,131
Share Capital	1,200	
	631	
Reserves	1,831	
Minority Interest	100	1,931
Current Liabilities		200
		2,131

Example - [Case viii] Minority Interest, Inter-Company Dividends

Balance Sheet as on 31st December 2008

	P	S
	Rs.	Rs.
Fixed Assets	1,000	450
Investment in S.	500	
Dividend Receivable	40	
Other Current Assets	360	
Current Assets	400	150
	1,900	**600**
Share Capital	1,200	300
Reserves	600	200
Dividend Payable	70	50
Other Current Liabilities	30	50
Current Liabilities	100	100
	1,900	**600**

The Parent Co. (P) acquired 80% shares of the Subsidiary Co. (S) on 1st January 2008 when its reserves were worth Rs.120. Goodwill impaired with Rs. 33 during the year.

Required:
Prepare the Consolidated Balance Sheet as at 31/12/2008.

Solution - [Case vii]

W-1

H%	80%	Determine the % of holding by dividing the number of equity shares acquired with the total number of shares of the subsidiary company
MI%	20%	%age representing the minority interest is very simple to calculate, just subtract H% from 100

W-2
Analysis of Equity of S Co.

	Pre- Acquisition	Post-acquisition
Share Capital	300	Nil
Reserves	120	80
	420	**80**

W-3

Calculation of goodwill

		Rupees
Cost of investment		500
Pre acquisition equity of S Co.	420 x 80%	(336)
		164
Impairment loss		(33)
Goodwill		131

W-4

Group Reserves

All reserves of P Co	600
Post acquisition reserves of S Co. (Rs.80 x 80%)	64
Impairment loss	(33)
	631

W-5

Minority Interest

Owners' equity of Subsidiary Company @ MI% = 500 x 20%

= 100

<u>Detailed working</u>

	Total	Pre-acquisition	Post-acquisition
Owners' equity of S Co.	500	420	80
Holding - 80%	(400)	(336)	(64)
Minority Interest - 20%	100	84	16

W-6
Cancellation effects of Intra group Dividend

	P		S
	Rs.	~~40~~ 10 50	Rs.
Fixed Assets	1,000		450
Investment in S.	500		
Dividend Receivable	~~40~~		
Other Current Assets	360		
Current Assets	400		150
	1,900		600
Share Capital	1,200		300
Reserves	600		200
Dividend Payable	70		50
Other Current Liabilities	30		50
Current Liabilities	100		100
	1,900		600

Consolidated Balance Sheet
As at 31 December 2008

	Rs.	Rs.
Fixed Assets		1,450
Goodwill		131
Current Assets		510
		2,091
Share Capital		1,200
Reserves		631
Minority Interest		100
Other current liabilities		80
Dividend payable by P	70	
Dividends due to minority	10	80
Current Liabilities		160
		2,091

LESSON # 39

GROUP ACCOUNTS (Cont.)

Example - [Case ix] Inter Company Trading (P to S)

Balance Sheet as on 31st December 2008

	P	S
	Rs.	Rs.
Fixed Assets	1,000	550
Investment in S.	500	
Current Assets	400	350
	1,900	900
Share Capital	1,200	400
Reserves	500	300
Current Liabilities	200	200
	1,900	900

The Parent Co. (P) acquired 80% shares of the Subsidiary Co. (S) on 1st January 2003 when it's reserves were worth Rs.120. Total amount of Goodwill has been impaired. During the year 2008, P Co sold goods to S Co for Rs.500 that was costing Rs. 400. On the closing date, goods costing Rs.150 remained unsold in the inventories of S Co.

Required:
Prepare the Consolidated Balance Sheet as at 31/12/2008.

Solution: [Case ix]
W-1

H%	80%	Determine the % of holding by dividing the number of equity shares acquired with the total number of shares of the subsidiary company
MI%	20%	%age representing the minority interest is very simple to calculate, just subtract H% from 100

W-2

Analysis of Equity of S Co

	Pre-acquisition	Post-acquisition
Share Capital	400	Nil
Reserves	120	180
	520	180

W-3

Calculation of goodwill

		Rupees
Cost of investment		500
Pre acquisition equity of S Co.	520 x 80%	-416
		84
Impairment loss		-84
Goodwill		Nil

W-4

Group Reserves

All reserves of P Co		500
Post acquisition reserves of S Co to the extent of H%	180 x 80%	144
Impairment loss		-84
Reserves		560
Unrealized profit		-30
		530

Note:
The unrealized profit is given in this example that is Rs. 30.This amount of unrealized profit is to be subtracted form the Consolidated Stocks and also from the group reserves.

W-5
Minority Interest
Owners' equity of Subsidiary Company @ MI% = 700 x 20%
= 140

Consolidated Balance Sheet
As at 31 December 2008

		Rs.	Rs.
Fixed Assets	1000+550		1,550
Current Assets	400+350-30		720
			2,270
Owners' Equity			
Share Capital		1,200	
Group Reserves		530	
		1,730	
Minority Interest		140	1,870
Current Liabilities			400
			2,270

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Example - [Case x] Inter Company Trading (S to P)

Balance Sheet as on 31st December 2008	P	S
	Rs.	Rs.
Fixed Assets	1,000	550
Investment in S.	500	
Current Assets	400	350
	1,900	900
Share Capital	1,200	400
Reserves	500	300
Current Liabilities	200	200
	1,900	900

The Holding Co. (H) acquired 80% shares of the Subsidiary Co. (S) on 1st January 2003 when it's reserves were worth Rs.120. Total amount of Goodwill has been impaired. During the year 2008, S sold goods to P for Rs.500, the profit to S being 20% of selling price. On the closing date, goods costing Rs.150 remained unsold in the inventories of P. on which S made a profit of Rs. 30.

Required:
Prepare the Consolidated Balance Sheet as at 31/12/2008.

Solution: [Case x]

W-1

H%	80%	Determine the % of holding by dividing the number of equity shares acquired with the total number of shares of the subsidiary company

W-2

Analysis of Equity of S Co

	Pre-acquisition	Post-acquisition
Share Capital	400	Nil
Reserves	120	180
	520	180

W-3

Calculation of goodwill

		Rupees
Cost of investment		500
Pre acquisition equity of S Co.	520 x 80%	-416
		84
Impairment loss		-84
Goodwill		Nil

W-4

Group Reserves		Rs.
All reserves of P Co		500
Post acquisition reserves of S Co to the extent of H%	180 x 80%	144
Impairment loss		-84
		560
Unrealized profit to the extent of H% 30 x 80%		-24
		536

W-5

Minority Interest

Owners' equity of S Co to the extent of MI%	700 x 20%	140
Unrealized profit	30 x 20%	-6
		134

The unrealized profit given in this example is Rs. 30.This amount of unrealized profit given is to be subtracted form the Consolidated Stocks and also from the group reserves.

Consolidated Balance Sheet
As at 31 December 2008

	Rs.
Fixed Assets	1,550
Current Assets	720
	2,270
Share Capital	1,200
Reserves	536
Minority Interest	134
Current Liabilities	400
	2,270

LESSON # 40

GROUP ACCOUNTS(Cont.)

Example - [Case xi] Fair Value Adjustments

Balance Sheet as on 31st December 2008

	P	S
	Rs.	Rs.
Fixed Assets	1,000	550
Investment in S.	750	
Current Assets	400	350
	2,150	**900**
Share Capital	1,200	400
Reserves	700	300
Current Liabilities	250	200
	2,150	**900**

The Parent Co. (P) acquired 80% shares of the Subsidiary Co. (S) on 1st January 2008 when its reserves were worth Rs.200 and the fair value of Net Assets of S was Rs. 300 more than the book value.

Required:
Prepare the Consolidated Balance Sheet as at 31/12/2008.

Solution - [Case xi]
W-1

H%	80%	Determine the % of holding by dividing the number of equity shares acquired with the total number of shares of the subsidiary company
MI%	20%	%age representing the minority interest is very simple to calculate, just subtract H% from 100

W-2
Analysis of Equity of S Co

	Pre-acquisition	Post-acquisition
Share Capital	400	Nil
Reserves	200	100
	600	
Fair Value adjustment	300	
	900	100

W-3
Calculation of goodwill

		Rupees
Cost of investment		750
Pre acquisition equity of S Co. to the extent of H%	900 x 80%	-720
Goodwill		30

W-4
Group Reserves

All reserves of P Co		700
Post acquisition reserves of S Co to the extent of H%	100 x 80%	80
		780

W-5
Minority Interest

Owners' equity of Subsidiary Company	700
Fair Value adjustment	300
	1,000
	x 20%
	200

Alternative working
Analysis of Equity of S Co

			Pre-acquisition	Post-acquisition
		Share Capital	400	Nil
		Reserves	200	100
			600	
		Fair Value adjustment	300	
			900	100
H%	*80%*		*720*	*80*
MI%	*20%*		*180*	*20*

Consolidated Balance Sheet
As at 31 December 2008

			Rs.
Fixed Assets	*(1,000+550=1,550+300)*		*1,850*
Goodwill			*30*
Current Assets			*750*
			2,630
Share Capital		*1,200*	
Reserves		*780*	
		1,980	
Minority Interest		*200*	*2,180*
Current Liabilities			*450*
			2,630

Example - [Case xii] Fair Value Adjustments (with depreciation adjustment)

Balance Sheet as on 31st December 2008

	P	**S**
	Rs.	Rs.
Fixed Assets	1,000	550
Investment in S.	750	
Current Assets	400	350
	2,150	900
Share Capital	1,200	400
Reserves	700	300
Current Liabilities	250	200
	2,150	900

The Parent Co. (P) acquired 80% shares of the Subsidiary Co. (S) on 1st January 2008 when its reserves were worth Rs.200 and the fair value of Net Assets of S was Rs.300 more than the book value. The revaluation of assets of S were subject to depreciation of Rs.45. Goodwill has been impaired by Rs. 6.

Required:

Prepare the Consolidated Balance Sheet as at 31/12/2008.

Solution - [Case xii]

W-1

H%	80%	Determine the % of holding by dividing the number of equity shares acquired with the total number of shares of the subsidiary company
MI%	20%	% age representing the minority interest is very simple to calculate, just subtract H% from 100

W-2

Analysis of Equity of S Co

	Pre-acquisition	Post-acquisition
Share Capital	400	Nil
Reserves	200	100
	600	
Fair Value adjustment	300	
	900	100

W-3

Calculation of goodwill

		Rupees
Cost of investment		750
Pre acquisition equity of S Co. to the extent of H%	900 x 80%	-720
Goodwill		30
Impairment loss		6
		24

W-4

Group Reserves

All reserves of P Co		700
Post acquisition reserves of S Co to the extent of H% (Rs. 100 x 80%)		80
		780
Impairment loss of goodwill		-6
Depreciation against fair value adjustment to the extent of H%	{45 x 80%}	-36
		738

W-5

Minority Interest

Owners' equity of Subsidiary Company		700
Fair Value adjustment		300
		1,000
		x 20%
		200
Depreciation against fair value adjustment to the extent of MI%	*{45 x 20%}*	*-9*
		191

Note:
All revaluation reserves against the fair value adjustment would be treated as pre-acquisition equity. Whereas, the depreciation charge on the fair value adjustment would be treated as post acquisition.

Alternative working

Analysis of Equity of S Co.

			Pre-acquisition	Post-acquisition
		Share Capital	400	Nil
		Reserves	200	100
			600	
		Fair value adjustment/depreciation	300	-45
			900	55
H%	80%		720	44
MI%	20%		180	11

*Minority interest = Rs. 180 + 11 = Rs. 191

Consolidated Balance Sheet
As at 31 December 2008

			Rs.
Fixed Assets	(1,000+550=1,550+300-45)		1,805
Goodwill			24
Current Assets			750
			2,579
Share Capital		1,200	
Reserves		738	
		1,938	
Minority Interest		191	2,129
Current Liabilities			450
			2,579

LESSON # 41

GROUP ACCOUNTS (Cont.)

Example - [Case xiii] Pre-acquisition Profits, Dividends

Balance Sheet as on 31st December 2008

	P	S
	Rs.	Rs.
Fixed Assets	3,500	1,450
Investment in S.	2,180	
Current Assets	2,700	1,250
	8,380	2,700
Share Capital (ordinary shares of Rs.1 each).	5,000	1,000
Reserves	3,380	1,700
	8,380	2,700

The Parent Co. (P) acquired 800 of the 1,000 Re.1 ordinary shares of the Subsidiary Co. (S) on 1st January 2008 for Rs.2,500. S's balance sheet at 31 December 2007 showed a payable ordinary dividend of Rs.400 and reserves of Rs.1,200. Goodwill has been impaired by Rs. 105.

Hint: Share of P Co in the dividend payable out of the pre-acquisition profit is Rs. 320 being 80%

Required:

Prepare the Consolidated Balance Sheet as at 31/12/2008.

Solution - [Case xiii]

W-1

H%	80%	Determine the % of holding by dividing the number of equity shares acquired with the total number of shares of the subsidiary company
MI%	20%	%age representing the minority interest is very simple to calculate, just subtract H% from 100

W-2

Analysis of Equity of S Co

	Pre-acquisition	Post-acquisition
Share Capital	1,000	Nil
Reserves	1,200	500
	2,200	500

W-3

Calculation of goodwill

		Rupees
Cost of investment	2,500	
Dividend out of pre-acquisition profits	-320	
		2,180
Pre acquisition equity of S Co. to the extent of H% (2,200x 80%)		-1,760
Goodwill		420
Impairment loss		105
		315

W-4

Group Reserves

All reserves of P Co	3,380
Post acquisition reserves of S Co to the extent of H% (500 x 80%)	400
	3,780
Impairment loss of goodwill	-105
	3,675

W-5

Minority Interest

Owners' equity of Subsidiary Company to the extent of MI% (2,700 x 20%)	540

Consolidated Balance Sheet
As at 31 December 2005

	Rs.
Fixed Assets	4,950
Goodwill	315
Current Assets	3,950
	9,215
Share Capital	5,000
Reserves	3,675
Minority Interest	540
	9,215

Example - [Case xiv] Acquisition during the year

Balance Sheet as on 31st December 2008

	P	S
	Rs.	Rs.
Fixed Assets	5,500	4,500
Investment in S.	4,000	
Current Assets	2,500	1,500
	12,000	6,000
Share Capital	8,000	3,000
Reserves	2,500	2,008
Current Liabilities	1,500	1,000
	12,000	6,008

The Parent Co. (P) acquired 80% shares of the Subsidiary Co. (S) on 1st October 2008. S's reserves on 31 December 2007 were worth Rs.1,200. (Assume that profits of S accrue evenly throughout the year).

Required:

Prepare the Consolidated Balance Sheet as at 31/12/2008.

Solution - [Case xiv]

W-1

Reserves of S Co on 31-12-2008	2,000
Reserves of S Co on 1-1-2008	1,200
Profit for the year ending on 31-12-2008	800

W-2

Profit for the year 2008 representing the pre-acquisition period from 1-1-2008 to 30-09-2008 (9 months) 800 x 9/12	600
Profit for the year 2008 representing the post-acquisition period from 1-10-2008 to 31-12-2008 (3 months) 800 x 3/12	200
	800

W-3

Analysis of Equity of S Co

	Pre-acquisition		Post-acquisition
Share Capital	3,000		Nil
Reserves			
as on 1-1-2008	1,200		
from 1-1-2008 to 30-9-2008		600	200
		4,800	200

H%	3,840	160
MI%	960	40

Minority Interest Rs. 1,000

W-4

Calculation of goodwill

	Rupees
Cost of investment	4,000
Pre acquisition equity of S Co. to the extent of H%	-3,840
Goodwill	160

W-5

Group Reserves

All reserves of P Co		2,500
Post acquisition reserves of S Co to the extent of H%	200 x 80%	160
		2,660

W-6

Minority Interest

Owners' equity of Subsidiary Company to the extent of MI%

=Rs. 5,000 x 20%= RS.1,000

Consolidated Balance Sheet
As at 31 December 2008

		Rs.
Fixed Assets		10,000
Goodwill		160
Current Assets		4,000
		14,160
Share Capital	8,000	
Reserves	2,660	
	10,660	
Minority Interest	1,000	11,660
Current Liabilities		2,500
		14,160

Example - [Case xv] Negative Goodwill

Balance Sheet as on 31st December 2008

	P	S
	Rs.	Rs.
Fixed Assets	1,000	600
Investment in S.	400	
Current Assets	300	200
	1,700	800
Share Capital	1,200	500
Reserves	400	200
Current Liabilities	100	100
	1,700	800

The Parent Co. (P) acquired 80% shares of the Subsidiary Co. (S) on 1st January 2008 when its reserves were worth Rs.120.

Required:

Prepare the Consolidated Balance Sheet as at 31/12/2008.

Solution - [Case xv]

Analysis of Equity of S Co

W-1

		Pre-acquisition	Post-acquisition
	Share Capital	500	Nil
	Reserves	120	80
		620	80
H%	80%	496	64
MI%	20%	124	16

Minority Interest 140

W-2

Calculation of goodwill

	Rupees
Cost of investment	400
Pre acquisition equity of S Co. to the extent of H%	-496
Negative Goodwill	-96

W-3

Group Reserves

All reserves of P Co		400
Post acquisition reserves of S Co to the extent of H%	80 x 80%	64
		464
Add Negative Goodwill		96
		560

W-4

Minority Interest

Owners' equity of Subsidiary Company to the extent of MI%

= Rs. 700 x 20%= Rs. 140

Consolidated Balance Sheet
As at 31 December 2008

		Rs.
Fixed Assets		1,600
Goodwill		0
Current Assets		500
		2,100
Share Capital	1,200	
Reserves	560	
	1,760	
Minority Interest	140	1,900
Current Liabilities		200
		2,100

LESSON # 42

GROUP ACCOUNTS (Cont.)

Profit & Loss

Example - [Case i] Simple Consolidation

Income Statement for the year ended 31st December 2008

	P	S
	Rs.	Rs.
Sales	7,500	4,000
Cost of Goods Sold	(4,500)	(2,900)
Gross Profit	3,000	1,100
Operating Expenses	(1,800)	(600)
Operating Profit	1,200	500
Income Tax	(480)	(200)
Net Profit after Tax	720	300
Retained Profits b/f	1,000	450
Retained Profits c/f	1,720	750

The Parent Co. (P) acquired 100% equity of the Subsidiary Co. (S) on 1st January 2008 for Rs.1,700 when S's paid up share capital was Rs.1,250 & it's reserves were worth Rs.450. (Assume all reserves comprise only of Retained Profits).

Required: Prepare the Consolidated Income Statement for the year ended 31/12/2008.

Solution - [Case i]

Computation of Goodwill

	Rs.	Rs.
Cost of Acquisition		1,700
Ordinary Share Capital of S	1,250	
Pre-acquisition Retained Profits of S	450	0
Goodwill		1,700

Computation of opening balance of Group's Retained Profits

	Rs.	Rs.
Total amount of opening balance of retained profits of P Co		1,000
Post acquisition part in opening balance of retained profits of S Co		
opening balance of retained profits of S Co	450	
pre-acquisition retained profits	-450	0
Opening balance of Group's Retained Profits b/f		1,000

Consolidated Income Statement
For the year ended 31st December 2008

	Rs.
Sales	11,500
Cost of Goods Sold	(7,400)
Gross Profit	4,100
Operating Expenses	(2,400)
Operating Profit	1,700
Income Tax	(680)
Net Profit after Tax	1,020
Retained Profits b/f	1,000
Retained Profits c/f	2,020

Example - [Case ii] Post acquisition opening balance of retained profits

Income Statement for the year ended 31st December 2008

	P	**S**
	Rs.	Rs.
Sales	7,500	4,000
Cost of Goods Sold	(4,500)	(2,900)
Gross Profit	3,000	1,100
Operating Expenses	(1,800)	(600)
Operating Profit	1,200	500
Income Tax	(480)	(200)
Net Profit after Tax	720	300
Retained Profits b/f	1,000	450
Retained Profits c/f	1,720	750

The Parent Co. (P) acquired 100% equity of the Subsidiary Co. (S) on 1st January 2007 for Rs.1,700 when S's paid up share capital was Rs.1,250 & it's reserves were worth Rs.150. (Assume all reserves comprise only of Retained Profits).

Required:
Prepare the Consolidated Income Statement for the year ended 31/12/2008.

Solution - [Case ii]

Computation of Goodwill

	Rs.	Rs.
Cost of Acquisition		1,700
Ordinary Share Capital of S	1,250	
Pre-acquisition Retained Profits of S	150	(1,400)
		300

Computation of opening balance of Group's Retained Profits

	Rs.	Rs.
Total amount of opening balance of retained profits of P Co		1,000
Post acquisition part in opening balance of retained profits of S Co		
opening balance of retained profits of S Co	450	
pre-acquisition retained profits	-150	300
Opening balance of Group's Retained Profits b/f		1,300

Consolidated Income Statement
For the year ended 31st December 2008

	Rs.
Sales	11,500
Cost of Goods Sold	(7,400)
Gross Profit	4,100
Operating Expenses	(2,400)
Operating Profit	1,700
Income Tax	(680)
Net Profit after Tax	1,020
Retained Profits b/f	1,300
Retained Profits c/f	2,320

Example - [Case iii] Inter Co. Dividends

Income Statement for the year ended 31st December 2008

	P	**S**
	Rs.	Rs.
Sales	7,500	4,000
Cost of Goods Sold	(4,500)	(2,900)
Gross Profit	3,000	1,100
Operating Expenses	(1,800)	(600)
Operating Profit	1,200	500
Dividend Income	125	
Net Profit before Tax	1,325	500
Income Tax	(530)	(200)
Net Profit after Tax	795	300
Dividend Paid	(250)	(125)
	545	175
Retained Profits b/f	1,000	450
Retained Profits c/f	1,545	625

The Parent Co. (P) acquired 100% equity of the Subsidiary Co. (S) on 1st January 2006 for Rs.1,700 when S's paid up share capital was Rs.1,250 & it's reserves were worth Rs.50. (Assume all reserves comprise only of Retained Profits).

Required: Prepare the Consolidated Income Statement for the year ended 31/12/2008.

Solution - [Case iii]

Computation of Goodwill		
	Rs.	Rs.
Cost of Acquisition		1,700
Ordinary Share Capital of S	1,250	
Pre-acquisition Retained Profits of S	50	(1,300)
		400

Computation of opening balance of Group's Retained Profits		
	Rs.	Rs.
Total amount of opening balance of retained profits of P Co		1,000
Post acquisition part in opening balance of retained profits of S Co		
opening balance of retained profits of S Co	450	
pre- acquisition retained profits	-50	400
Opening balance of Group's Retained Profits b/f		1,400

Income Statement for the year ended 31st December 2008		
	P	**S**
	Rs.	Rs.
Sales	7,500	4,000
Cost of Goods Sold	(4,500)	(2,900)
Gross Profit	3,000	1,100
Operating Expenses	(1,800)	(600)
Operating Profit	1,200	500
Dividend Income	~~125~~	
Net Profit before Tax	1,325	500
Income Tax	(530)	(200)
Net Profit after Tax	795	300
Dividend Paid	(250)	~~(125)~~
	545	175
Retained Profits b/f	1,000	450
Retained Profits c/f	1,545	625

Consolidated Income Statement
For the year ended 31st December 2008

	Rs.
Sales	11,500
Cost of Goods Sold	(7,400)

Gross Profit	4,100
Operating Expenses	(2,400)
Operating Profit	1,700
Income Tax	(730)
Net Profit after Tax	970
Dividend Paid	(250)
	720
Retained Profits b/f	1,400
Retained Profits c/f	2,120

Example - [Case iv] Minority Interest

Income Statement for the year ended 31st December 2008

	P	**S**
	Rs.	Rs.
Sales	7,500	4,000
Cost of Goods Sold	(4,500)	(2,900)
Gross Profit	3,000	1,100
Operating Expenses	(1,800)	(600)
Operating Profit	1,200	500
Income Tax	(480)	(200)
Net Profit after Tax	720	300
Dividend Paid	(200)	
	520	300
Retained Profits b/f	1,000	450
Retained Profits c/f	1,520	750

The Parent Co. (P) acquired 80% equity of the Subsidiary Co. (S) on 1st January 2006 for Rs.1,700 when S's paid up share capital was Rs.1,250 & it's reserves were worth Rs.50. (Assume all reserves comprise only of Retained Profits).

Required: Prepare the Consolidated Income Statement for the year ended 31/12/2008.

Solution - [Case iv]

Computation of Goodwill

		Rs.	Rs.
Cost of Acquisition			1,700
Ordinary Share Capital of S	80% of Rs.1,250	1,000	
Pre-acquisition Retained Profits of S	80% of Rs.50	40	(1,040)
	80% of Rs. 1300		660

Computation of opening balance of Group's Retained Profits

	Rs.	Rs.
Total amount of opening balance of retained profits of P Co		1,000
Post acquisition part in opening balance of retained profits of S Co		
opening balance of retained profits of S Co	450	
pre-acquisition retained profits	-50	
to the extent of H% i.e.80%	400	320
Opening balance of Group's Retained Profits b/f		1,320

Computation of Minority Interest

		Rs.
Profits after tax of S Co. to the extent of MI%	20% of Rs.300	60

Consolidated Income Statement
For the year ended 31st December 2008

	Rs.	Rs.
Sales		11,500
Cost of Goods Sold		(7,400)
Gross Profit		4,100
Operating Expenses		-2,400
Operating Profit		1,700
Income Tax		(680)
Net Profit after Tax		1,020
Minority Interest		(60)
		960
Dividend Paid		(200)
		760
Retained Profits b/f		1,320
Retained Profits c/f		2,080

LESSON # 43

GROUP ACCOUNTS (Cont.)

Example - [Case v] Minority Interest, Inter Co. Dividends

Income Statement for the year ended 31st December 2008

	P	S
	Rs.	Rs.
Sales	7,500	4,000
Cost of Goods Sold	(4,500)	(2,900)
Gross Profit	3,000	1,100
Operating Expenses	(1,800)	(600)
Operating Profit	1,200	500
Dividend Income	100	
Net Profit before Tax	1,300	500
Income Tax	(520)	(200)
Net Profit after Tax	780	300
Dividend Paid	(250)	(125)
	530	175
Retained Profits b/f	1,000	450
Retained Profits c/f	1,530	625

The Parent Co. (P) acquired 80% equity of the Subsidiary Co. (S) on 1st January 2003 for Rs.1,700 when S's paid up share capital was Rs.1,250 & it's reserves were worth Rs.50. (Assume all reserves comprise only of Retained Profits). Total amount of goodwill has been impaired

Required: Prepare the Consolidated Income Statement for the year ended 31/12/2008.

Solution - [Case v]

Computation of Goodwill

		Rs.	Rs.
Cost of Acquisition			1,700
Ordinary Share Capital of S	80% of Rs.1,250	1,000	
Pre-acquisition Retained Profits of S	80% of Rs.50	40	(1,040)
			660
Goodwill totally impaired			(660)
			0

Computation of opening balance of Group's Retained Profits

	Rs.	Rs.

Total amount of opening balance of retained profits of P Co		1,000
Post acquisition part in opening balance of retained profits of S Co		
opening balance of retained profits of S Co	450	
pre-acquisition retained profits	-50	
to the extent of H% i.e.80%	400	320
Opening balance of Group's Retained Profits b/f		1,320
Goodwill impairment loss		(660)
		660

Computation of Minority Interest

		Rs.
Profits after tax of S Co. to the extent of MI%	20% of Rs.300	60

Consolidated Income Statement
For the year ended 31st December 2008

	Rs.
Sales	11,500
Cost of Goods Sold	(7,400)
Gross Profit	4,100
Operating Expenses	(2,400)
Operating Profit	1,700
Income Tax	(720)
Net Profit after Tax	980
Minority Interest	(60)
	920
Dividend Paid	(250)
	670
Retained Profits b/f	660
Retained Profits c/f	1,330

Note:

In consolidated income statement the amount of dividend paid by the S Co. is completely eliminated, only the amount of dividend paid by the P Co is shown.

Example - [Case vi] Inter Co. Trading (when there is no URP)

Income Statement for the year ended 31st December 2008

	P	**S**
	Rs.	Rs.
Sales	7,500	4,000
Cost of Goods Sold	(4,500)	(2,900)
Gross Profit	3,000	1,100
Operating Expenses	(1,800)	(600)

Operating Profit	1,200	500
Dividend Income	100	
	1,300	500
Income Tax	(520)	(200)
Net Profit after Tax	780	300
Preference Dividend		
Ordinary Dividend	250	125
Dividend Paid	(250)	(125)
	530	175
Retained Profits b/f	1,000	450
Retained Profits c/f	1,530	625

The Parent Co. (P) acquired 80% equity of the Subsidiary Co. (S) on 1st January 2003 for Rs.1,700 when S's paid up share capital was Rs.1,250 & it's reserves were worth Rs.50. During the year S sold to P goods costing Rs.1,000 & selling price of Rs.1,250. (Assume all reserves comprise only of Retained Profits). Goodwill has been impaired so far.

Required: Prepare the Consolidated Income Statement for the year ended 31/12/2008.

Solution - [Case vi]

Computation of Goodwill

		Rs.	Rs.
Cost of Acquisition			1,700
Ordinary Share Capital of S	80% of Rs.1,250	1,000	
Pre-acquisition Retained Profits of S	80% of Rs.50	40	(1,040)
			660
Goodwill totally impaired			(660)
			0

Computation of opening balance of Group's Retained Profits

	Rs.	Rs.
Total amount of opening balance of retained profits of P Co		1,000
Post acquisition part in opening balance of retained profits of S Co		
opening balance of retained profits of S Co	450	
pre-acquisition retained profits	-50	
to the extent of H% i.e.80%	400	320
Opening balance of Group's Retained Profits b/f		1,320
Goodwill impairment loss		(660)

	660

Computation of Minority Interest		
		Rs.
Profits after tax of S Co. to the extent of MI%	20% of Rs.300	60

Consolidated Income Statement
For the year ended 31st December 2008

		Rs.
Sales	(7,500+4,000-1,250)	10,250
Cost of Goods Sold	(4,500+2,900-1250)	(6,150)
Gross Profit		4,100
Operating Expenses		(2,400)
Profit before tax		1,700
Income Tax		(720)
Net Profit after Tax		980
Minority Interest		(60)
		920
Dividend Paid		(250)
		670
Retained Profits b/f		660
Retained Profits c/f		1,330

Example - [Case viii] During the Year Acquisition of Wholly Owned Subsidiary

Income Statement for the year ended 31st December 2008

	P	**S**
	Rs.	Rs.
Sales	900	600
Cost of Goods Sold	(400)	(360)
Gross Profit	500	240
Operating Expenses	(200)	(48)
Selling & Distribution Expenses	(100)	(36)
Operating Profit	200	156
Income Tax	(90)	(72)
Net Profit after Tax	110	84

The Parent Co. (P) acquired 100% equity of the Subsidiary Co. (S) on 30th September 2008. (Assume profits and losses accrue evenly throughout the year).

Required: Prepare the Consolidated Income Statement for the year ended 31/12/2008.

Solution - [Case viii]

Income Statement for the year ended 31st December 2008

	12 months S Rs.	3 months S Rs.
Sales	600	150
Cost of Goods Sold	(360)	(90)
Gross Profit	240	60
Operating Expenses	(48)	(12)
Selling & Distribution Expenses	(36)	(9)
Operating Profit	156	39
Income Tax	(72)	(18)
Net Profit after Tax	84	21

Consolidated Income Statement
For the year ended 31st December 2008

	Rs.
Sales	1,050
Cost of Goods Sold	(490)
Gross Profit	560
Operating Expenses	(212)
Selling & Distribution Expenses	(109)
Operating Profit	239
Income Tax	(108)
Net Profit after Tax	131

LESSON # 44

GROUP ACCOUNTS (Cont.)

Example - [Case vii] Inter Co. Trading (when there is unrealized profit)

Income Statement for the year ended 31st December 2008

	P	S
	Rs.	Rs.
Sales	7,500	4,000
Cost of Goods Sold	(4,500)	(2,900)
Gross Profit	3,000	1,100
Operating Expenses	(1,800)	(600)
Operating Profit	1,200	500
Dividend Income	100	
	1,300	500
Income Tax	(520)	(200)
Net Profit after Tax	780	300
Ordinary Dividend paid	(250)	(125)
	530	175
Retained Profits b/f	1,000	450
Retained Profits c/f	1,530	625

The Parent Co. (P) acquired 80% equity of the Subsidiary Co. (S) on 1st January 2003 for Rs.1,700 when S's paid up share capital was Rs.1,250 & it's reserves were worth Rs.50. During the year S sold to P goods costing Rs.1,000 & selling price of Rs.1,250 of which inventory of Rs. 200 cost to P Co. remained unsold. (Assume all reserves comprise only of Retained Profits). Goodwill has been impaired so far.

Required: Prepare the Consolidated Income Statement for the year ended 31/12/2008.

Solution - [Case vii]

Inventory of P Co represents purchases made from S Co worth Rs. 200, which from the standpoint of the group is above cost and hence reflects unrealized profit.

Profit made by the S Co in the intera group transaction

Selling price	1,250	100%
Cost to the S Co	(1,000)	
profit made by S Co	250	20%

Unrealized profit is the profit made by the S Co on the stock remained unsold by P Co

stock at cost to the group is infect selling price of the S Co. therefore the %age of the profit is 20%. Applying this %age on the selling price of the unsold stock we get (200 x 20%) Rs. 40 of the URP

Computation of Goodwill			
		Rs.	Rs.
Cost of Acquisition			1,700
Ordinary Share Capital of S	80% of Rs.1,250	1,000	
Pre-acquisition Retained Profits of S	80% of Rs.50	40	(1,040)
			660
Goodwill totally impaired			(660)
			0

Computation of opening balance of Group's Retained Profits		
	Rs.	Rs.
Total amount of opening balance of retained profits of P Co		1,000
Post acquisition part in opening balance of retained profits of S Co		
opening balance of retained profits of S Co	450	
pre-acquisition retained profits	-50	
to the extent of H% i.e.80%	400	320
Opening balance of Group's Retained Profits b/f		1,320
Goodwill impairment loss		(660)
		660

Computation of Minority Interest		
	Rs.	Rs.
Profits after tax of S Co.	300	
Unrealized profit	-40	
to the extent of MI%	260	52

Consolidated Income Statement
For the year ended 31st December 2008

		Rs.
Sales	(7,500+4,000-1,250)	10,250
Cost of Goods Sold	(4,500+2,900-1250+40)	(6,190)
Gross Profit		4,060
Operating Expenses		(2,400)
Profit before tax		1,660
Income Tax		(720)
Net Profit after Tax		940
Minority Interest		(52)
		888
Dividend Paid		(250)
		638
Retained Profits b/f		660
Retained Profits c/f		1,298

Example - [Case viii] During the Year Acquisition of Wholly Owned Subsidiary

Income Statement for the year ended 31st December 2008

	P	S
	Rs.	Rs.
Sales	900	600
Cost of Goods Sold	(400)	(360)
Gross Profit	500	240
Operating Expenses	(200)	(48)
Selling & Distribution Expenses	(100)	(36)
Operating Profit	200	156
Income Tax	(90)	(72)
Net Profit after Tax	110	84

The Parent Co. (P) acquired 100% equity of the Subsidiary Co. (S) on 30th September 2008. (Assume profits and losses accrue evenly throughout the year).

Required: Prepare the Consolidated Income Statement for the year ended 31/12/2008.

Solution - [Case viii]

Income Statement for the year ended 31st December 2008

	12 months	3 months
	S	S
	Rs.	Rs.
Sales	600	150
Cost of Goods Sold	(360)	(90)
Gross Profit	240	60
Operating Expenses	(48)	(12)
Selling & Distribution Expenses	(36)	(9)
Operating Profit	156	39
Income Tax	(72)	(18)
Net Profit after Tax	84	21

Consolidated Income Statement
For the year ended 31st December 2008

		Rs.
Sales	(900+150)	1,050
Cost of Goods Sold	(400+90)	(490)
Gross Profit		560
Operating Expenses	(200+12)	(212)
Selling & Distribution Expenses	(100+9)	(109)
Operating Profit		239
Income Tax	(90+18)	(108)
Net Profit after Tax		131

LESSON # 45

GROUP ACCOUNTS (Cont.)
Comprehensive Workings in Group Accounts
Consolidated Balance Sheet

W-1

H% $\frac{\text{Number of ordinary shares of S Co acquired by P Co}}{\text{Total number of ordinary shares in S Co}} \times 100 = \%$

MI % 100 - H% = MI%

W-2

Analysis of equity of S Co for pre and post acquisition

	Pre-acquisition	Post-acquisition
Ordinary share capital	All	Nil
Reserves	on the date of acquisition	after the date of acquisition
Fair value adjustment	All	Nil
Total		
H% of total	Parent's share	Parent's share
MI% of total	Minority's share	Minority's share

W-3

Calculation of Goodwill	Rs.
Cost of investment in S Co's ordinary shares	*****
less Dividend received out of the pre-acquisition profits	*****
	*****
Pre-acquisition fair value of net assets (owners' equity) of S Co x H%	*****
Goodwill	*****
less Impairment loss	(****)
Goodwill to be presented in consolidated balance sheet	*****

W-4

Calculation of Group Reserves

Reserves of Parent Co	All
add Post acquisition equity of S Co to the extent of H%	*****
less Un-realized profit (if intra group sale from P to S)	(All)
less Un-realized profit (if intra group sale from S to P) to the extent of H%	(****)
less depreciation effect on fair vale adjustment to the extent of H%	(****)
less impairment loss of goodwill	(****)
	*****

W-5

Calculation of Minority Interest

Owners' equity of S Co	All
add Fair value Adjustment	All
less URP (incase of intra group sale from S to P)	(All)
less Depreciation effect on fair value adjustment	(All)
Total value	Total

Minority Interest = Total x MI%

Calculations specific to the scenario

	Scenario	Action
1	Intra group loans	To be cancelled
2	Intra group current accounts	To be cancelled and balance if any to be shown as goods in transit or cash in transit, as the case may be.
3	Intra group dividend	To be cancelled to the extent of H%, the balance to be shown in the consolidated balance sheet as payable to Minority
4	Negative goodwill	To be added in the group reserve

5	During the year acquisition of S Co and calculation for pre acquisition reserves	Reserves as on the opening date of the year in which the S Co was acquired + profit for the year in which the S Co was acquired to the extend of the number of months remained in the group's acquisition

Consolidated Income Statement

W-1

Calculation of opening balance of group's retained profits

Opening balance of Retained profits of P Co	All
add Post acquisition opening balance of retained profits of S Co x H%	*****
less Goodwill imapirment loss	(****)
	*****

W-2

Calculation of Minority Interest

Profit after tax of S Co.	*****
less Un-realized profit (if intra group sales from S to P)	(****)
Net/Total	*****

Net/Total amount x MI% = Minority Interest

Calculations specific to the scenario

1	Intra group dividend	To be cancelled. **TIP:** All amount of dividend paid by the S Co will be eliminated only the amount of dividend paid by the P Co will appear in the Consolidated Income Statement
2	Intra group trading	Deduct the same amount from the sales and also from the cost of goods sold in the consolidated income

		statement
3	Unrealized profits	Add in the consolidated cost of goods sold and subtract from the profit after tax of S Co before applying MI% to calculate Minority interest (only when the intra group trading is from S to P) If it is intra group trading from P to S then do nothing for Minority Interest calculation