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CHAPTER 1

IAS 10, IAS 37 & IFRIC 1

IN THIS CHAPTER:

AT A GLANCE

SPOTLIGHT

1. IAS 10: Events after the reporting period
2. IAS 37: Definitions and recognition
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STICKY NOTES

AT A GLANCE

IAS 10 prescribes:

- when an entity should adjust its financial statements for events after the reporting period; and
- the disclosures that an entity should give about the date when the financial statements were authorised for issue and about events after the reporting period.

IAS 10 also requires that an entity should not prepare its financial statements on a going concern basis if events after the reporting period indicate that the going concern assumption is not appropriate.

IAS 10 also includes a requirement that the financial statements should disclose when the financial statements were authorised for issue, and who gave the authorisation.

IAS 37 provides guidance on provisions, contingent liabilities and contingent assets in terms of definitions, recognition, measurement, reimbursement, changes and disclosure.

In brief, it requires that a provision is only recognised where there is a legal or constructive present obligation as a result of a past event, and payment is probable, and the amount can be reliably estimated. The amount of the provision should be the best estimate of the amount required to settle the obligation at the reporting date.

Contingent liabilities are not recognised, but are disclosed unless the possibility of an outflow of economic resources is remote. Contingent assets are not recognised, but are disclosed where an inflow of economic benefits is probable.

IFRIC 1 provides additional guidance on how to deal with changes in existing decommissioning, restoration and similar liabilities that have been recognised in accordance with IAS 37.

1. IAS 10: EVENTS AFTER THE REPORTING PERIOD

1.1 Definition [IAS 10: 3]

Events after the reporting period are those events, favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements are authorised for issue.

Two types of events can be identified:

- those that provide evidence of conditions that existed at the end of the reporting period (**adjusting events after the reporting period**); and
- Those that are indicative of conditions that arose after the reporting period (**non-adjusting events after the reporting period**).

1.2 Date of authorization [IAS 10: 4, 5 & 7 and Companies Act, 2017: Section 232]

IAS 10 explains that 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 Pakistan, the financial statements must be approved by the board of directors of the company and signed on behalf of the board of directors by the chief executive and at least one director of the company, and in case of a listed company also by the chief financial officer. The date of approval by members in annual general meeting is not the date of authorisation.

► Example 01:

The management of an entity completes draft financial statements for the year to 30 June 20X2 on 31 August 20X2. On 18 September 20X2, the board of directors reviews the financial statements and authorises them for issue. The entity announces its profit and selected 'other financial information' on 19 September 20X2. The financial statements are made available to shareholders and others on 1 October 20X2. The shareholders approve the financial statements at their annual meeting on 24 October 20X2 and the approved financial statements are then filed with SECP/registrar on 20 November 20X2.

Required:

What is date of authorization for issue of financial statements?

► ANSWER:

The financial statements are authorised for issue on 18 September 20X2 (date of board of directors authorisation for issue).

Events after the reporting period include all events up to the date when the financial statements are authorized for issue, **even if** those events occur after the **public announcement of profit** or of **other selected financial information**.

1.3 Accounting treatment of adjusting events [IAS 10: 8, 9 & 19]

Adjusting events provide evidence of conditions that existed at the end of the reporting period. The accounting treatment is to adjust the amounts recognized in financial statements to reflect adjusting events and update the relevant disclosure relating to adjusting events in the light of new information.

The following are examples of adjusting events that require an entity to adjust the amounts recognized in its financial statements, or to recognize items that were not previously recognized:

- The settlement of a court case after the reporting period that confirms that the entity had a present obligation at year end.
- The receipt of information after the reporting period indicating that an asset was impaired at year end or that the amount of a previously recognized impairment loss for that asset needs to be adjusted. For example:
 - the bankruptcy of a customer that occurs after the reporting period usually confirms that the customer was credit-impaired at the end of the reporting period; and

- ii. The sale of inventories after the reporting period may give evidence about their NRV at the end of the reporting period.
- c) The determination after the reporting period of the cost of assets purchased, or the proceeds from assets sold, before the end of the reporting period.
- d) The determination after the reporting period of the amount of profit-sharing or bonus payments, if the entity had a present legal or constructive obligation at year end to make such payments.
- e) The discovery of fraud or errors that show that the financial statements are incorrect.

► **Example 02:**

On 30 June 20X1, G Limited is involved in a court case. It is being sued by a supplier. On 15 September 20X1, the court decided that G Limited should pay the supplier Rs.45,000 in settlement of the dispute. The financial statements for G Limited for the year ended 30 June 20X1 were authorised for issue on 04 October 20X1.

The settlement of the court case is an adjusting event after the reporting period:

- It is an event that occurred between the end of the reporting period and the date the financial statements were authorised for issue.
- It provided evidence of a condition that existed at the end of the reporting period. In this case, the court decision provides evidence that the company had an obligation to the supplier as at the end of the reporting period.

Since it is an adjusting event after the reporting period, the financial statements for the year ended 30 June 20X1 must be adjusted to include a provision for Rs.45,000. The alteration to the financial statements should be made before they are approved and authorised for issue.

1.4 Accounting treatment of non-adjusting events [IAS 10: 10, 11 & 21]

Non-adjusting events are indicative of conditions that arose after the year end. The accounting treatment is not to adjust the amounts recognized in financial statements. However, the nature and financial effect (if can be made) of **material** non-adjusting events shall be disclosed.

► **Example 03:**

A decline in fair value of investments between the end of the reporting period and the date when the financial statements are authorized for issue

► **ANSWER:**

An entity does not adjust the amounts recognised in its financial statements for the investments. Similarly, the entity does not update the amounts disclosed for the investments as at the end of the reporting period, although it may need to give additional disclosure of nature of event and financial effect, if it is material.

1.5 Dividends [IAS 10: 12 & 13 and Companies Act, 2017: Section 243]

If an entity declares dividends to owners after the reporting period, the entity shall not recognize those dividends as a liability at year-end.

Such dividends are disclosed in the notes in accordance with IAS 1 Presentation of Financial Statements.

In Pakistan, final dividend is proposed by the Board of Directors and is approved by members in Annual General Meeting (AGM) i.e. date of recognising liability is the date of AGM. Interim dividend is declared by directors i.e. date of declaration and recognizing liability is date of directors meeting.

► **Example 04:**

ABC Limited is in the process of finalizing its financial statements for the year ended June 30, 20Y1. Assume today is 31st August 20Y1 and the intended date of authorisation of financial statements is September 15, 20Y1.

- a) On July 7, 20Y1, ABC Limited announced to discontinue producing its Product C due to heavy loss which represented 22% of total revenue.

- b) On July 27, 20Y1 the auditors have pointed out that certain sales invoices were omitted from recording during March 20Y1.
- c) The board of directors announced the dividend for its ordinary shareholders of Rs. 3 per share on July 09, 20Y1 from the profits for the year ended 30 June 20Y1.
- d) On July 12, 20Y1 information was received that a foreign customer had gone into liquidation in May 20Y1. There are no chances of recovery of this debt now.
- e) On August 20, 20Y1 it was discovered that another customer, who owed Rs.100,000 at year end was declared insolvent on 15 August 20Y1 after its premises burnt down two weeks ago. The premises were completely destroyed and were not insured.
- f) On July 15, 20Y1 one of corporate customer declared bankruptcy. The liquidator announced that only 30% of the debt would be paid on liquidation.
- g) On August 15, 20Y1 the company sold 1,000 units of Product B for only Rs. 120 per unit due to damage caused by water spoilage on August 05, 20Y1. The cost per unit was Rs. 200. However, this Product had been valued at its NRV of Rs. 150 per unit on June 30, 20Y1.
- h) On July 15, 20Y1 the company sold 1,000 units of Product C for only Rs. 120 per unit. The cost per unit was Rs. 200.

Required:

Identify the above events as either adjusting or non-adjusting and briefly suggest accounting treatment.

► **ANSWER:**

- a) Non-adjusting event – being material, only disclosure shall be made.
- b) Adjusting event – The correction of error should be made in financial statements for the year ended June 30, 20Y1 as it pertained to March 20Y1.
- c) Non-adjusting event – No amount shall be recognised in the financial statements in respect of the dividend announced after the year end. However, the same shall be disclosed in notes to the financial statements.
- d) Adjusting event – The foreign debt should be written off as an expense in financial statements for the year ended June 30, 20Y1 since there are no chances of recovery.
- e) Non-adjusting – Although the debt owing by the customer existed at reporting date, the inability of the customer to pay did not exist at reporting date – this condition only arose in 15 August 20Y1 after the fire. Thus, reporting the debtor at its full carrying amount of Rs. 100,000 is correct at 30 June 20Y1, according to circumstances in existence at this date.
- f) Adjusting event – The debtor's balance should be written down by 70% amount due to his bankruptcy/insolvency.
- g) Non-adjusting event – The inventory shall continue to be valued at Rs. 150 per unit as the damage caused after the year end.
- h) Adjusting event – The inventory shall be valued at lower of cost (i-e. Rs.200 per unit) or net realisable value (NRV) i-e. Rs. 120 per unit as the cost of an item would not be recoverable if inventory will be sold.

► **Example 05:**

You are finance manager of Tibet Limited (TL). You are finalizing the financial statements of TL for the year ended 31 December 20Y0. The Chief Executive of TL has sent you the following email:

20Y0 was a tough year for TL due to COVID-19. The net profit of TL is expectedly very low as compared to previous years. However, I have identified the following matters which may improve TL's net profit for 20Y0:

- On 25 January 20Y1, Government has enacted amendments in the income tax laws to reduce the rate of income tax for companies by 10% for 3 years including 20Y0.
- The exchange rate has risen from Rs. 150 per USD as on 31 December 20Y0 to Rs. 162 per USD. TL has significant receivables in USD due to export sales.
- A major local customer has settled his full balance after receiving bank loan last week. At year-end, the customer was facing financial difficulty and therefore TL had provided 40% of his balance as doubtful receivable.
- In December 20Y0, Government has announced a compensation scheme for entities which have not terminated any employee in 20Y0. Under the scheme, these entities would be reimbursed 25% of salaries expense of 20Y0. TL would initiate the process of obtaining the reimbursement after completion of audit. The reimbursement might take few months.

Required:

Discuss how each of the above matters would affect TL's net profit for the year ended 31 December 20Y0. Support your answer with justifications. (Discussion on disclosure requirements is not required).

► **ANSWER:**

- Reduction of income tax rate after the year end is a non-adjusting event as it was enacted after reporting date i.e. 31 December 20Y0 so it would not affect profit for 20Y0.
- Increase in exchange rate after the year end is a non-adjusting event so it would not affect the profit for 20Y0.
- The financial position of customer has improved after year-end upon obtaining the bank loan so it is a non-adjusting event. The provision on this customer balance would remain in the books and it would not affect the profit for 20Y0.
- Though government has announced the grant/compensation scheme in 20Y0, the grant would be recognized when there is reasonable assurance that the grant will be received. As the process has not yet initiated and would take few months, it seems that there is no reasonable assurance as at 31 December 20Y0 that the grant will be received. Therefore, it would not affect the profit for 20Y0.

► **Example 06:**

Attock Technologies Limited (ATL) manufactures five hi-tech products, each on a different plant. It is in the process of preparing its financial statements for the year ended June 30, 20X5. As the CFO of the company, the following matters are under your consideration:

- Inventory carried at Rs. 25 million on June 30, 20X5 was sold for Rs. 15 million after it had been damaged in a flood, in July 20X5.
- On July 5, 20X5 one of ATL's corporate customers declared bankruptcy. The liquidator announced on August 25, 20X5 that 20% of the debt would be paid on liquidation.
- A new product introduced by a competitor on August 1, 20X5 had caused a significant decline in the market demand of one of ATL's major products. As a result, ATL is considering a reduction in price and a cut in production.
- On August 18, 20X5 the government announced a retrospective increase in the tax rate applicable to the company.
- The directors of ATL declared a dividend of Rs. 3 per share on August 28, 20X5.

Required:

State how the above events should be treated in ATL's financial statements for the year ended June 30, 20X5. You may assume that all the above events are material to the company.

► **ANSWER:**

- a) Since the event which caused the inventory to be sold at a loss occurred after the year end, it is non-adjusting event. However, the effect of the event should be disclosed in the financial statements for the year ended June 30, 20X5.
- b) It is an adjusting event as the debt existed at year end and there is no indication as to collectability issues being arisen solely due to events after the year end. The debtor's balance should be written down by 80% amount.
- c) Usually, when inventory is sold at lower than cost after the year-end, it is indication that inventory value had declined and the condition existed at year end unless there is contrary evidence. The issue, here, seems different as ATL is still considering price reduction (i.e. has not reduced price already) and also considering cut in production (i.e. relevant to inventory levels in future and not those that existed at year-end). Therefore, it is a non-adjusting event.
- d) Since this change was not enacted before the reporting date, it is a non-adjusting event. However, a disclosure should be made for this change.
- e) Since the declaration was announced after the year-end and there was no obligation at year-end it is a non-adjusting event. Details of the dividend declaration must, however, be disclosed in accordance with IAS 1.

1.6 Going concern assumption [IAS 10: 14 to 16]

IAS 10 requires that an entity shall not prepare its financial statements on a going concern basis if management determines after the reporting period either:

- a) that it intends to liquidate the entity; or
- b) that it intends to cease trading; or
- c) that it has no realistic alternative but to do so.

Deterioration in operating results and financial position after the reporting period may indicate a need to consider whether the going concern assumption is still appropriate. There are a large number of circumstances that could lead to going concern problems. For example:

- a) The financial difficulty of a major customer leading to their inability to pay their debt to the agreed schedule if at all.
- b) An event leading to the net realizable value of lines of inventory falling to less than cost.
- c) An event leading to a crucial non-current asset falling out of use. This might cause difficulties in supplying customers and fulfilling contracts.
- d) A change in market conditions leading to a loss in value of major investments.
- e) Shortages of important supplies
- f) The emergence of a highly effective competitor

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.

IAS 1 specifies required disclosures if:

- a) the financial statements are not prepared on a going concern basis; or
- b) Management is aware of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern. The events or conditions requiring disclosure may arise after the reporting period.

Therefore, financial statements are adjusted even if going concern issue has arisen after the reporting period.

► *Example 07:*

Fit Limited (FL) is in the course of finalizing its financial statements for the year ended June 30, 20X0. Due to international recession the company has lost its major customers. The company now intends to cease its business operations and liquidate the company.

Required:

What would be impact of above issue on the financial statements?

► *ANSWER:*

FL should not prepare the financial statements on a going concern basis. It must also disclose the fact that the financial statements have not been prepared on going concern basis and give relevant disclosures under IAS 1.

1.7 Disclosure [IAS 10: 17 to 22]

An entity shall disclose:

- a) the date when the financial statements were authorized for issue; and
- b) who gave that authorization

If the entity's owners or others have the power to amend the financial statements after issue, the entity shall disclose that fact. It is important for users to know when the financial statements were authorised for issue, because the financial statements do not reflect events after this date.

If an entity receives information after the reporting period about conditions that existed at the end of the reporting period, it shall update disclosures that relate to those conditions, in the light of the new information. An entity may need to update the disclosures even when the information does not affect the amounts that it recognizes in its financial statements.

An entity shall disclose the following for each material category of non-adjusting event after the reporting period:

- a) the nature of the event; and
- b) an estimate of its financial effect, or a statement that such an estimate cannot be made

A non-adjusting events is material if non-disclosure could reasonably be expected to influence decisions that the primary users of general-purpose financial statements make on the basis of those financial statements. The following are examples of non-adjusting events after the reporting period that would generally result in disclosure:

- a) a major business combination after the reporting period or disposing of a major subsidiary;
- b) announcing a plan to discontinue an operation;
- c) major purchases of assets, disposals of assets, or expropriation of major assets by government;
- d) the destruction of a major production plant by a fire after the reporting period;
- e) announcing, or commencing the implementation of, a major restructuring;
- f) major ordinary share transactions and potential ordinary share transactions after the reporting period;
- g) entering significant commitments or contingent liabilities, for example, by issuing significant guarantees; and
- h) commencing major litigation arising solely out of events that occurred after the reporting period.

► *Example 08:*

Earley Inc is finalising its accounts for the year ended 31 December 20X4. The following events have arisen since the year end and the financial director has asked you to comment on the final accounts.

- a) At 31 December 20X4 trade receivables included a figure of Rs. 250,000 in respect of Nedengy Inc. On 8 March 20X5, when the current debt was Rs. 200,000, Nedengy Inc went into receivership. Recent correspondence with the receiver indicates that no dividend will be paid to unsecured creditors.

- b) On 15 March 20X5 Earley Inc sold its former head office building, Whitley Wood, for Rs. 2.7 million. At the year end the building was unoccupied and carried at a value of Rs. 3.1 million.
- c) Inventories at the year-end included Rs. 650,000 of a new electric tricycle, the Opasney. In January 20X5 the European Union declared the tricycle to be unsafe and prohibited it from sale. An alternative market, in Bongolia, is being investigated, although the current price is expected to be cost less 30%.
- d) Stingy Inc, a subsidiary in Outer Sonning, was nationalised in February 20X5. The Outer Sonning authorities have refused to pay any compensation. The net assets of Stingy Inc have been valued at Rs. 200,000 at the year end.
- e) Freak floods caused Rs. 150,000 damage to the Southcote branch of Earley Inc in January 20X5. The branch was fully insured.
- f) On 1 April 20X5 Earley Inc announced a 1 for 1 rights issue aiming to raise Rs. 15 million.

Required:

Explain how you would respond to the matters listed above.

► **ANSWER:**

- a) This is an adjusting event as the receivable balance existed at year end. IAS 10 specifically includes the example of bad debts, where information about bankruptcy of a customer is received after year end and there is no indication as to bankruptcy arising solely due to events after the year end. In this case, Nedengy appears to have recovered part of the debt and as such only Rs.200,000 needs to be provided. IFRS 15 states that when uncertainty arises about the collectability of an amount already included in revenue, the amount should be recognized as an expense (as bad debts).
- b) It is likely that the fall in the value of the property will fit the IAS 10 definition of adjusting events noted in (a) above, unless it can be argued that the decline in the property market occurred after the year-end. IAS 36 and IAS 16 also require to periodically review carrying amount of PPE for any possible indicators of impairment.
- c) IAS 2 Inventories requires that inventories be stated at the lower on cost and net realisable value. Unless Earley was making a significant margin on the tricycles, it is likely that the reduction in selling price of 30% will necessitate a write- down to net realisable value, especially considering the transportation costs to Bongolia which must be included. If the Bongolia option is unlikely to proceed, it may be necessary to write the tricycles down to scrap value.
- d) Under IAS 10, the nationalisation is likely to be regarded as a non-adjusting event that merely requires disclosure in the financial statements. It seems here that Earley has neither control nor significant influence, nor even an investment as the assets have been in fact, expropriated. The loss of the investment should be accounted for in the year in which it occurred, but disclosed in the current year. If the loss of the subsidiary results in Earley no longer being a going concern, then the event becomes an adjusting event and financial statements would need to be adjusted.
- e) As per IAS 10, non-adjusting events are those post reporting date events the conditions of which arise after reporting date, in the given situation the loss amounting Rs.150,000 due to floods in January 20X5 i.e. after reporting date, hence the same may be disclosed as non-adjusting event.
- f) As per IAS 10, non-adjusting events are those post reporting date events the conditions of which arise after reporting date. Since the declaration was announced after year-end, there is no past event and no obligation at year-end, hence the same is disclosed as non-adjusting event.

2. IAS 37: DEFINITIONS AND RECOGNITION

2.1 Provision [IAS 37: 7& 10]

A provision is a liability of uncertain timing or amount. The examples include provisions for;

- litigation,
- warranty,
- environmental clean-up and
- restoration / dismantling.

In some countries the term 'provision' is also used in the context of items such as depreciation, impairment of assets and doubtful debts: these are adjustments to the carrying amounts of assets and are not addressed in IAS 37.

2.1.1 Obligating event [IAS 37: 10]

A past event that leads to a present obligation is called an obligating event. An obligating event is an event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation.

2.1.2 Legal obligation [IAS 37: 10]

A legal obligation is an obligation that derives from:

- a) a contract (through its explicit or implicit terms);
- b) legislation; or
- c) other operation of law.

2.1.3 Constructive obligation [IAS 37: 10]

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; and
- b) as a result, the entity has created a valid expectation on the part of those other parties that it will

► Example 09:

A clothing retailer has a policy of taking back items of clothing that customers have purchased, and refunding the purchase price, simply because the purchaser has changed his or her mind about the item.

The retailer does not have a legal obligation to do this under the consumer protection legislation that applies in the jurisdiction in which it operates.

If this is the usual practice of a particular retailer, and the retailer's policy is well-known or has been made known to customers, then a constructive obligation exists whenever a sale is made.

2.1.4 Distinguishing provisions from other liabilities [IAS 37: 11]

Provisions implicate uncertainty about the timing or amount of the future expenditure required in settlement.

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. 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. Provisions are reported separately but accruals are often reported as part of trade and other payables.

2.2 Contingent liability [IAS 37: 10]

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 recognised because:
 - i. it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
 - ii. the amount of the obligation cannot be measured with sufficient reliability

► Example 10:

A company has given guarantee for loan taken by its associated company. The company may or may not have to pay the guaranteed amount as associated company may or may not default. It is a contingent liability

► Example 11:

A company has not complied with a legal requirement. The law states that penalty can be up to Rs. 1m. However, the law is not enforced strictly, and it is not probable that the amount will have to be paid. It is a contingent liability.

► Example 12:

In a litigation, the entity's lawyers have advised that damages will have to be paid. However, no reliable estimate of the amount could be made. It is a contingent liability.

2.3 Contingent asset [IAS 37: 10]

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.

► Example 13:

An entity filed a litigation against one of its vendor claiming damages for Rs. 3 million for supplying the faulty goods. The company may or may not win the case. This is a contingent asset.

2.4 Recognition of a provision [IAS 37: 14]

A provision shall be recognised 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 any of these conditions is not met, no provision shall be recognised.

In a general sense, all provisions are contingent because they are uncertain in timing or amount. However, within IAS 37 the term 'contingent' is used for liabilities and assets that are not recognised as they do not meet the recognition criteria.

2.4.1 Dealing with uncertainties [IAS 37: 16]

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 lawsuit, 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 end of the reporting period by taking account of all available evidence, including, for example, the opinion of experts. The evidence considered includes any additional evidence provided by events after the reporting period. On the basis of such evidence a provision may be recognised or contingent liability be disclosed if obligation existed at year end.

2.4.2 Past events [IAS 37: 17 to 19]

A past event that leads to a present obligation is called an obligating event (creating legal or constructive obligation). Financial statements deal with the financial position of an entity at the end of its reporting period and not its possible position in the future. The only liabilities recognised in an entity's statement of financial position are those that exist at the end of the reporting period. It is only those obligations arising from past events existing independently of an entity's future actions (i.e. the future conduct of its business) that are recognised as provisions.

► **Example 14:**

An entity has legal obligation to clean up the environmental damage caused by its operation. The entity is obliged to rectify damage already caused. The provision shall be recognised.

► **Example 15:**

Alpha Properties owns various office floors in shopping malls across the city of Multan. The government introduces legislation that requires safety glass to be fitted in all windows on floors above the ground floor. The legislation only applies initially to new buildings, but all buildings will have to comply within 3 years. Discuss.

► **ANSWER:**

There is no obligating event. Even though Alpha Properties will have to comply within 3 years it can avoid the future expenditure by its future actions, for example by selling the office floors. There is no present obligation for that future expenditure and no provision is recognised.

► **Example 16:**

Alpha Chemicals operates in a country where there is no environmental legislation. Its operations cause pollution in this country. Alpha Chemicals has a widely published policy in which it undertakes to clean up all contamination that it causes, and it has honoured this published policy. Discuss.

► **ANSWER:**

There is an obligating event. Alpha Chemicals has a constructive obligation which will lead to an outflow of resources embodying economic benefits regardless of the future actions of the entity. A provision would be recognised for the clean-up.

2.4.3 The concept of obligation [IAS 37: 20 to 22]

An obligation always involves another party to whom the obligation is owed. It is not necessary, however, to know the identity of the party to whom the obligation is owed, indeed the obligation may be to the public at large.

► **Example 17:**

Alpha Engineering provides 3-year warranty, to make any manufacturing defects good, at time of sale. It maintains record of product serial number and date of sale but does not keep record relating to customer identification. Discuss.

► **ANSWER:**

There is an obligating event. It is not necessary to know the identity of customers to whom obligations owed.

An obligation always involves a commitment to another party. It means that management decision alone does not result in obligation. It becomes obligation when it is communicated to those affected by it.

► **Example 18:**

A week before year end, Alpha Textiles decided to close a factory. The closure will lead to 500 redundancies at a significant cost to the entity. At year end, no news of this plan had been communicated to the workforce. Discuss.

► **ANSWER**

There is no obligating event. This will only come into existence when decision is communicated to the workforce.

An event that does not give rise to an obligation immediately may do so at a later date, because of changes in the law or because an act by the entity gives rise to a constructive obligation

► **Example 19:**

An entity caused environmental damage and there was no obligation (neither legal nor constructive) to remedy the consequences. The cause of this damage will become an obligating event when a new law will require the existing damage to be rectified, or the entity will publicly accept responsibility for rectification in a way that creates a constructive obligation.

Where details of a proposed new law have yet to be finalised, an obligation (legal) arises only when the legislation is virtually certain to be enacted as drafted. Differences in circumstances surrounding enactment make it impossible to specify a single event that would make the enactment of a law virtually certain. In many cases it will be impossible to be virtually certain of the enactment of a law until it is enacted.

2.4.4 Probable outflow of economic benefits [IAS 37: 23 & 24]

An outflow of resources or other event is regarded as probable if the event is more likely than not to occur. Where it is not probable that a present obligation exists, an entity discloses a contingent liability, unless the possibility of an outflow is remote.

Where there are a number of similar obligations (e.g. product warranties or similar contracts) the probability that an outflow will be required in settlement is determined by considering the class of obligations as a whole.

Although the likelihood of outflow for any one item may be small, it may well be probable that some outflow of resources will be needed to settle the class of obligations as a whole. If that is the case, a provision is recognised (if the other recognition criteria are met).

► **Example 20:**

Alpha Limited guaranteed ABC Bank that Beta Limited (an associate of Alpha Limited) shall repay its loan. It is almost certain that Beta Limited will repay the loan and Alpha Limited shall not have to pay the guaranteed amount. Discuss.

► **ANSWER:**

No provision is recognised. The outflow of economic benefits is not probable.

2.4.5 Reliable estimate of the obligation [IAS 37: 25 & 26]

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 items in the statement of financial position.

Mostly, an entity will be able to determine a range of possible outcomes and can therefore make an estimate of the obligation that is sufficiently reliable to use in recognising a provision. In the extremely rare case where no reliable estimate can be made, a liability exists that cannot be recognised. That liability is disclosed as a contingent liability.

2.5 Accounting treatment of contingent liability [IAS 37: 27 to 30]

An entity shall not recognise a contingent liability. A contingent liability is disclosed unless the possibility of an outflow of resources embodying economic benefits is remote (ignored in financial statements if remote).

Contingent liabilities are assessed continually to determine whether an outflow of resources embodying economic benefits has become probable. If so, a provision is recognised.

Where an entity is jointly and severally liable for an obligation, a provision is recognised for own share of obligation, while a contingent liability is disclosed for obligation related to other parties.

2.6 Accounting treatment of contingent asset [IAS 37: 31 to 35]

An entity shall not recognise a contingent asset. A contingent asset is disclosed where an inflow of economic benefits is probable.

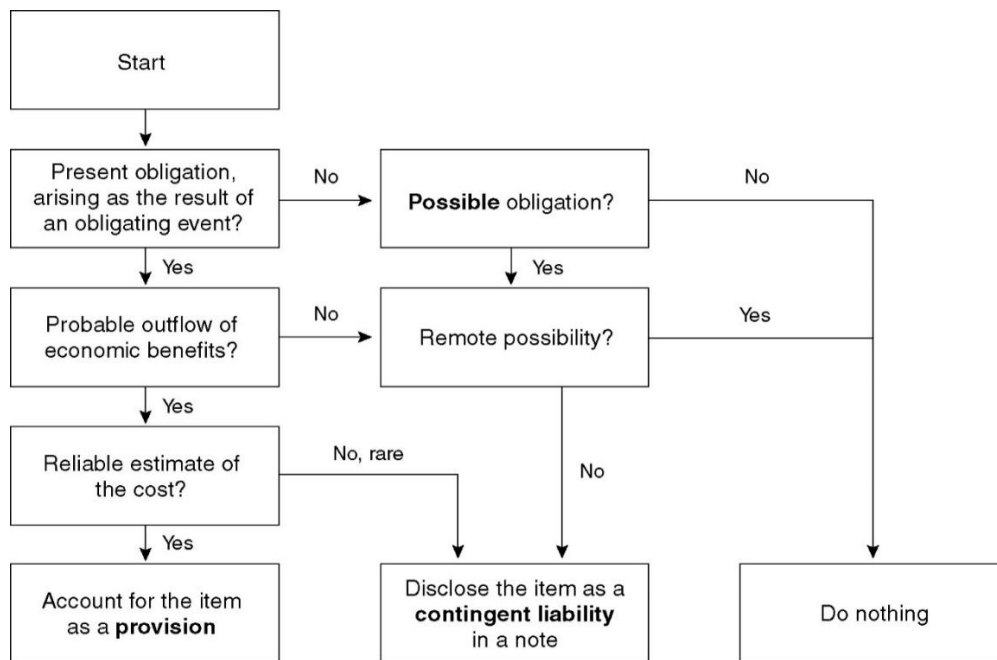
Contingent assets are not recognised in financial statements since this may result in the recognition of income that may never be realised. However, when the realisation of income is virtually certain, then the related asset is not a contingent asset and its recognition (as an asset) is appropriate.

Contingent assets are assessed continually to ensure that developments are appropriately reflected in the financial statements. If it has become virtually certain that an inflow of economic benefits will arise, the asset and the related income are recognised in the financial statements of the period in which the change occurs.

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.

2.7 Summary

An Appendix to IAS 37 includes a decision tree, showing the rules for deciding whether an item should be recognised as a provision, reported as a contingent liability, or not reported at all in the financial statements.



A summarised chart suggesting the accounting term and treatment based on chances of outflow may be useful:

Qualitative general term	Quantitative range*	Accounting treatment	
		Obligation	Assets
Remote	0 to 5%	Do nothing	Do nothing
Possible	5%+ to 50%	Disclose contingent liability	Do nothing
Probable	50%+ to 85%	Recognise provision	Disclose contingent asset
Virtually certain	85%+ to 99.9%	Recognise liability	Recognise asset and related income
Certain	100%		

*based on professional judgement and may vary according to circumstances.

► *Example 21:*

A manufacturer gives warranties at the time of sale to purchasers of its product. Under the terms of the contract for sale the manufacturer undertakes to make good, by repair or replacement, manufacturing defects that become apparent within three years from the date of sale. On past experience, it is probable that there will be some claims under the warranties and a reliable estimate is available.

Required: Discuss the accounting treatment.

► *ANSWER:*

Obligation: The obligating event is the sale of the product with a warranty, which gives rise to a present legal obligation under the warranty contract.

Outflow: Probable for the warranties as a whole.

Reliable estimate: Available.

Conclusion: A provision is recognised for the best estimate of the costs of making good under the warranty products sold before the end of reporting period.

► *Example 22:*

An entity in the oil industry causes contamination and operates in a country where there is no environmental legislation. However, the entity has a widely published environmental policy in which it undertakes to clean up all contamination that it causes. The entity has a record of honouring this published policy. The entity has reliably estimated the cost to be incurred on clean-ups.

Required: Discuss the accounting treatment.

► *ANSWER:*

Obligation: The obligating event is the contamination of the land, which gives rise to a present constructive obligation because the conduct of the entity has created a valid expectation on the part of those affected by it that the entity will clean up contamination.

Outflow: Probable.

Reliable estimate: Available.

Conclusion: A provision is recognised for the best estimate of the costs of clean-up.

► *Example 23:*

An entity operates an offshore oilfield where its licensing agreement requires it to remove the oil rig at the end of production and restore the seabed. 90% of the eventual costs relate to the removal of the oil rig and restoration of damage caused by building it, and 10% arise through the extraction of oil. At the end of the reporting period, the rig has been constructed but no oil has been extracted. The reliable estimate for removal of oil rig is available.

Required: Discuss the accounting treatment.

► *ANSWER:*

Obligation: The construction of the oil rig creates a present legal obligation under the terms of the licence to remove the rig and restore the seabed and is thus an obligating event. At the end of the reporting period, however, there is no obligation to rectify the damage that will be caused by extraction of the oil.

Outflow: Probable.

Reliable estimate: Available.

Conclusion: A provision is recognised for the best estimate of 90% of the eventual costs that relate to the removal of the oil rig and restoration of damage caused by building it. These costs are included as part of the cost of the oil rig.

The 10% of costs that arise through the extraction of oil are recognised as a liability when the oil is extracted and not before.

► *Example 24:*

Under new legislation, an entity is required to fit smoke filters to its factories by 30 June 20Y2. The entity has not fitted the smoke filters. The cost of smoke filters is Rs. 15 million. In case of non-compliance a fine of Rs. 3 million may be payable.

Required: What is impact of this at 31 December 20Y1, the end of the reporting period?

► *ANSWER:*

Obligation: There is no obligation because there is no obligating event either for the costs of fitting smoke filters or for fines under the legislation.

Outflow: Not applicable

Reliable estimate: Available.

Conclusion: No provision is recognised for the cost of fitting the smoke filters.

► *Example 25:*

Under new legislation, an entity is required to fit smoke filters to its factories by 30 June 20Y2. The entity has not fitted the smoke filters. The cost of smoke filters is Rs. 15 million. In case of non-compliance, a fine of Rs. 3 million may be payable.

Required: What is impact of this at 31 December 20Y2, the end of the reporting period?

► *ANSWER:*

Obligation: There is still no obligation for the costs of fitting smoke filters because no obligating event has occurred (the fitting of the filters). However, an obligation might arise to pay fines or penalties under the legislation because the obligating event has occurred (the non-compliant operation of the factory).

Outflow: Assessment of probability of incurring fines and penalties by non-compliant operation depends on the details of the legislation and the stringency of the enforcement regime.

Reliable estimate: Available.

Conclusion: No provision is recognised for the costs of fitting smoke filters. However, a provision is recognised for the best estimate of any fines and penalties if probable to be imposed.

► *Example 26:*

The government introduces a number of changes to the income tax system. As a result of these changes, an entity in the financial services sector will need to retrain a large proportion of its administrative and sales workforce in order to ensure continued compliance with financial services regulation. At the end of the reporting period, no retraining of staff has taken place.

Required: Discuss the accounting treatment.

► *ANSWER:*

Obligation: There is no obligation because no obligating event (retraining) has taken place.

Outflow: Not applicable.

Reliable estimate: Irrelevant.

Conclusion: No provision is recognised.

► *Example 27:*

After a wedding in 20Y0, ten people died, possibly as a result of food poisoning from products sold by the entity. Legal proceedings are started seeking damages of Rs. 20 million from the entity but it disputes liability. Up to the date of authorisation of the financial statements for the year to 31 December 20Y0 for issue, the entity's lawyers advise that it is probable that the entity will not be found liable.

Required: Discuss the accounting treatment for financial statements for year 20Y0.

► **ANSWER:**

Obligation: On the basis of the evidence available when the financial statements were approved, there is no obligation as a result of past events.

Outflow: Not applicable.

Reliable estimate: Available.

Conclusion: No provision is recognised. The matter is disclosed as a contingent liability unless the probability of any outflow is regarded as remote.

► **Example 28:**

After a wedding in 20Y0, ten people died, possibly as a result of food poisoning from products sold by the entity. Legal proceedings are started seeking damages of Rs. 20 million from the entity but it disputes liability. Up to the date of authorisation of the financial statements for the year to 31 December 20Y0 for issue, the entity's lawyers advise that it is probable that the entity will not be found liable.

However, when the entity prepares the financial statements for the year to 31 December 20Y1, its lawyers advise that, owing to developments in the case, it is probable that the entity will be found liable for the damages as claimed.

Required: Discuss the accounting treatment for financial statements for the year 20Y1.

► **ANSWER:**

Obligation: On the basis of the evidence available, there is a present obligation.

Outflow: Probable

Reliable estimate: Available i.e. Rs. 20 million.

Conclusion: A provision is recognised for the best estimate of the amount to settle the obligation i.e. Rs. 20 million.

► **Example 29:**

A furnace has a lining that needs to be replaced every five years for technical reasons. At the end of the reporting period, the lining has been in use for three years. The cost of replacement after two years is Rs. 10 million.

Required: Discuss the accounting treatment.

► **ANSWER:**

Obligation: There is no present obligation.

Outflow: Not applicable.

Reliable estimate: Irrelevant.

Conclusion: No provision is recognised. The cost of replacing the lining is not recognised because, at the end of the reporting period, no obligation to replace the lining exists independently of the company's future actions—even the intention to incur the expenditure depends on the company deciding to continue operating the furnace or to replace the lining.

Instead of a provision being recognised, the depreciation of the lining takes account of its consumption, i.e. it is depreciated over five years. The re-lining costs then incurred are capitalised with the consumption of each new lining shown by depreciation over the subsequent five years.

► **Example 30:**

An airline is required by law to overhaul its aircraft once every three years. The next overhauling is estimated to cost Rs. 45 million.

Required: Discuss the accounting treatment.

► **ANSWER:**

Obligation: There is no present obligation.

Outflow: Not applicable.

Reliable estimate: Irrelevant.

Conclusion: No provision is recognised. The costs of overhauling aircraft are not recognised as a provision for the same reasons as the cost of replacing the lining is not recognised as a provision in previous scenario. Even a legal requirement to overhaul does not make the costs of overhaul a liability, because no obligation exists to overhaul the aircraft independently of the entity's future actions—the entity could avoid the future expenditure by its future actions, for example by selling the aircraft.

Instead of a provision being recognised, the depreciation of the aircraft takes account of the future incidence of maintenance costs, i.e. an amount equivalent to the expected maintenance costs is depreciated over three years.

3. MEASUREMENT, REIMBURSEMENT AND CHANGES

3.1 Best Estimate [IAS 37: 36 to 41]

IAS 37 requires that the amount recognised as a provision shall be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period (need not actually settle on period-end, use estimate).

The best estimate is the amount that an entity would rationally pay to settle the obligation at the end of the reporting period or to transfer it to a third party at that time.

The estimates of outcome and financial effect are determined by:

- the judgement 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 reporting period. The provision is measured before tax, as the tax consequences of the provision, and changes in it, are dealt with under IAS 12.

Uncertainties surrounding the amount to be recognised as a provision are dealt with by various means according to the circumstances. The following guidance is relevant:

Circumstances	Suggested best estimate
The provision being measured involves a large population of items.	Use expected value i.e. the obligation is estimated by weighting all possible outcomes by their associated probabilities.
There is a continuous range of possible outcomes and each point in that range is as likely as any other.	The mid-point of the range is used.
A single obligation is being measured.	The individual most likely outcome may be the best estimate of the liability. However, even in such a case, the entity considers other possible outcomes.
Where other possible outcomes are either mostly higher or mostly lower than the most likely outcome.	The best estimate will be the higher or lower amount.

► Example 31:

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. 850,000 would result. If major defects were detected in all products sold, repair costs of Rs. 4,500,000 would result.

The entity's past experience and future expectations indicate that, for the coming year, 75% of the goods sold will have no defects, 20% of the goods sold will have minor defects and 5% of the goods sold will have major defects.

Required

Calculate the amount of provision to be recognised in respect of warranty.

► **ANSWER:**

The best estimate in this case is expected value of the warranty expenditure. The expected value of the cost of repairs is:

Outcome x Probability	Rs.
Rs. Nil x 75%	-
Rs. 850,000 x 20%	170,000
Rs. 4,500,000 x 5%	225,000
Total	395,000

► **Example 32:**

Many customers (i.e. 30 out of 40) of Zeta Limited (ZL) filed claims for compensation due to supply of faulty goods. ZL estimates that each claim will be settled in the range of Rs. 80,000 to Rs. 100,000 per claim, each amount in this range is as likely as any other. Calculate the amount of provision.

► **ANSWER:**

The mid-point should be used i.e. Rs. 90,000 per claim x 30 customers = Rs. 2,700,000 (Provision).

► **Example 33:**

A suit for infringement of patents, seeking damages of Rs. 2 million, was filed by a third party. Entity's legal consultant is of the opinion that an unfavourable outcome is most likely.

On the basis of past experience, he has advised that there is 60% probability that the amount of damages would be Rs. 1 million and 40% likelihood that the amount would be Rs. 1.5 million.

Required: Briefly advise on measurement of above provision.

► **ANSWER:**

The entity should make a provision of the amount of Rs. 1 million being most likely outcome. The expected value is more suitable when there is large population of similar items.

► **Example 34:**

An entity has to rectify a serious fault in a major plant that it has constructed for a customer. The individual most likely outcome for the repair to succeed at the first attempt at a cost of Rs. 200,000. However, there is significant chance that second attempt would be necessary costing an additional Rs. 80,000.

Required: Briefly advise on measurement of provision.

► **ANSWER:**

A provision of Rs. 280,000 is best estimate as there is significant chance that second attempt would be necessary.

3.2 Risk and uncertainties [IAS 37: 42 to 44]

The risks and uncertainties that inevitably surround many events and circumstances shall be taken into account in reaching the best estimate of a provision.

Risk describes variability of outcome and a risk adjustment may increase (or decrease) the amount at which a liability is measured.

Caution is needed in making judgements under conditions of uncertainty, so that income or assets are not overstated and expenses or liabilities are not understated. However, uncertainty does not justify the creation of excessive provisions or a deliberate overstatement of liabilities. Care is needed to avoid duplicating adjustments for risk and uncertainty with consequent overstatement of a provision. Disclosure of the uncertainties surrounding the amount of the expenditure is also made.

3.3 Other measurement issues [IAS 37: 45 to 52]

3.3.1 Present value [IAS 37: 45 & 47]

The amount of provisions is discounted (i.e. recognised at present value), where the effect of time value of money is material. The discount rate (or rates) shall be a pre-tax rate (or rates) that reflect(s) current market assessments of the time value of money and the risks specific to the liability. To avoid duplication, the discount rate(s) shall not reflect risks for which future cash flow estimates have (already) been adjusted.

3.3.2 Future events [IAS 37: 48 & 50]

Future events that may affect the amount required to settle an obligation shall be reflected in the amount of a provision where there is sufficient objective evidence that they will occur.

Expected future technology

It is appropriate to include, for example, expected cost reductions associated with increased experience in applying existing technology or the expected cost of applying existing technology to a larger or more complex clean-up operation than has previously been carried out.

However, an entity does not anticipate the development of a completely new technology for cleaning up unless it is supported by sufficient objective evidence

► *Example 35:*

X Limited has installed a plant (useful life 10 years) at a total cost of Rs. 20 million on January 01, 20X1. There is a legal requirement to restore the site at the end of useful life. It is estimated that Rs. 5 million shall have to be incurred on 31 December 20Y0 using technology on the restoration that X Limited has used in the past as well. However, if another existing technology is used on this type of restoration it would cost Rs. 3 million only. The entity uses pre-tax discount rate of 10% wherever applicable.

Required: Calculate the amount of provision at its inception

► *ANSWER:*

Due to recent technological development, the entity shall consider the amount of provision to be Rs. 3 million so as to reflect the impact of future events.

Further, as the effect of time value of money seems to be material, this amount shall be discounted.

$$\text{Rs. } 3,000,000 \times (1+10\%)^{-10} = \text{Rs. } 1,156,630$$

Possible new legislation

The effect of possible new legislation is taken into consideration in measuring an existing obligation when sufficient objective evidence exists that the legislation is virtually certain to be enacted.

Evidence is required both of what legislation will demand and of whether it is virtually certain to be enacted and implemented in due course.

► *Example 36:*

An entity in the oil industry causes contamination but cleans up only when required to do so under the laws of the particular country in which it operates. One country in which it operates has had no legislation requiring cleaning up, and the entity has been contaminating land in that country for several years. At 31 December 20Y0 it is virtually certain that a draft law requiring a clean-up of land already contaminated will be enacted shortly after the year-end. The cleaning up will cost Rs. 4 million in present value terms.

Required: Discuss accounting treatment.

► *ANSWER:*

The obligating event is the contamination of the land because of the virtual certainty of legislation requiring cleaning up and since outflow is probable and a reliable estimate of Rs. 4,000,000 is available, a provision is recognised for the best estimate of the costs of the clean-up.

3.3.3 Expected disposal of assets [IAS 37: 51 & 52]

Gains from the expected disposal of assets shall not be taken into account in measuring a provision, even if the expected disposal is closely linked to the event giving rise to the provision.

Instead, an entity recognises gains on expected disposals of assets at the time specified by the Standard dealing with the assets concerned e.g. IAS 16 for PPE.

► **Example 37:**

Z Limited installed a plant costing Rs. 25 million with a useful life of 10 years. There is legal requirement to restore the site used by the plant at the end of its useful life which shall cost Rs. 1 million. The plant has residual value of Rs. 2 million and may be sold for Rs. 3.5 million at the end of useful life. The assistant accountant is of the view that there is no need to create the provision for restoration as this shall be adjusted against the expected gain on disposal of the plant.

Required: Comment on the statement made by the assistant accountant

► **ANSWER:**

Gains from the expected disposal of assets are not taken into account while measuring a provision. Therefore, a provision at present value of Rs. 1 million shall be recognised.

3.4 Reimbursement [IAS 37: 53 to 58]

Some or all of the expenditure required to settle a provision may be expected to be reimbursed by another party e.g. manufacturer of products or insurance company. In such situation, following summary guidance is useful:

Obligation Scenario	The entity is not liable if third party (vendor/insurer) fails to pay.	The entity remains liable to pay if third party fails to pay.	
Reimbursement	-	It is virtually certain that reimbursement will be received if the entity settles the obligation.	It is NOT virtually certain that reimbursement will be received if the entity settles the obligation.
Accounting for obligation	There is no liability.	Recognise provision at full amount of liability.	
Accounting for asset	-	Recognise separate asset.	No asset is recognised.
Offsetting	-	Not allowed in SFP but net amount may be presented in PL.	-
Restriction	-	The amount of asset recognised cannot exceed the liability.	-
Disclosure	No disclosure is required.	The reimbursement is to be disclosed.	A contingent asset is to be disclosed, if probable.

► **Example 38:**

Daniyal Distribution (DD) are dealers of Product CC which are sold to customers with one-year warranty. The product is manufactured by Maria Multinational (MM).

Under the warranty arrangement, DD just verifies customer data on warranty claims and repair and replacement is made directly by MM. In case MM defaults, DD has no obligation. DD received 50 claims and estimates that repair and replacement would cost Rs. 400,000 which shall be settled by MM.

Required: Discuss the accounting treatment for DD.

► **ANSWER:**

DD has not obligation to settle the claim and therefore neither the provision nor the reimbursement asset is recognised. There is no disclosure requirement.

► **Example 39:**

Daniyal Distribution (DD) are dealers of Product CC which are sold to customers with one-year warranty. The product is manufactured by Maria Multinational (MM).

Under the warranty arrangement, DD is responsible to repair and replace the items and submits the detail of warranty claims to MM which pays 80% of the cost incurred to DD. In the past, MM has never denied any claim of repairs and replacements made by DD.

DD received 50 claims and estimates that repair and replacement would cost Rs. 400,000

Required: Discuss the accounting treatment for DD.

► **ANSWER:**

DD has present obligation to settle the claims and a provision of Rs. 400,000 shall be recognised. A separate reimbursement asset of Rs. 320,000 (80%) is also to be recognised. In SPL the net expense of Rs. 80,000 may be presented. Disclosure of reimbursement shall also be made.

► **Example 40:**

Daniyal Distribution (DD) are dealers of Product CC which are sold to customers with one-year warranty. The product is manufactured by Maria Multinational (MM).

Under the warranty arrangement, DD is responsible to repair and replace the items and submits the detail of warranty claims to MM which evaluates claims and may or may not pay the claims based on their evaluation criteria.

DD received 50 claims and estimates that repair and replacement would cost Rs. 400,000. It is probable that Rs. 100,000 would be received from MM.

Required: Discuss the accounting treatment for DD.

► **ANSWER:**

DD has present obligation to settle the claims and a provision of Rs. 400,000 shall be recognised. No separate asset shall be recognised but a contingent asset of Rs. 100,000 shall be disclosed.

► **Example 41:**

A claim has been made against X Limited for damage suffered by adjacent property due to work being undertaken on building of X Limited by a sub-contractor. The lawyers have confirmed that X Limited will have to pay damages of Rs. 3 million but due to a clause in agreement with sub-contractor will also be able to recover Rs. 2 million from the sub-contractor.

The recovery from sub-contractor is virtually certain.

Required: Pass the journal entry for the above.

► **ANSWER:**

	Debit Rs.	Credit Rs.
Receivable from sub-Contractor	2000,000	
Compensation expense (net)	1,000,000	
Provision for damages		3,000,000

3.5 Change in provisions [IAS 37: 59 & 60]

Review	Provisions shall be reviewed at the end of each reporting period and adjusted to reflect the current best estimate.
Reversal	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.
Change in present value	Where discounting is used, the carrying amount of a provision increases in each period to reflect the passage of time. This increase is recognised as borrowing cost.

► **Example 42:**

In Year 1, a claim of Rs. 12 million was filed against the company. The lawyers were of the opinion that it is probable to pay the damages of Rs. 12 million.

In Year 2, the case is still pending but lawyers now estimate that an amount of Rs. 15 million might be payable.

In Year 3, the case is still pending and due to development in the case lawyers now estimate that only Rs. 9 million might be payable.

Required: Journal entries.

► **ANSWER:**

Journal entries

Date	Particulars	Debit Rs. m	Credit Rs. m
Year 1	Profit or loss	12	
	Provision for legal damages		12
Year 2	Profit or loss	3	
	Provision for legal damages		3
Year 3	Provision for legal damages	6	
	Profit or loss		6

► **Example 43:**

On year end of 31 December 20Y1, a provision is expected to be settled for Rs. 110,000 one year later. The suitable discount rate is 10%.

Required: Pass Journal entries in respect of above for the year 20Y1 and 20Y2 assuming that the provision was settled as expected.

► **ANSWER:**

Journal entries

Date	Particulars	Debit Rs.	Credit Rs.
31 Dec 20Y1	Expense/Profit or loss	100,000	
	Provision [Rs. 110,000 x 1.10 ⁻¹]		100,000
31 Dec 20Y2	Finance cost [Rs. 100,000 x 10%]	10,000	
	Provision		10,000
31 Dec 20Y2	Provision	110,000	
	Bank		110,000

3.6 Use of provision [IAS 37: 61 & 62]

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

► **Example 44:**

A company has created a provision of Rs.300,000 for the cost of warranties and guarantees. The company now finds that it will probably have to pay Rs.250,000 to settle a legal dispute.

It cannot use the warranties provision for the costs of the legal dispute. An extra Rs. 250,000 expense must be recognised.

► **Example 45:**

Last year an employee filed a claim of Rs. 4 million against the company. The lawyers were of the opinion that it is probable to pay the damages of Rs. 4 million and therefore, the company recognised the provision for this amount.

During the year, the case has now been decided in favour of the company. However, in another legal suit for copyright infringement against the company (filed during the year) the company had to pay damages of Rs. 4 million. The payment has not been recorded yet.

Required: Pass the journal entries for the above transactions.

► **ANSWER:**

Journal entries

Sr.#	Particulars	Debit Rs. m	Credit Rs. m
1	Provision for employee claim	4	
	Profit or loss (reversal)		4
2	Damages exp (PL)	4	
	Bank (payment of other litigation)		4

► **Example 46:**

Quality Garments Limited (QGL) is a manufacturer of readymade garments. During May 20X4, a fire broke out in one of its units which resulted in deaths and severe injuries to a number of workers.

At the time of finalisation of QGL's financial statements for the year ended 30 June 20X4, the following issues pertaining to the fire are under consideration:

- Families of certain deceased workers have filed compensation claims amounting to Rs. 60 million. A government agency has imposed a penalty of Rs. 35 million for negligence on the part of the company. QGL's lawyers anticipate that the company would have to pay Rs. 20 million and Rs. 10 million to settle the workers' claims and the penalty respectively.
- To maintain goodwill of the company, the Board of Directors is considering additional payments to the families of the deceased workers amounting to Rs. 25 million.
- Loss to fixed assets and inventories is estimated at Rs. 60 million. In this respect, a fire insurance claim has been lodged. Due to certain policy clauses, QGL's consultant anticipates that the claim for Rs. 15 million may not be accepted. The matter is under negotiation with the insurance company.
- Due to closure of the unit for repair, QGL would not be able to meet sales orders of Rs. 50 million. This will reduce QGL's profitability for the half year ending 31 December 20X4 by Rs. 10 million.

Required:

Discuss how the above issues should be dealt with in the financial statements of QGL for the year ended 30 June 20X4. Support your answers in the context of relevant International Financial Reporting Standards.

► **ANSWER:****Part (i) Liability for workers' compensation and penalty**

Provisions are recognised when there is present obligation, probable outflow and reliable estimate. All the conditions as mentioned for provisions are met to the extent of Rs. 20 million for the claims of families of workers and Rs. 10 million for the penalty levied by a government agency. Therefore, a provision of Rs. 30 million (20+10) would be made.

For the remaining amount of Rs. 65 million (60+35-30), it is not probable that an outflow of economic benefits will be required. Therefore, a contingent liability would be disclosed giving information about nature, estimate of financial effect, indication of uncertainties and possibility of reimbursement.

Part (ii) Additional compensation for the families of the deceased workers

The obligation for additional compensation to the families of the deceased workers is neither legal nor constructive obligation as the matter is still under consideration and no formal announcement was made that may create a valid expectation.

There is neither present obligation (for provision) nor possible obligation (for disclosure as contingent liability). Therefore, no provision or disclosure is required in this respect.

Part (iii) Insurance claim

This is reimbursement scenario. Reimbursement is recognised as asset when virtually certain and disclosed as contingent asset when probable.

As the insurance claim to the extent of Rs. 45 million (60-15) is virtually certain to be received; an insurance claim would be recognized for this amount.

Where an inflow for the remaining amount of Rs. 15 million is probable, a contingent asset would be disclosed giving information about nature and financial effect. OR where an inflow for the remaining amount of Rs. 15 million is not probable, no contingent asset should be disclosed.

Part (iv) Reduction in future profit by Rs. 10m for the half year ending 31 Dec 20X4

There is no present obligation to incur future losses. No provision or disclosure is required for future operating losses as they arise from future events not past events.

4. IAS 37: SPECIFIC APPLICATION

4.1 Future operating losses [IAS 37: 63 to 65]

Provisions shall not be recognised for future operating losses because future operating losses do not meet the definition of a liability and the general recognition criteria. There is no present obligation arising from past events. However, future operating losses is indication that certain assets might have been impaired.

4.2 Onerous contracts [IAS 37: 66 to 69]

An onerous contract is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.

Many contracts (for example, some routine purchase orders) can be cancelled without paying compensation to the other party, and therefore there is no obligation. Other contracts establish both rights and obligations for each of the contracting parties. If an entity has a contract that is onerous, the present obligation under the contract shall be recognised and measured as a provision.

The unavoidable costs under a contract reflect the least net cost of exiting from the contract, which is the lower of:

- the cost of fulfilling it; and
- any compensation or penalties arising from failure to fulfil it.

Before a separate provision for an onerous contract is established, an entity recognises any impairment loss that has occurred on assets dedicated to that contract.

► Example 47:

An entity operates profitably from a factory that it has leased under an operating lease. During December 20Y0 the entity relocates its operations to a new factory. The lease on the old factory continues for the next four years at Rs. 100,000 per annum, it cannot be cancelled, and the factory cannot be re-let to another user.

The company uses 10% for discounting to present value (cumulative annuity factor 3.1699).

Required: Discuss accounting treatment.

► ANSWER:

Nature: Onerous contract

Obligation: The obligating event is the signing of the lease contract, which gives rise to a legal obligation.

Outflow: When the lease becomes onerous, an outflow of resources embodying economic benefits is probable.

Estimate: Rs. 100,000 x 3.1699 = Rs. 316,990

Conclusion: A provision is recognised for the best estimate of the unavoidable lease.

► Example 48:

SK Limited is engaged in trading of chemical products and has entered into following contract on December 20, 20Y0 with XYZ Limited (a firm contract) to buy 500 units of Product X at Rs. 10 to be delivered on January 20, 20Y1. On December 31, 20Y0 the purchase price of Product X has fallen to Rs. 7 per unit.

Required: Record journal entries due to change in purchase price at December 31, 20Y0, the year-end.

► ANSWER:

Expected loss on firm purchase contract Rs. 10 – 7 = Rs. 3 x 500 units = Rs. 1,500

Journal entry

Date	Particulars	Debit Rs.	Credit Rs.
31 Dec 20Y0	Loss on onerous contract	1,500	
	Provision for onerous contract		1,500

4.3 Restructuring [IAS 37: 70 to 71]

A restructuring is a programme that is planned and controlled by management, and materially changes either:

- the scope of a business undertaken by an entity; or
- the manner in which that business is conducted.

The following are examples of events that may fall under the definition of restructuring:

- sale or termination of a line of business;
- the closure of business locations in a country or region or the relocation of business activities from one country or region to another;
- changes in management structure, for example, eliminating a layer of management; and
- fundamental reorganisations that have a material effect on the nature and focus of the entity's operations.

A provision for restructuring costs is recognised only when the general recognition criteria for provisions are met.

4.3.1 Constructive obligation for restructuring [IAS 37: 72 & 78]

A constructive obligation to restructure arises only when an entity:

- a) has a detailed formal plan for the restructuring identifying at least:
 - i. the business or part of a business concerned;
 - ii. the principal locations affected;
 - iii. the location, function, and approximate number of employees who will be compensated for terminating their services;
 - iv. the expenditures that will be undertaken; and
 - v. when the plan will be implemented; and
- b) has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.

No obligation arises for the sale of an operation until the entity is committed to the sale, i.e. there is a binding sale agreement. When a sale is only part of a restructuring, a constructive obligation can arise for the other parts of the restructuring before a binding sale agreement exists. When the sale of an operation is envisaged as part of a restructuring, the assets of the operation are reviewed for impairment under IAS 36.

4.3.2 Implementation and announcement of restructuring [IAS 37: 73 & 74]

Evidence that an entity has started to implement a restructuring plan would be provided, for example, by dismantling plant or selling assets or by the public announcement of the main features of the plan.

Only if public announcement is made in such a way and in sufficient detail that it gives rise to valid expectations in other parties such as customers, suppliers and employees (or their representatives) that the entity will carry out the restructuring.

If it is expected that there will be a long delay before the restructuring begins or that the restructuring will take an unreasonably long time, it is unlikely that the plan will raise a valid expectation on the part of others that the entity is at present committed to restructuring, because the timeframe allows opportunities for the entity to change its plans.

4.3.3 Status of management decision [IAS 37: 75 to 77]

A constructive obligation is not created solely by a management decision. It must have been implemented or announced before the end of reporting period as well. If an entity implements or announces, only after the reporting period, disclosure is required under IAS 10. Although a constructive obligation is not created solely by a management decision, an obligation may result from other earlier events together with such a decision.

For example, negotiations with employee representatives for termination payments, or with purchasers for the sale of an operation, may have been concluded subject only to board approval. Once that approval has been obtained and communicated to the other parties, the entity has a constructive obligation to restructure.

In some countries, notification to employees' representatives may be necessary before the board decision is taken. Because a decision by such a board involves communication to these representatives, it may result in a constructive obligation to restructure.

► **Example 49:**

On 12 December 2010 the board of an entity decided to close down a division. Before the end of the reporting period (31 December 2010) the decision was not communicated to any of those affected and no other steps were taken to implement the decision.

Required: Assuming that the reliable estimate is available, what will be accounting treatment for the above?

► **ANSWER:**

There has been no obligating event and so there is no obligation as the decision has not been communicated and no constructive obligation has arisen. Therefore, no provision is recognised.

► **Example 50:**

On 12 December 2010, the board of an entity decided to close down a division making a particular product. On 20 December 2010 a detailed plan for closing down the division was agreed by the board; letters were sent to customers warning them to seek an alternative source of supply and redundancy notices were sent to the staff of the division.

Required: Assuming that the reliable estimate is available, what will be accounting treatment for the above?

► **ANSWER:**

Obligation: The obligating event is the communication of the decision to the customers and employees, which gives rise to a constructive obligation from that date, because it creates a valid expectation that the division will be closed.

Outflow: Probable

Reliable estimate: Available.

Conclusion: A provision is recognised at 31 December 2010 for the best estimate of the costs of closing the division.

4.3.4 Measurement [IAS 37: 80 to 83]

A restructuring provision shall include only the direct expenditures arising from the restructuring, which are those that are both:

- necessarily entailed by the restructuring; and
- not associated with the ongoing activities of the entity.

A restructuring provision does not include such costs as:

- retraining or relocating continuing staff;
- marketing; or
- investment in new systems and distribution networks.

Identifiable future operating losses up to the date of a restructuring are not included in a provision, unless they relate to an onerous contract. Gains on the expected disposal of assets are not taken into account in measuring a restructuring provision, even if the sale of assets is envisaged as part of the restructuring. These expenditures relate to the future conduct of the business and are not liabilities for restructuring at the end of the reporting period. Such expenditures are recognised on the same basis as if they arose independently of a restructuring.

► **Example 51:**

Singh & Co has year-end of 30 June. On June 25, 20X1 Singh & Co has decided to change its management and operational structure in order to work efficiently and competitively. The plan has been formally approved and announced to all major stakeholders. The implementation shall start from August 31, 20X1. The following costs are expected to be incurred:

	Rs.
Shifting allowance to employees	500,000
Consultant fee	700,000
New computer and distribution network systems	1,500,000
Staff training	50,000
Advertisement of new and improved operations	120,000
Implementation expenses specifically incurred for restructuring	450,000

Required: Which of the above shall be included in measurement of provision for restructuring?

► **ANSWER:**

Only consultant fee of Rs. 700,000 and implementation expenses of Rs. 450,000 shall be included in the measurement of the provision.

4.4 Future Repairs and replacements [IAS 37: 19]

Some assets need to be repaired or to have parts replaced at intervals during their lives. For example, suppose that a furnace has a lining that has to be replaced every five years. If the lining is not replaced, the furnace will break down.

IAS 37 states that a provision cannot be recognised for the cost of future repairs or replacement parts unless the company has an obligation to incur the expenditure, which is unlikely. The obligating event is normally the actual repair or purchase of the replacement part. Repair costs, however, are expenses that should be included in profit or loss as incurred.

4.5 Warranty claims [IAS 37: 24]

An entity provides warranty to its customers to repair or replace certain types of damage to its products within a certain specific period following the sale date.

If the company can reasonably estimate the amount of warranty claims likely to arise under the policy, it should recognise provision for reflects the cost of these anticipated claims. The accrual/provision should be recorded in the same reporting period in which the related product's sales are recorded so that the financial statements represent all costs associated with product sales most accurately.

4.6 Loan guarantee / joint obligations [IAS 37: 27 to 29]

An entity may become surety (guarantor) for loan granted to some other entity. These are disclosed as contingent liabilities being possible obligation. However, in case of default, possible obligation becomes present obligation and a provision is to be recognised.

Where an entity is jointly and severally liable for an obligation, the part of the obligation that is expected to be met by other parties is treated as a contingent liability. The entity recognises a provision for the part of the obligation for which an outflow of resources embodying economic benefits is probable, except in the extremely rare circumstances where no reliable estimate can be made.

4.7 Decommissioning, restoration and similar liabilities [IAS 37: 19]

A company may be required to 'clean up' a location where it has been working when production ceases.

A company has an obligation to 'clean-up' a site if:

- it is required to do so by law (a legal obligation); or
- its actions have created a constructive obligation to do so.

IAS 16 identifies the initial estimate of the costs of dismantling and removing an item and restoring the site upon which it is located as part of the cost of an asset. The asset is then depreciated.

Future clean-up costs often occur many years in the future so any provision recognised is usually discounted to its present value and then re-measured for changes in present value.

► Example 52:

The following information relates to the financial statements of Badar for the year to 31 March 20X5.

The mining division of Badar has a 3 year operating licence from an overseas government. This allows it to mine and extract copper from a particular site. When the licence began on 1 April 20X4, Badar started to build on the site. The cost of the construction was Rs. 500,000.

The overseas country has no particular environmental decommissioning laws. In its past financial statements Badar has given information about the company's environmental policy and has provided examples to demonstrate that it is a responsible company that believes in restoring mining sites at the end of the extraction period. The cost of removing the construction at the end of the three years is estimated to be Rs. 100,000.

The cost of the site currently shown in the trial balance is Rs. 500,000. The company has a cost of borrowing of 10%.

Required: Explain the correct accounting treatment for the above (with calculations if appropriate).

► ANSWER:

Although there is no legal requirement to restore the site, the company has established a constructive obligation by setting a valid expectation in the market, due to its published policies and past practice, from which it cannot realistically withdraw.

It therefore appears probable that Badar will have to pay money to improve the site and so a provision should be created for the expected amount. As the expected payment of Rs.100,000 will not be settled for three years, the provision should be discounted and entered at its net present value of Rs.75,131 ($\text{Rs.}100,000 \times (1.1)^{-3}$).

Over the three years, the discounting should be unwound and charged to profit or loss as finance costs, resulting in a provision of Rs.100,000 by the end of the third year.

The cost of the construction work has been correctly capitalised. The cost of the future decommissioning work should be added to this asset so that the total costs of the site can be matched to the revenue from the copper over the period of mining. This will result in an asset of Rs.575,131 which should be depreciated over the three year life in line with anticipated revenues.

► **Example 53:**

Karim Limited (KL) bought a special purpose engineering plant on 1 January 20X5 at a cost of Rs. 1,755 million inclusive of sales tax @ 17% (refundable).

KL is required to decommission the plant after a period of 2 years. Decommissioning cost is estimated at Rs. 300 million. The applicable discount rate is 11%.

KL uses the cost model for subsequent measurement of its property, plant and equipment. Plant is being depreciated using the straight line method over its useful life.

Required: Prepare journal entries to record the above transactions for the years 20X5 and 20X6.

► **ANSWER:****Journal entries**

Date	Particulars	Debit Rs. m	Credit Rs. m
1 Jan 20X5	Plant W1	1,743.49	
	Sales tax refundable	255	
	Bank		1,755
	Provision for decommissioning		243.49
31 Dec 20X5	Finance cost [243.49 x 11%]	26.78	
	Provision for decommissioning		26.78
31 Dec 20X5	Depreciation [1,743.49/2 years]	871.75	
	Accumulated depreciation		871.75
31 Dec 20X6	Finance cost [(243.49+26.78) x 11%]	29.73	
	Provision for decommissioning		29.73
31 Dec 20X6	Depreciation [1,743.49/2 years]	871.75	
	Accumulated depreciation		871.75
31 Dec 20X6	Provision for decommissioning	300	
	Bank		300
31 Dec 20X6	Accumulated depreciation	1,743.49	
	Plant		1,743.49

Workings:

W1: Computation of cost of plant		Rs. m
Amount inclusive of sales tax		1,755
Less: Sales tax	[Rs. 1,755m x 17/117]	(255)
		1,500
Add: Provision for decommissioning	[Rs. 300m x 1.11 ⁻²]	243.49
		1,743.49

► **Example 54:**

Turquoise Limited (TL) is in the process of finalizing its financial statements for the year ended 30 June 20X9. Following matters are under consideration:

- i. On 10 July 20X9, the owner of the adjacent building filed a case against TL claiming Rs. 50 million. The claim is made in respect of severe damage to his building during a fire incident in TL's head office in June 20X9. He is of the view that TL was negligent in maintaining fire safety systems in its head office. According to TL's lawyers, there is 70% probability that TL would be found negligent and would need to pay 40% of the amount claimed.
- ii. In May 20X9, TL's board of directors decided to relocate its regional office from Multan to Lahore. In this respect, a detailed plan was approved by the management and a formal public announcement was made in June. TL has planned to complete the relocation by December 20X9. The related costs have been estimated as under:

	Rs. in million
Redundancy payments	20
Costs of moving office equipment to Lahore	3
Compensation to employees agreeing to relocate	10
Salary of existing operation manager (responsible to supervise the relocation)	2

- iii. TL had 6,000 unsold units of product A as on 30 June 20X9 acquired at Rs. 500 per unit. In June 20X9, the selling price of product A has fallen to Rs. 350 per unit.

TL acquires product A under the contract in which TL has to buy 10,000 units of product A per month for Rs. 500 per unit. The contract is valid till 31 August 20X9 and if TL decides to cancel the contract, then it must pay a cancellation penalty of Rs. 4 million. TL is of view that the market may not improve in near future.

- iv. TL sells product B with a warranty of 12 months, though the manufacturer i.e. Sulphur Limited (SL) provides a warranty of 8 months only. Warranty services are provided by SL. However, TL is responsible if SL fails to honour its obligation for this warranty. If warranty claim arises within 8 months, SL does not charge any cost.

However, SL charges Rs. 500, Rs. 1,000 and Rs. 2,500 for a minor, moderate and major defect respectively in each unit if the defect arises in the extended warranty period of 4 months offered by TL. The probability that a warranty claim in respect of a unit sold may arise, is as under:

Nature of defect	First 8 months	Last 4 months
Minor	12%	6%
Moderate	7%	10%
Major	4%	5%

During the year ended 30 June 20X9, a total of 12,000 units of product B has been sold by TL and warranty cost of Rs. 1.2 million has been paid to SL in respect of these units.

Required:

Discuss how the above issues should be dealt with in the financial statements of TL for the year ended 30 June 20X9. Support your answers in the context of relevant IFRSs.

► **ANSWER:****Part (i)**

TL should recognise the provision of Rs. 20 million (50×40%) due to the following:

- Filing of case by owner of adjacent building is considered as an adjusting event because the fire incident was occurred in June consequently evidence of conditions i.e. severe damage to such building was exist at reporting date.
- The payment is probable as according to TL's lawyers, there is 70% probability that TL would be determined to be negligent.

- Amount can also be estimated reliably as TL's lawyers is of view that TL will have to pay 40% of the amount claimed.

Part (ii)

A provision for restructuring cost is to be recognised, as a formal restructuring plan has been finalised and approved by the management and a formal public announcement was made prior to 30 June 20X9.

However, a provision should only be made for redundancy cost of Rs. 20 million as it pertains to the closing of Multan unit.

Costs of moving machinery to the Lahore and compensation to employees agreeing to transfer Lahore relate to future conduct of the business / ongoing business of TL should not be recorded in the year ended 30 June 20X9.

Salary of the existing operation manager should not be recorded as it is not incremental cost, and would be incurred whether relocation takes place or not.

Part (iii)

In the given scenario, following two adjustments in respect of product A are required:

- Since selling price is lower than cost so NRV adjustment in respect of closing inventory at year end should be made by Rs. 900,000 $[6,000 \times 150(500-350)]$
- Further, as the contract become onerous, TL should also record provision for unavoidable cost of Rs. 3 million being lower of:
 - Cost of fulfilling the contract i.e. Rs. 3 million $[10,000 \times 2 \times 150(500-350)]$
 - Cancel the contract (penalty) i.e. Rs. 4 million

Part (iv)

In the given scenario, warranty period is divided into two i.e. First eight months and subsequent four months. Both periods are discussed separately below:

First 8 months:

Since SL is responsible for warranty claim arising in this period and no cost is charged by SL so no provision is required in TL's books. However since TL is responsible if SL does not honour its obligation for this warranty period, TL should disclose this fact as contingent liability.

Subsequent 4 months:

Since SL charges an amount from TL depend upon nature of defect, provision should be recorded in TL's books as there is present obligation as a result of past event (Sale of Product B). Computation is as follows:

Nature of defect	% defective units	No. of units	Rs. per unit	Rupees
Minor	6%	720	500	360,000
Moderate	10%	1,200	1,000	1,200,000
Major	5%	600	2,500	1,500,000
				3,060,000
Less: Already claimed				(1,200,000)
Provision to be made				1,860,000

► **Example 55:**

Naba Power Limited (NPL) is preparing its financial statements for the year ended 30 June 20X7.

Following issues are under consideration.

- a) NPL entered into a contract on 1 August 20X6 to supply customised batteries to a new customer. As per the terms of the agreement, NPL is required to deliver 50,000 batteries at the end of each month from December 20X6 to September 20X7 at a consideration of Rs. 15 million per month. Penalty for each late delivery or cancellation of the contract would be Rs. 5 million and Rs. 20 million respectively.

On 1 August 20X6 NPL had estimated that cost of production would be Rs. 10 million per month. However, cost of production increased subsequently. Despite the increase in the cost of production, NPL made timely deliveries till May 20X7 at a total cost of Rs. 99 million. Supply for June 20X7 was made on 15 July 20X7 at a total cost of Rs. 18 million of which Rs. 14 million had been incurred till 30 June 20X7. It is estimated that Rs. 55 million would need to be spent to make the last 3 deliveries within time.

- b) On 15 May 20X7 an explosion occurred at one of NPL's factories. Several claims were filed by affected employees against NPL. The details are as under:

- (i) Seven injured employees made claims before 30 June 20X7 and further three injured employees lodged claims in July 20X7. According to NPL's legal advisor, the probability that NPL would be determined to be negligent is 80%. If NPL is found negligent, the estimated average cost of each payout will be Rs. 1 million.
- (ii) Additional four employees made claims before 30 June 20X7, seeking compensation for the stress, rather than any injury, caused to them. If these claims succeed, the legal advisor is of the view that the estimated average cost of each payout will be Rs. 0.7 million. However, according to the legal advisor, the chance that these employees will succeed is 30%.
- (iii) 80% of all such payouts are recoverable according to the terms of the insurance policy.

- c) On 1 November 20X6 a new law was introduced requiring all factories to install specialized safety equipment within five months. The equipment costing Rs. 15 million was ordered in February 20X7 to be installed by 30 April 20X7. However the supplier delayed installation till 31 July 20X7. On 5 August 20X7 the company received a notice from the authorities levying a penalty of Rs. 1.6 million i.e. Rs. 0.4 million for each month during which the violation continued. It is probable that this penalty will be recovered from the supplier.

Required: Discuss how each of the above issues should be dealt with in NPL's financial statements for the year ended 30 June 20X7. (Quantify effects where practicable).

► **ANSWER:****Part (a) Penalty, write-down and onerous contract**

NPL should recognize following provision / expense as on 30 June 20X7:

		Rs. in million
Provision for penalty	(Note 1)	5
Write down to NRV [14 minus 11 (15-4)]	(Note 2)	3
Provision for onerous contract [45-55]	(Note 3)	10
		18

Note 1: Supply for June 20X7 was made after delay of 15 days so as per terms of agreement provision for penalty should be made for this adjusting event.

Note 2: Since cost incurred till 30 June 20X7 (Rs. 14 million) is higher than the net realizable value of inventory i.e. Rs.11 million (selling price of 15 million less 4 million cost to be incurred) expense of Rs. 3 million related to write-down of inventory to NRV should be recognized.

Note 3: Since estimated cost of Rs. 55 million which would need to be spent is more than the total revenue of Rs. 45 million for last 3 deliveries, the contract is considered as onerous and the provision should be made at Rs. 10 million that is lower of cost of fulfilling it (Rs. 10 million i.e. $55 - 45$) or penalty arising from failure to fulfil it (Rs. 20 million).

Part (b) Claim regarding NPL's negligence

As on 30 June 20X7 NPL should recognize a provision for ten injured employees because at reporting date there is present obligation in respect of past event (injuries suffered from explosion occurred before year end). NPL's lawyers estimate that probability of NPL being declared negligent is 80% which is considered as probable. Therefore, provision should be made for total payout of Rs 10 million (1 million for each employee).

According to the terms of insurance policy, 80% of the cost is recoverable from insurance company so it is virtually certain that reimbursement will be made. According to IAS 37, NPL should recognize a separate asset (receivable) of Rs. 8 million ($10 \text{ million} \times 80\%$). In the statement of comprehensive income provision may be presented net of reimbursement amount.

As per legal adviser, there is only 30% chance that the claims lodged against the company for undue stress will succeed so payment of Rs 2.8 million ($0.7 \text{ million} \times 4$) is possible (not a present) obligation. Consequently, provision is not required and NPL should disclose this amount as contingent liability giving brief description of the event and estimate of financial effect.

Part (c) Penalty for non-compliance of new law

As on 30 June 20X7, NPL should recognize expense of Rs. 1.2 million (0.4×3) in relation to penalty for non-compliance of new law from 1 April to 30 June 20X7 because at the reporting date there is a present obligation (payment of penalty) in respect of a past event (non-compliance of statutory requirement). NPL should disclose the penalty amount in its financial statement.

Since the reimbursement of penalty amount from the vendor is probable, the reimbursement of only two months (May and June 20X7) of Rs. 0.8 million (0.4×2) should be disclosed as a contingent asset giving brief description of the event and estimate of financial effect.

5. DISCLOSURE

5.1 Provision [IAS 37: 84 & 85]

An entity shall disclose (for each class of provision):

- the carrying amount at the beginning and end of the period;
- additional provisions made in the period, including increases to existing provisions;
- amounts used (i.e. incurred and charged against the provision) during the period;
- unused amounts reversed during the period; and
- the increase during the period in the discounted amount arising from the passage of time and the effect of any change in the discount rate.

Comparative information is not required.

► *Example 56:*

The following is an illustrative disclosure of movement in provision:

	Damages	Restoration	Total
	Rs. in million		
Balance at beginning of year	10	20	30
Estimate changes and additional provision	5	11	16
Provision used	(4)	(6)	(10)
Unused amounts reversed	(1)	-	(1)
Increase due to passage of time	1	3	4
Balance at end of year	11	28	39

An entity shall also disclose the following for each class of provision:

- a brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits;
- an indication of the uncertainties about the amount or timing of those outflows. Where necessary to provide adequate information, an entity shall disclose the major assumptions made concerning future events; and
- the amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement.

► *Example 57:*

A manufacturer gives warranties at the time of sale to purchasers of its three product lines. Under the terms of the warranty, the manufacturer undertakes to repair or replace items that fail to perform satisfactorily for two years from the date of sale. At the end of the reporting period, a provision of 60,000 has been recognised. The provision has not been discounted as the effect of discounting is not material. The narrative illustrative disclosures may be presented as follows:

Disclosure: A provision of Rs. 60,000 has been recognised for expected warranty claims on products sold during the last three financial years. It is expected that the majority of this expenditure will be incurred in the next financial year, and all will be incurred within two years after the reporting period.

► **Example 58:**

In 2000, an entity involved in nuclear activities recognises a provision for decommissioning costs of Rs. 300 million. The provision is estimated using the assumption that decommissioning will take place in 60–70 years' time. However, there is a possibility that it will not take place until 100–110 years' time, in which case the present value of the costs will be significantly reduced. The narrative illustrative disclosures may be presented as follows:

Disclosure: A provision of Rs. 300 million has been recognised for decommissioning costs. These costs are expected to be incurred between 2060 and 2070; however, there is a possibility that decommissioning will not take place until 2100–2110. If the costs were measured based upon the expectation that they would not be incurred until 2100–2110 the provision would be reduced to Rs. 136 million. The provision has been estimated using existing technology, at current prices, and discounted using a real discount rate of 2 per cent.

5.2 Contingent liabilities [IAS 37: 86, 88 & 91]

Unless the possibility of any outflow in settlement is remote, an entity shall disclose for each class of contingent liability at the end of the reporting period a brief description of the nature of the contingent liability and, where practicable:

- an estimate of its financial effect;
- an indication of the uncertainties relating to the amount or timing of any outflow; and
- the possibility of any reimbursement.

Where a provision and a contingent liability arise from the same set of circumstances, an entity makes the disclosures required in a way that shows the link between the provision and the contingent liability. Where any of the information required is not disclosed because it is not practicable to do so, that fact shall be stated.

► **Example 59:**

The following is an illustrative disclosure relating to contingent liability:

Disclosure: There is a pending litigation against the company for damages of Rs. 20 million filed by Customer alleging the defective performance by a company on two different contracts. However, no provision has been recognised because company lawyers are confident that the matter would be decided in company's favour. Even if the claim turns out to be successful, the insurance company shall reimburse 50% of the amount claimed.

► **Example 60:**

Scenario: Twin-Track Limited (TTL) is construction company. During July 2025, an accident at construction site resulted in deaths and severe injuries to many workers. Families of deceased workers have filed compensation claims amounting to Rs. 60 million. TTL's lawyers anticipate that the company would have to pay Rs. 20 million to settle the workers' claims. The chances of paying remaining amount is neither remote nor probable.

Provision: Provisions are recognised when there is present obligation, probable outflow and reliable estimate. All the conditions as mentioned for provisions are met to the extent of Rs. 20 million for the claims of families of workers. Therefore, a provision of Rs. 20 million would be made.

Contingent liability: For the remaining amount of Rs. 40 million (60-20), it is not probable that an outflow of economic benefits will be required. Therefore, a contingent liability would be disclosed giving information about nature, estimate of financial effect, indication of uncertainties and possibility of reimbursement.

5.3 Aggregation [IAS 37: 87]

In determining which provisions or contingent liabilities may be aggregated to form a class, it is necessary to consider whether the nature of the items is sufficiently similar for a single statement about them to fulfil the disclosure requirements.

► **Example 60:**

An entity manufactures two electronic products, Product A and Product B. Product A is sold under warranty for 3 years while Product B is sold under warranty for 5 years. The provision of warranty on both products may be aggregated.

► *Example 61:*

It is not appropriate to aggregate the provision of warranty and provision relating to legal proceedings for copyright issue.

5.4 Contingent assets [IAS 37: 89 to 91]

Where an inflow of economic benefits is probable, an entity shall disclose:

- a) a brief description of the nature of the contingent assets at the end of the reporting period, and,
- b) where practicable, an estimate of their financial effect.

It is important that disclosures for contingent assets avoid giving misleading indications of the likelihood of income arising. Where any of the information required is not disclosed because it is not practicable to do so, that fact shall be stated.

► *Example 62:*

The following is an illustrative disclosure relating to contingent asset:

Disclosure: The company has filed a suit against one of its supplier for supplying faulty goods. The amount of damages claimed is Rs. 35 million. The company lawyers are confident that the company shall win the suit.

5.5 Where disclosure might affect entity's position [IAS 37: 92]

In extremely rare cases, disclosure of some or all of the information required by IAS 37 disclosures can be expected to prejudice seriously the position of the entity in a dispute with other parties on the subject matter of the provision, contingent liability or contingent asset.

In such cases, an entity need not disclose the information, but shall disclose the general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed.

► *Example 63:*

An entity is involved in a dispute with a competitor, who is alleging that the entity has infringed patents and is seeking damages of Rs. 100 million. The entity recognises a provision for its best estimate of the obligation, but discloses none of the information required by IAS 37 in general.

Rather, the following information is disclosed:

Disclosure: Litigation is in process against the company relating to a dispute with a competitor who alleges that the company has infringed patents and is seeking damages of Rs. 100 million. The information usually required by IAS 37 is not disclosed on the grounds that it can be expected to prejudice seriously the outcome of the litigation.

The directors are of the opinion that the claim can be successfully resisted by the company.

► *Example 64:*

A factory worker of Industrial Chemicals Limited (ICL) was seriously injured on 10 June 20X5 during a production process. Subsequent developments in this matter are as follows:

- i. On 26 July 20X5, the worker filed a claim for Rs. 25 million and alleged violation of safety measures on the part of ICL. The lawyers of ICL anticipate that there is 60% probability that the court would award Rs. 12 million and 40% likelihood that the amount would be Rs. 8 million.
- ii. According to the terms of the insurance policy, ICL filed a claim of Rs. 18 million which was principally accepted by the insurance company on 5 August 20X5 to the extent of Rs. 14 million. ICL is negotiating with the insurance company and it is probable that ICL would recover a further sum of Rs. 2 million.
- iii. On representation by the Labour Union, the management is considering to pay to the affected worker an amount of Rs. 1.5 million, in addition to the compensation that may be awarded by the court.

Required: Explain accounting treatment and the disclosure requirements in respect of the above matters in ICL's financial statements for the year ended 30 June 20X5.

► **ANSWER:****Part (i)**

Rs. 12 million [OR Rs. 10.4 million ($12 \times 60\% + 8 \times 40\%$)] for the pending claim of the worker as it is most likely that ICL would require to pay this amount as advised by ICL's lawyers. For the remaining amount of Rs. 13 million ($25 - 12$) [OR Rs. 14.6 million ($25 - 10.4$)], it is not probable that an outflow of economic benefits will be required. Therefore, a contingent liability would be disclosed giving information as under:

- A brief nature of the contingent liability.
- Where practicable an estimate of finance liability and indication of uncertainties; and
- The possibility of any reimbursement

Part (ii) Reimbursements:

Insurance claim to the extent of Rs. 14 million is accepted in principle by the insurance company; therefore, it will be taken as 'virtually certain to be received'. However, the insurance claim to be recognized as receivable shall be restricted to Rs. 12 million (OR Rs. 10.4 million) for which the provision is recorded.

Recovery of the insurance claim to the extent of Rs. 2.0 million is probable, therefore, a contingent asset would be disclosed for this amount giving information as under:

- A brief nature of the contingent asset; and
- An estimate of financial effect and indication of uncertainties.

Part (iii)

As regards the additional compensation of Rs. 1.5 million under consideration of the management, neither provision nor disclosure shall be made as the obligation is neither legal nor constructive as the matter is still under consideration and no formal intimation was made that may create a valid expectation in this respect.

► **Example 65:**

Multan Petrochem Limited (MPL) operates in the oil extraction and refining business and is preparing its draft financial statements for the year ended 31 December 20X6. The following information has been collected for the preparation of the provisions and contingencies notes.

- 1) A new site was acquired on 1 January 20X5 and is being used as the site for a new oil refinery. Initial preparation work was undertaken at the site at the start of 20X5 and the oil refinery was completed and ready for use on 31 December 20X5. The new refinery was expected to have a useful life of 25 years. MPL has a well-publicised policy that it will reinstate any environmental damage caused by its activities. The present value of the estimated cost of reinstating the environment is Rs. 1,300,000 for damage caused during the initial preparation work. This amount is based on a discount rate of 8%.
- 2) An explosion at one of MPL's oil extraction plants on 1 July 20X6 has led to a number of personal injury claims being made by employees who were injured during the explosion. Five claims have been made to date but if these claims are successful, it is likely that a further three employees who were also injured will make a claim. MPL's lawyers estimate that it is probable that the claims will succeed and that the estimated average cost of each pay-out will be Rs. 150,000. The lawyers have recommended that MPL settles the claims out of court as quickly as possible at their estimated amount for all eight employees injured to avoid any adverse publicity.

An additional two claims have been made by employees for the stress, rather than injury, that the explosion has caused them. If these claims were to succeed the lawyers have estimated that the likely pay-out would be around Rs. 10,000 per employee. However, the lawyers have stated that they believe it to be unlikely that these employees will win such a case.

MPL made an insurance claim to try to recover the personal injury costs that it is probable that it will incur. The claim is now in its advanced stages and the insurance company has agreed to meet the cost of the claims in full. The insurance company will refund MPL once the claims have been settled.

- 3) The future of MPL's business operations is in doubt following the explosion at the oil extraction plant. The national press criticised MPL for the way that it handled the problem. To address this, on 1 October 20X6 MPL paid Rs. 12,000 to a risk assessment specialist who has recommended introducing a new disaster recovery plan at an estimated cost of Rs. 500,000.
- 4) MPL entered into an operating lease in the previous period for some office space. However, the company's plans changed and the office space was no longer required. At 1 January 20X6 a correctly calculated provision had been made for the future outstanding rentals of Rs. 80,000 for the remaining five years. This was based on a discount rate of 8%. The rent paid during the period was Rs. 15,000. In addition, MPP has signed a sub-lease to rent out the space for the first six months of next year for total rental income of Rs. 6,000. No other tenants are expected to be found for the office space.

Required:

- a) Prepare the provisions and contingencies notes for inclusion in the financial statements of MPP for the year ended 31 December 20X6.
- b) List the amounts that should be recognised in the statement of profit or loss for the year ended 31 December 20X6.

► **ANSWER:****Part (a) Provisions and contingencies**

	Environmental damage	Legal claims	Onerous lease	Total
	Rs.			
At 1 Jan 20X6	1,300,000	–	80,000	1,380,000
Unwinding of the discount (8%)	104,000		6,400	110,400
Utilised in the year	–	–	(15,000)	(15,000)
Charge/(credit) to statement of profit or loss	–	1,200,000	(6,000)	1,194,000
At 31 Dec 20X6 (Working)	1,404,000	1,200,000	65,400	2,669,400

Environmental damage

The provision in respect of the environmental damage relates to restoration of land following the initial ground work undertaken to set up a new oil refinery. The company has an advertised policy that it will restore all environmental damage caused by its business operations. The provision is based on the estimated cost of reinstating the environmental damage caused and is not likely to be paid until 2040.

Legal claims

During the year an explosion at one of the company's oil extraction plants caused a number of employees to suffer injury. This provision is to cover personal injury claims made by the individuals concerned. The provision is based on lawyers' best estimate of the likely amount at which the claims can reasonably be settled. It is hoped that the claims will be settled in the next financial year. It is expected that the full amount of these claims will be reimbursed by an insurance company following their payment.

Onerous lease

The company has an ongoing lease obligation in respect of office space that is not being utilised by the company. The outstanding lease liability at the year-end was Rs. 65,000 and the lease has another four years to run. MPP has found a tenant for the office space on a six-month short lease and this will reduce the outstanding obligation by Rs. 6,000 in 20X7.

Contingent liability

Following the explosion at the oil extraction plant a number of employees have made claims against the company for undue stress. Based on lawyers' advice the company do not believe that it is probable that a court case against the company will be brought. If such a case was to be heard the estimated pay-out in total is Rs. 20,000.

Workings

Personal injury claims: $8 \times 150,000 = 1,200,000$

Onerous lease: $(80,000 - 15,000) - 6,000 = 59,000$

Part (b)**Summary of amounts included in income statement for year ended 31 December 20X6**

Operating costs:	Rs.
Movement in provision (total expense as calculated in part a)	1,194,000
Consultancy fees	12,000
Depreciation on oil refinery environmental damage $(1,300,000 \div 25\text{yrs})$	52,000
Borrowing costs	
Unwinding of the discount $(104,000 + 6,400)$	110,400
Other operating income:	
Insurance reimbursement $(150,000 \times 8 \text{ claims})$	1,200,000

► **Example 66:**

Sahiwal Transformers Ltd (STL) is organised into several divisions.

The following events relate to the year ended 31 December 20X7.

- A number of products are sold with a warranty. At the beginning of the year the provision stood at Rs. 750,000.

A number of claims have been settled during the period for Rs. 400,000.

As at the year-end there were unsettled claims from 150 customers. Experience is that 40% of the claims submitted do not fulfil warranty conditions and can be defended at no cost.

The average cost of settling the other claims will be Rs. 7,000 each.

- A transformer unit supplied to Rahim Yar Khan District Hospital exploded during the year.

The hospital has initiated legal proceedings for damages of Rs. 10 million against STL.

STL's legal advisors have warned that STL has only a 40% chance of defending the claim successfully. The present value of this claim has been estimated at Rs. 9 million.

The explosion was due to faulty components supplied to STL for inclusion in the transformer. Legal proceedings have been started against the supplier. STL's legal advisors say that STL have a very good chance of winning the case and should receive 40% of the amount that they have to pay to the hospital.

- On 1 July 20X7 STL entered into a two-year, fixed price contract to supply a customer 100 units per month.

The forecast profit per unit was Rs. 1,600 but, due to unforeseen cost increases and production problems, each unit is anticipated to make a loss of Rs. 800.

- On 1 July 20X6 one of STL's divisions has commenced the extraction of minerals in an overseas country. The extraction process causes pollution progressively as the ore is extracted.

There is no environmental clean-up law enacted in the country.

STL made public statements during the licence negotiations that as a responsible company it would restore the environment at the end of the licence.

STL has a licence to operate for 5 years. At the end of five years the cost of cleaning (on the basis of the planned extraction) will be Rs. 5,000,000.

Extraction commenced on 1 July 20X6 and is currently at planned levels.

Required:

Prepare the provisions and contingencies note for the financial statements for the year ended 31 December 20X7, including narrative commentary.

► ANSWER:

	Warranty	Legal claim	Onerous contract	Clean-up costs	Total
	Rs. 000	Rs. 000	Rs. 000	Rs. 000	Rs. 000
At 1 January 20X7	750	nil	nil	500	1,250
Used in the year	(400)				(400)
Statement of profit or loss (balance)	280	9,000	1,440	1,000	11,720
At 31 December 20X7	630	9,000	1,440	1,500	12,570
	W1		W2	W3	

Warranty: The company grants warranties on certain categories of goods. The measurement of the provision is on the company's experience of the likelihood and cost of paying out under the warranty.

Legal claim: The legal claim provision is in respect of a claim made by a customer for damages as a result of faulty equipment supplied by the company. It represents the present value of the amount at which the company's legal advisors believe the claim is likely to be settled.

Contingent asset: The company is making a claim against a supplier of components. These components led in part to the legal claim against the company for which a provision has been made above. Legal advice is that this claim is likely to succeed and should amount to around 40% of the total damages (Rs. 3.6 million).

Onerous contract: The provision for the onerous contract is in respect of a two-year fixed-price contract which the company entered into on 1 July 20X7. Due to unforeseen cost increases and production problems, a loss on this contract is now anticipated. The provision is based on the amount of this loss up to the end of the contract.

Clean-up costs: The provision for clean-up costs is in respect of the company's overseas mineral extraction operations.

The company is 18 months into a five year operating licence. The estimated cost of cleaning up the site at the end of the five years is Rs. 5,000,000. A provision of Rs. 1,000,000 per annum is recognised.

W1 Warranty provision: $150 \times \text{Rs. } 7,000 \times 60\% = \text{Rs. } 630,000$.

W2 Onerous contract: $18 \text{ months} \times 100 \text{ units} \times \text{Rs. } 800 = \text{Rs. } 1,440,000$.

W3 Clean-up costs: Rs. 1,000,000 per annum as it is the extraction that causes the cost.

6. IFRIC 1: CHANGES IN EXISTING DECOMMISSIONING, RESTORATION AND SIMILAR LIABILITIES

6.1 Background, scope and issue [IFRIC 1: 1 to 4]

According to IAS 16, the cost of an item of property, plant and equipment includes the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

For example, a decommissioning, restoration or similar liability may exist for decommissioning a plant, rehabilitating environmental damage in extractive industries, or removing equipment.

IAS 37 contains requirements on how to measure such decommissioning, restoration and similar liabilities and IFRIC 1 provides guidance on how to account for the effect of changes in the measurement of existing decommissioning, restoration and similar liabilities.

IFRIC 1 (the interpretation) applies to changes in the measurement of any existing decommissioning, restoration and similar liabilities that is both recognised as:

- part of the cost of an item of PPE (IAS 16) or as part of the cost of a right-of-use asset (IFRS 16); and
- a liability in accordance with IAS 37.

The Interpretation addresses how the effect of the following events that change the measurement of an existing DR&SL should be accounted for:

- a change in the estimated outflow of resources embodying economic benefits (e.g. cash flows) required to settle the obligation;
- a change in the current market-based discount rate (this includes changes in the time value of money and the risks specific to the liability); and
- an increase that reflects the passage of time (also referred to as the unwinding of the discount).

6.2 Consensus: Cost Model [IFRIC 1: 5]

The first step is to calculate carrying amount i.e. account for any depreciation or impairment. Then the change in provision should be accounted for as follows:

Situation	Journal entry
Increase in Provision	Debit Property, plant and equipment Credit Provision for dismantling etc. The entity should also consider whether there is indication of impairment and, if yes, the asset should be reviewed for impairment in accordance with IAS 36.
Decrease in Provision	Debit Provision for dismantling etc. Credit Property, plant and equipment Exception: If the decrease exceeds the carrying amount, the excess amount shall be charged to profit or loss. Debit Provision for dismantling etc. Credit Profit or loss (excess amount) Credit Property, plant and equipment (upto carrying amount)

► **Example 67:**

On 1 January 20Y1, Adeel Limited (AL) installed a plant at a total cost of Rs. 100,000 with useful life of 5 years and nil residual value. There is legal requirement to dismantle the plant at the end of useful life. It was estimated that dismantling would require cash outflows of Rs. 16,105 at the end of useful life. Relevant pre-tax discount rate was estimated as 10%.

On 31 December 20Y1, the estimate of dismantling cash outflows and relevant pre-tax discount rate was revised to Rs. 19,735 and 11%, respectively.

On 31 December 20Y2, the estimate of dismantling cash outflows and relevant pre-tax discount rate was revised to Rs. 13,971 and 14%, respectively.

In later December 20Y3, the plant suffered a damage and its recoverable amount was determined to be Rs. 5,000 only on 31 December 20Y3, following the impairment review.

On 31 December 20Y3, the estimate of dismantling cash outflows and relevant pre-tax discount rate was revised to Rs. 5,382 and 16%, respectively.

AL has financial year end of December 31.

Required: Prepare movement of plant's carrying amount and provision for dismantling, identifying the amounts that will be charged to profit or loss from 1 January 20Y1 to 31 December 20Y3 for AL.

► **ANSWER:****Adeel Limited – Movement in PPE and Provision**

Particulars	PPE	Provision	PL	Working
	Rupees			
1 Jan 20Y1	110,000	10,000		[100,000 + 16,105 x 1.10 ⁻⁵]
Depreciation	(22,000)		22,000	[110,000 / 5 years]
Interest		1,000	1,000	[10,000 x 10%]
31 Dec 20Y1	88,000	11,000		
Increase in provision	2,000	2,000		(balancing)
31 Dec 20Y1	90,000	13,000		[19,735 x 1.11 ⁻⁴]
Depreciation	(22,500)		22,500	[90,000 / 4 years]
Interest		1,430	1,430	[13,000 x 11%]
31 Dec 20Y2	67,500	14,430		
Decrease in provision	(5,000)	(5,000)		(balancing)
31 Dec 20Y2	62,500	9,430		[13,971 x 1.14 ⁻³]
Depreciation	(20,833)		20,833	[62,500 / 3 years]
Interest		1,320	1,320	[9,430 x 14%]
	41,667	10,750		
Impairment	(36,667)		36,667	[41,667 - 5,000]
31 Dec 20Y3	5,000	10,750		
Decrease in provision	(5,000)	(6,750)	1,750	(balancing)
31 Dec 20Y3	-	4,000		[5,382 x 1.16 ⁻²]

► **Example 68:**

Violet Power Limited is running a coal based power project in Pakistan. The Company has built its plant in an area which contains large reserves of coal. The company has signed a 20 year agreement for sale of power to the Government. The period of the agreement covers a significant portion of the useful life of the plant. The company is liable to restore the site by dismantling and removing the plant and associated facilities on the expiry of the agreement.

Following relevant information is available:

- The plant commenced its production on July 1, 20X5. It is the policy of the company to measure the related assets using the cost model;
- Initial cost of plant was Rs. 6,570 million including erection, installation and borrowing costs but does not include any decommissioning cost;
- Residual value of the plant is estimated at Rs. 320 million;
- Initial estimate of amount required for dismantling of plant, at the time of installation of plant was Rs. 780 million. However, such estimate was reviewed as of June 30, 20X6 and was revised to Rs. 1,021 million;
- The Company follows straight line method of depreciation; and
- Real risk-free interest rate prevailing in the market was 8% per annum when initial estimates of decommissioning costs were made. However, at the end of the year such rate has dropped to 6% per annum.

Required:

Work out the carrying value of plant and decommissioning liability as of June 30, 20X6.

► **ANSWER:****Carrying value of plant and decommissioning liability**

Particulars	PPE	Provision	Workings
	Rs in million		
Initial Cost: 01 July 20X5	6,570		
Provision: 01 July 20X5	167	167	[780 x 1.08 ⁻²⁰]
	6,737	167	
Depreciation	(321)		[(6,737 - 320) / 20 years]
Interest		13	[167 x 8%] or (balancing)
	6,416	180	[780 x 1.08 ⁻¹⁹]
Increase in Provision	157	157	(balancing)
At 30 June 20X6	6,573	337	[1,021 x (1.06 ⁻¹⁹)]

6.3 Consensus: Revaluation Model [IFRIC 1: 6]

The first step is to revalue the asset, if necessary, in accordance with IAS 16. Then the change in provision should be accounted for as follows:

Situation	Journal entry
Increase in Provision	Debit Other comprehensive income (Note 1) Debit Profit or loss (excess, if any) Credit Provision for dismantling etc. Note 1: upto the balance in revaluation surplus account (net of incremental depreciation effect).
Decrease in Provision	Debit Provision for dismantling etc. Credit Profit or loss (Note 1) Credit Other comprehensive income (excess, if any) Note 1: reversal of revaluation loss earlier recognised (net of depreciation decrease effect).

The change in liability is an indication that the asset may have to be revalued and if revaluation is necessary, all assets of that class shall be revalued.

IAS 1 requires disclosure of each component of other comprehensive income (including gain on revaluation) in statement of comprehensive income. A change in revaluation surplus arising from change in liability shall be separately identified and disclosed.

► **Example 69:**

On 1 January 20Y1, Multan Limited (ML) installed a plant at a total cost of Rs. 100,000 with useful life of 5 years and nil residual value. There is legal requirement to dismantle the plant at the end of useful life. It was estimated that dismantling would require cash outflows of Rs. 16,105 at the end of useful life. Relevant pre-tax discount rate was estimated as 10%.

On 31 December 20Y1, plant was revalued to Rs. 87,500 and the estimate of dismantling cash outflows and relevant pre-tax discount rate was revised to Rs. 19,735 and 11%, respectively.

On 31 December 20Y2, plant was revalued to Rs. 67,000 and the estimate of dismantling cash outflows and relevant pre-tax discount rate was revised to Rs. 13,971 and 14%, respectively.

On 31 December 20Y3, the plant was revalued to Rs. 40,000 and the estimate of dismantling cash outflows and relevant pre-tax discount rate was revised to Rs. 5,382 and 16%, respectively.

ML has financial year end of December 31.

Required:

Prepare movement of plant's carrying amount, provision for dismantling and revaluation surplus, identifying the amounts that will be charged to profit or loss from 1 January 20Y1 to 31 December 20Y3 for ML.

► ANSWER:

Multan Limited – Movement in PPE, Provision and Revaluation surplus

Particulars	PPE	Provision	Revaluation		Other	Working
			OCI (RS)	PL	PL	
	Rupees					
1 Jan 20Y1	110,000	10,000				[100,000 + 16,105 x 1.10 ⁻⁵]
Depreciation	(22,000)				22,000	[110,000 / 5 years]
Interest		1,000			1,000	[10,000 x 10%]
31 Dec 20Y1	88,000	11,000				
Revaluation	(500)			(500)		
	87,500	11,000		(500)		
Increase in provision		2,000		(2,000)		(balancing)
31 Dec 20Y1	87,500	13,000	0	(2,500)		[19,735 x 1.11 ⁻⁴]
Depreciation	(21,875)				21,875	[87,500 / 4 years]
Depreciation decrease				625		[2,500 / 4 years]
Interest		1,430			1,430	[13,000 x 11%]
31 Dec 20Y2	65,625	14,430		(1,875)		
Revaluation	1,375			1,375		
	67,000	14,430		(500)		
Decrease in provision		(5,000)	4,500	500		(balancing)
31 Dec 20Y2	67,000	9,430	4,500	0		[13,971 x 1.14 ⁻³]
Depreciation	(22,333)				22,333	[67,000 / 3 years]
Incremental depreciation			(1,500)			[4,500 / 3 years]
Interest		1,320			1,320	[9,430 x 14%]
31 Dec 20Y3	44,667	10,750	3,000	0		
Revaluation	(4,667)		(3,000)	(1,667)		
	40,000	10,750	0	(1,667)		
Decrease in provision		(6,750)	5,083	1,667		(balancing)
31 Dec 20Y3	40,000	4,000	5,083	0		[5,382 x 1.16 ⁻²]

► **Example 70:**

Faraz is a chartered accountant and employed as Finance Manager of Gladiator Limited (GL). He has recently returned after a long medical leave and has been provided with draft financial statements of GL for the year ended 30 June 20X7. Following figures are reflected in the draft financial statements:

	----- Rs. in million -----
Profit before tax	125
Total assets	1,420
Total liabilities	925

While reviewing the financial statements, he noted the following issues:

- As at 30 June 20X7, dismantling cost relating to a plant has increased from initial estimate of Rs. 30 million to Rs. 40 million. Further, fair value of the plant on that date was assessed at Rs. 112 million (net of dismantling cost). No accounting entries have been made in respect of increase in dismantling liability and revaluation of the plant.
- The plant had a useful life of 5 years when it was purchased on 1 July 20X5. The carrying value of plant and related revaluation surplus included in the financial statements are Rs. 135.4 million (after depreciation for the year ended 30 June 20X7) and Rs. 3.15 million (after transferring incremental depreciation for the year ended 30 June 20X7) respectively.

The appropriate discount rate is 8%.

Required: Determine the revised amounts of profit before tax, total assets and total liabilities after incorporating the impact of above adjustments, if any.

► **ANSWER:**

Revised amounts	Net Profit	Total Assets	Total Liabilities
	Rs in Million		
As per question	125	1,420	925
Increase in PPE (W1)		8.35	
Increase in Provision (W1)			7.94
Revised amounts	125	1,428.35	932.94

W1:	PPE	Provision	PL	RS/OCI
	Rs in million			
As at June 30 (given)	135.40	23.81		3.15
Revaluation effect	8.35			8.35
Increase in provision		7.94		(7.94)
As at June 30 (revised)	143.75	31.75	-	3.56
Provision (before estimate change)	Rs. 30m x 1.08 ⁻³ =			23.81
Provision (after estimate change)	Rs. 40m x 1.08 ⁻³ =			31.75
Fair value of asset (gross)	Rs. 112m + 31.75m =			143.75

6.4 Consensus: Common Issues [IFRIC 1: 7 & 8]

The following rules apply to both, the cost model and the revaluation model:

- The adjusted depreciable amount of the asset is depreciated over its useful life.
- Once the related asset has reached the end of its useful life, all subsequent changes in the liability shall be recognised in profit or loss as they occur.
- The periodic unwinding of the discount shall be recognised in profit or loss as a finance cost as it occurs. Capitalisation under IAS 23 is not permitted.

7. COMPREHENSIVE EXAMPLES

► Example 74:

The following information pertains to Zamil Limited (ZL) for the year ended 31 December 20X4:

- On 20 December 20X4, ZL lodged a claim of Rs. 10 million with one of its vendors for supply of inferior quality goods. On 1 February 20X5, the vendor agreed to adjust Rs. 6 million against future purchases of ZL. For the remaining claim amount, ZL took up the matter with vendor's parent company in UK and it is probable that 70% of the remaining claim would be recovered.
- In February 20X5, it was revealed that ZL's cashier withdrew Rs. 10 million fraudulently from ZL's bank accounts. Of these, Rs. 7 million was withdrawn before 31 December 20X4. ZL and its insurance company reached an agreement for settlement of the claim at Rs. 8 million.
- In October 20X4, ZL decided to relocate its production unit from Sukkur to Karachi. In this respect, a detailed plan was approved by the management and a formal public announcement was made on 1 December 20X4. ZL has planned to complete the relocation by the end of June 20X5. The related costs have been estimated as under:

	Rs. in million
Redundancy cost	3.58
Relocation of staff to Karachi	0.45
Staff training	0.86
Salary of existing operation manager (responsible to supervise the relocation)	1.20
	6.09

- In December 20X4, a citizen committee of the area met with the directors of the company and lodged a complaint that ZL's vehicles carrying chemicals are not fully equipped with the safety equipment and resultantly creating serious threats to health of the residents. The management held a meeting in this regard on 25 December 20X4 and decided to install the safety equipment in its vehicles.

The estimated cost of installing the equipment is Rs. 25 million. The company has neither legal obligation nor any published policy regarding installation of such safety equipment in its vehicles.

Required: Discuss how each of the above issues should be dealt with in ZL's financial statements for the year ended 31 December 20X4. (Quantify effects where practicable)

► ANSWER:

Part (a) Claim for supply of inferior quality goods

Claim to the extent of Rs. 6 million is accepted by the vendor, therefore, a claim would be recognized as an asset by ZL as it is virtually certain that it will be received.

For the probable claim amount of Rs. 2.8 million $[(10-6) \times 70\%]$, it should be treated as a loss and charged to profit and loss account and a contingent asset amounting to Rs. 2.8 million should also be disclosed, giving a brief description of the contingent asset at the end of the reporting period.

Recovery of Rs. 1.2 million $[(10-6) \times 30\%]$ is not probable, therefore, it would be charged to profit and loss account.

Part (b) Withdrawal of funds from ZL's bank accounts fraudulently

Cash withdrawal before 31 December 20X4 amounted to Rs. 7 million from ZL's bank accounts is an adjusting event as the event existed on 31 December 20X4 though it was revealed after the year end. Cash lost to the extent of 80% is certain to be received, therefore a claim of Rs. 5.6 million $(7 \times 80\%)$ would be recognized as an asset. Remaining amount of Rs. 1.4 million $(7 \times 20\%)$ is no more receivable, therefore, it would be charged to profit and loss account for the year ended 31 December 20X4.

Cash withdrawal of Rs. 3 million is a non-adjusting event as it occurred after year end. However, if the event is considered to be material, a disclosure should be made along with the expected recovery their against.

Part (c) Relocation of unit from Sukkur to Karachi

A provision for restructuring cost is to be recognised, as a formal restructuring plan has been finalised and approved by the management and a formal public announcement was made prior to 31 December 20X4. Therefore, a constructive obligation has arisen on 1 December 20X4.

However, a provision should only be made for redundancy cost of Rs. 3.58 million as it pertains to the closing of Sukkur unit.

Costs for staff training and relocation of staff relate to future conduct of the business and should not be recorded in the year ended 31 December 20X4. Salary of the existing operation manager should not be recorded as it is not incremental cost, and would be incurred whether relocation takes place or not.

Part (d) Installation of safety equipment to carrying vehicles of ZL

For the year ended 31 December 20X4, ZL is not required to make any provision for liability due to non-installation of safety equipment to its chemical carrying vehicles, as:

- There is no law requiring ZL to install the safety equipment.
- There is no constructive obligation to install the safety equipment, since ZL has neither past practice nor any published policy in this respect.

Although, decision has been made on 25 December 20X4 to install the safety equipment, cost would only be recorded on actual incurrence of cost.

► Example 75:

The following information pertains to Neptune Limited (NL) which is engaged in the manufacturing of batteries and chemicals:

- a) In July 20X5, NL was sued by a customer who claimed damages of Rs. 2 million on account of supply of 2000 defective batteries in January 20X5. The legal advisor at that time anticipated that it is probable that the case would be decided in favour of the customer.

In March 20X6, an independent team submitted a report to the Court showing that 80% of the batteries were not faulty and there were minor defects in the remaining batteries. As a result, the company's lawyer formed the view that it was highly unlikely that the Court would award compensation to the customer.

On 5 July 20X6, the Court decided the suit and ordered NL to replace all (20%) the faulty batteries supplied to the customer.

- b) In July 20X4, NL entered into a two year contract with a supplier of raw material. With effect from 1 November 20X4, the supplier stopped the supply of raw material and demanded price increase of 30%. Due to stoppage of supply, NL was unable to meet its sales orders. NL filed a suit claiming damages of Rs. 40 million from the supplier on 15 June 20X5. On 30 June 20X5, NL's lawyer anticipated that NL would be awarded damages up to 60% of its claim. On 15 August 20X6 the Court decided the case in favour of NL and awarded damages of Rs. 30 million to the company.

- c) On 30 April 20X5, NL's Board of Directors decided to dispose of the chemical division which was incurring heavy losses. The decision was made public on 10 December 20X5. NL commenced negotiations with Venus Limited in March 20X6. The sale was finally executed on 31 July 20X6.

Costs incurred during the months of July and August 20X6 in connection with the closure of the division were as follows:

	Rs. in million
Redundancy cost	10.5
Staff training for relocation to battery segment	3.5
Operating loss from 1 July 20X6 till closure of business	2.0

Required: Discuss giving reasons how each of the above issues should be dealt with in the financial statements of NL for the years ended 30 June 20X5 and 20X6 in accordance with the requirements of International Financial Reporting Standards. (Assume that NL's financial statements are authorized for issue three months after the year-end)

► **ANSWER:****Part (a)****20X5 Financial Statements:**

NL should have made a provision of Rs. 2 million because:

- i. NL had a present obligation as a result of past event;
- ii. The validity of customer's claim was confirmed by the company's lawyer which shows that an outflow will be required to settle the obligation
- iii. A reliable estimate of the amount of outflow was available.

20X6 Financial Statements:

The settlement of the case in July 20X6 was an adjusting event for the year ended 30 June 20X6. The provision created in 20X5 is to be reversed. The company should revise the provision keeping in view of the cost of replacement less the amount that would be recovered on disposal of faulty batteries.

Part (b)**20X5 Financial Statements:**

NL should disclose the recoverable damages as contingent assets because:

- i. IFRS does not allow recognition of a contingent asset in the financial statement;
- ii. an inflow of economic benefits is probable and is confirmed by the company's lawyer
- iii. NL should disclose the brief description of the nature of contingent assets and an estimate of their financial effect i.e. inflow of Rs. 24 million.

20X6 Financial Statements:

Since this is an adjusting event as subsequent to year ended 30 June 20X6, the court has decided to award a compensation of Rs. 30 million. After the court's order recovery of Rs. 30 million is virtually certain, as a result, it is no longer a contingent asset and it should be recognized as an asset.

Part (c)**20X5 Financial Statements:**

Neither provisions nor disclosure should be made as there is no constructive or legal obligation as on 30 June 20X5 because:

- i. NL has no detailed formal plan for the disposal
- ii. NL has not made its decision public and consequently did not raise any valid expectation in those affected

20X6 Financial Statements:

The provision should be recognized because the obligating event is the communication of the plan to the public which creates a valid expectation that the division will be closed.

However, the provision should only be recognised to the extent of redundancy cost. IAS-37 prohibits the recognition of future operating losses and staff training costs.

► **Example 76:**

On 16 June 20Y0, an aircraft of Sukoon Airlines Limited (SAL) made an emergency landing near a factory building. Though all persons on board were safe, the nearby factory was damaged. As a result, two factory workers lost their lives and five workers were injured.

After one week of this accident, SAL's CEO informed in a press conference that SAL will pay Rs. 1.5 million for each loss of life and Rs. 1 million for each injured worker.

On 8 July 20Y0, the factory owner filed a claim of Rs. 25 million for factory damages. The case is still pending; however, SAL's legal advisor is of the view that there is 70% probability that the amount of damages would be Rs. 20 million and 30% probability that the amount would be Rs. 15 million.

Due to this accident, the aircraft was damaged beyond repairs and consequently SAL cannot use this aircraft anymore. The aircraft was acquired on lease on monthly rental of USD 0.5 million for 10 months expiring on 31 October 20Y0. As per lease agreement, if aircraft faces any accident, SAL is required to pay monthly rentals to the lessor till settlement of insurance claim. The insurance claim was settled on 31 August 20Y0.

Required: In the context of relevant IFRSs, discuss how the above issues should be dealt with in the financial statements of SAL for the year ended 30 June 20Y0.

► **ANSWER:****Loss/injuries of workers**

As CEO committed in a press conference, it is constructive obligation/valid expectation that SAL would compensate factory workers. Therefore, SAL should make a provision of Rs. 8 million ($2 \times 1.5 + 5 \times 1$) in this regard.

Factory damages

The claim was filed subsequent to year-end but the obligating event i.e. emergency landing occurred before the year-end so this is an adjusting event.

As per legal advisor advice, SAL would be liable to pay damages in any case but amount is uncertain. So SAL should make a provision for most likely amount i.e. Rs. 20 million.

Aircraft lease

Since aircraft is no more usable for SAL and insurance claim is expected to settle by 31 August 20Y0, the contract became onerous. Therefore, SAL should make a liability for rentals of July and August i.e. USD 1 million (0.5×2).

USD amount should be translated into PKR by applying closing exchange rate.

► **Example 77:**► **Example 78:**

For the purpose of this question, assume that the date today is 15 February 20X8.

Melon Limited (ML) is in the process of finalizing its financial statements for the year ended 31 December 20X7. Following matters are under consideration:

- i. ML undertook a sales campaign in December 20X7 whereby customers can avail 20% discount on the purchase of its new product by presenting a coupon, which formed part of newspaper advertisements. The offer is valid from 1 January 20X8 to 28 February 20X8.

So far discounts of Rs. 4.5 million have been availed and the management estimates that a further discount of Rs. 3 million will be given before the end of the scheme.

- ii. On 15 December 20X7, a machine was disposed of for Rs. 3.5 million to Raspberry Limited (RL) for cash. However, as per agreement ML was also entitled to additional amount of Rs. 1.5 million which is dependent upon passing certain production tests after installation at RL's premises. On 25 January 20X8 RL confirmed that the required production testing had successfully been completed.
- iii. On 10 December 20X7, a worker filed a claim of Rs. 2.5 million and alleged violation of safety measures on the part of ML. As of 31 December 20X7 the legal advisor of ML advised that there was only a remote possibility that the Court would award any compensation to the worker.

The case is still pending, however ML's legal advisor now believes that there is a 40% chance that the Court would award compensation of Rs. 2 million to the worker.

- iv. In November 20X7, as part of restructuring plan an option of early retirement in exchange for a one-off payment of Rs. 1 million was offered to each employee aged above 50 years. According to restructuring plan, management expects that 25 employees would accept the offer. The option can be exercised till 31 March 20X8. 10 employees have already opted for the scheme till 31 December 20X7. A further 6 employees have opted for the scheme after year-end.
- v. Costs related to the restructuring except one-off payments to employees have already been provided by ML in its financial statements.

Required: Discuss how each of the above matters should be dealt with in ML's financial statements for the year ended 31 December 20X7.

► **ANSWER:**

Part (i)

In given scenario, present obligation was not existing at year end as the obligating event in this case is the actual sales of the product rather than the publishing of coupon in newspaper. Therefore, neither provision nor disclosure of contingent liability are required in the ML's financial statements for the year ended 31 December 20X7.

Part (ii)

Determination of the sale price after the reporting period for an asset sold, where the sale had been made before the year end is considered as an adjusting event under IAS 10. Consequently, ML is required to book receivable of Rs. 1.5 million at year end. Further, gain or loss on sale of machine has to be calculated by taking into account of such receivable.

Part (iii)

IAS 10 states that if an entity receives information after the reporting period about conditions that existed at the end of the reporting period, it shall update disclosures that relate to those conditions, in the light of the new information.

In light of above, ML is required to disclose the contingent liability in light of revised opinion of ML's lawyer i.e. 40% chances that the court would award compensation of Rs. 2 million to the effected worker.

Part (iv)

Announcement of restructuring plan to those employees who would be affected by the plan raises constructive obligation on ML. According to restructuring plan, management expects that 25 employees would accept the offer so provision/liability should be made for Rs. 25 million (Rs. 1 million × 25 employees) irrespective of employees who have already opted the scheme till now.

► **Example 79:**

► **Example 82:**

Walnut Limited (WL) is engaged in the business of import and distribution of electronic appliances.

The following events took place subsequent to the reporting period i.e. 31 December 20X5:

- i. On 15 January 20X6, one of WL's competitors announced launching of an upgraded version of DVD players. WL's inventories include a large stock of existing version of DVD players which are valued at Rs. 15 million. Because of the introduction of the upgraded version, the net realizable value of the existing version in WL's inventory at 31 December 20X5 has reduced to Rs. 12.5 million.
- ii. On 20 December 20X5, the board of directors decided to close down the division which imports and sells mobile sets. This decision was made public on 29 December 20X5. However, the business was actually closed on 29 February 20X6. Net costs incurred in connection with the closure of this division were as follows:

	Rs. m
Redundancy costs	1.50
Staff training	0.15
Operating loss from 1 July 20X5 to closure of division	0.80
Less: Profit on sale of remaining mobile sets	(0.50)
	1.95

- iii. On 16 January 20X6, LED TV sets valuing Rs. 3 million were stolen from a warehouse. These sets were included in WL's inventory as at 31 December 20X5.
- iv. WL owns 9,000 shares of a listed company whose price as on 31 December 20X5 was Rs. 22 per share. During February 20X6, the share price declined significantly after the government announced a new legislation which would adversely affect the company's operations. No provision in this regard has been made in the draft financial statements.
- v. On 31 January 20X6, a customer announced voluntary liquidation. On 31 December 20X5, this customer owed Rs. 1.5 million.
- vi. On 15 February 20X6, WL announced final dividend for the year ended 31 December 20X5 comprising 20% cash dividend and 10% bonus shares, for its ordinary shareholders.

Required: Describe how each of the above transactions should be accounted for in the financial statements of Walnut Limited for the year ended 31 December 20X5. Support your answer in the light of relevant International Financial Reporting Standards.

► **ANSWER:**

- i. This is an adjusting post reporting event as it provides evidence of conditions that existed at the end of the reporting period. The reasons for the competitor's price reduction will not have arisen overnight, but will normally have occurred over a period of time, may be due to superior investment in technology.
An inventory write down of Rs. 2.5 million should be recognised and the amount included as inventory on the Statement of Financial Position reduced to Rs. 12.5 million.
- ii. The provision should be recognised because the obligating event is the communication of event to the public which creates a valid expectation that the division will be closed.
However, the provision should only be recognised to the extent of redundancy costs. IAS prohibits the recognition of future operating losses, staff training and profits on sale of assets.
- iii. This is a non-adjusting event because the burglary and theft of consumable stores occurred after reporting date. However, if the event is material, it should be disclosed in the financial statements unless the loss is recoverable from the insurance company.
- iv. The drop in value of investment in shares is a non-adjusting event. Since the legislation was announced after the reporting date, the event is not a past event. However, if the amount is material, it should be disclosed in the financial statements.
- v. This is an adjusting event as it provides evidence of conditions that existed at the end of the reporting period. The insolvency of a debtor and the inability to pay usually builds up over a period of time and it can therefore be assumed that it was facing financial difficulty at year-end.
A bad debts expense of Rs. 1.5 million should be recognised in SOCI.
- vi. It is a non-adjusting event because the declaration was announced after the year-end and there was no obligation at year end. Details of the bonus shares declaration must, however, be disclosed.

► **Example 85:**

Oval Limited (OL) deals in medicines and surgical instruments. OL is in the process of finalizing its financial statements for the year ended 31 December 20X8. Following matters are under consideration:

- i. OL sells instruments A-1 and B-1 with 1-year warranty. These units are purchased from a manufacturer Star Limited (SL). The details of warranty are as under:

A-1: SL provides warranty services to the customers and recovers 50% of the cost from OL. However, in case of SL's default, the warranty services would have to be provided by OL.

B-1: OL provides warranty services to the customers and recovers the entire cost from SL.

On 31 December 20X8, it is estimated that total cost of Rs. 4 million and Rs. 7 million would be incurred in next year for providing warranty services for A-1 and B-1 respectively sold in 20X8.

- ii. In October 20X8, OL was sued by a customer for Rs. 18 million on account of supply of substandard surgical instruments.

By end of the year, OL communicated to the customer via email to pay Rs. 5 million. In respect of the remaining amount of the claim, OL's lawyers anticipate that there is 70% probability that the court would award Rs. 6 million and 30% probability that the amount would be Rs. 4 million.

OL lodged a claim with the supplier in December 20X8. The supplier principally accepted the claim to the extent of Rs. 9 million. However, OL is still negotiating with the supplier and it is probable that OL would recover a further sum of Rs. 3 million.

- iii. OL has imported 7,000 units of a medicine at a cost of Rs. 70 million. However, in November 20X8, a study was published in a medical journal which reveals that results of an alternate medicine are much better. At year end, 5000 units were in stock. On 25 January 20X9, 4000 units were sold at Rs. 8,000 per unit. OL also paid 10% commission.

Required: Discuss how the above issues should be dealt with in the financial statements of OL for the year ended 31 December 20X8. Support your answers in the context of relevant IFRSs.

► **ANSWER:****Part (i)**

As on 31 December 20X8, OL should recognize a provision for warranty service to be provided as there is a present obligation as a result of a past event (sale of A-1 and B-1 in 20X8). The amount of provision would be:

- Rs. 2 million ($4 \times 50\%$) in respect of A-1 as OL is liable to SL for 50% cost of services.
- Rs. 7 million (entire cost) in respect of B-1 as OL is responsible to the customers for providing warranty services.

OL is required to disclose a contingent liability for remaining warranty cost of A-1 (which should be incurred by SL) as OL would be responsible for it in case of SL's default. (Joint and several liability)

Further OL should recognize a separate asset (receivable) to the extent that reimbursements from SL in respect B-1 are virtually certain. In the statement of profit or loss, the expense relating to warranty services may be presented net of the amount recognized as receivable (reimbursement).

Part (ii)

As on 31 December 20X8, OL is required to record a liability of Rs. 5 million as this has already been approved by OL. In respect of remaining amount of the claim, a provision of Rs. 6 million shall be made as it is most likely that OL would require to pay this amount as advised by OL's lawyers.

Further OL should recognize a separate asset (receivable) to the extent of Rs. 9 million as it is accepted in principle by the supplier. Therefore, it will be taken as 'virtually certain to be received'. In the statement of profit or loss, the expense relating to the provision may be presented net of amount recognized as receivable (reimbursement).

However, recovery of the claim to the extent of Rs. 3 million is probable, therefore, a contingent asset would be disclosed.

Part (iii)

Introduction of new alternative drug with better results is an indication of reduction in value of existing medicine kept in stock. It is more evident by subsequent sales of such units at lower price i.e. Rs. 8,000 with 10% commission to distributors. According to IAS 2, inventory should be recorded at lower of cost or NRV (i.e. estimated selling price less estimated costs necessary to make the sale).

So OL is required to carry entire stock of this medicine at NRV i.e. Rs. 36 million $[5,000 \times 7,200 (8,000 - 800)]$.

► **Example 83:**

For the purpose of this question, assume that the date today is 1 August 20Y1.

On 1 January 20Y1, Holwah Automobiles Limited (HAL) launched vehicle with the brand name of 'Deluxe'. In March 20Y1, reports were circulated in social media that carbon emissions from Deluxe exceed the regulatory limits. In May 20Y1, HAL announced to halt the sales of Deluxe upon receiving an inquiry from regulatory authority.

On 1 June 20Y1, HAL announced that:

- high emissions were confirmed in those batches of Deluxe which were produced from March 20Y1 and onwards due to defect in assembling of emission kit.
- customers can get the defect fixed from the authorized dealers free of cost from 1 July 20Y1.
- sales of Deluxe will also resume from 1 July 20Y1.

The senior management has summarized the following financial implications of the above matter:

- i. On 10 June 20Y1, a penalty of Rs. 20 million was imposed by the regulatory authority. On 25 July 20Y1, an additional penalty of Rs. 2 million was imposed due to non-payment of penalty within 40 days. HAL has decided to challenge the additional penalty on the relevant forum.
- ii. Defect in the existing inventory of Deluxe will be fixed by HAL at its factory in the month of August 20Y1. The rework cost will be Rs. 15 million and loss of profit due to temporary suspension of production will be Rs. 30 million.
- iii. Defect in all vehicles sold during March to May 20Y1 will be fixed by the authorized dealers in July and August 20Y1. The cost will be re-imbursed to dealers at the end of each month on the basis of actual number of vehicles fixed. Though HAL is legally bound to fix the defect in all vehicles which will cost approximately Rs. 50 million, management estimates that only 85% of customers will get their vehicle fixed.
- iv. Market value of internally generated brand of Deluxe would reduce by Rs. 150 million.
- v. Value in use of the production line of Deluxe would reduce by Rs. 80 million.
- vi. In June 20Y1, the regulatory authority has introduced new emission protocol to ensure that the emissions are within the limits and needs to be complied by 30 September 20Y1. The new protocol will require modification in the existing production line at a cost of Rs. 100 million.

Required: In the context of relevant IFRSs, discuss how the above financial implications should be dealt with in the financial statements of HAL for the year ended 30 June 20Y1.

► **ANSWER:**

The treatment of the given financial implications in the financial statements for the year ended 30 June 20Y1 would be as follows:

- i. Penalty of Rs. 20 million should be recognised due to legal obligation arising on 10 June 20Y1. Additional penalty of Rs. 2 million should not be recognised as it has been imposed after year end.
- ii. Rework cost of Rs. 15 million should not be recognised. Rework cost should be deducted in calculating NRV of inventory of Deluxe and would be compared with the cost for identifying any potential NRV adjustment. No provision needs to be made for loss of profit of Rs. 30 million as future operating losses does not require any provision.

- iii. Repair cost which will be reimbursed to dealers should be provided because constructive / legal obligation arose due to announcement made on 1 June. The amount recognised as provision shall be the best estimate based on the most likely outcome hence provision should be recorded at 85% of Rs. 50 million i.e. 42.5 million.
- iv. Internally generated brands are not recognised in financial statements; hence no question arises of their impairment.
- v. Reduction in value in use of Rs. 80 million should not be recorded. The reduced value in use of the production line should be compared with the fair value less cost of disposal for assessing recoverable amount. If carrying amount exceeds recoverable amount then recognize impairment loss.
- vi. The modification cost of Rs. 100 million should not be provided despite announcement made by regulatory authority before year end. HAL has no present obligation for future expenditures as it can avoid the expenditure by its future actions i.e. by changing operations. The cost should be considered in estimating value in use of the related assets.

► **Example 86:**

The financial statements of Bravo Limited (BL) for the year ended 30 September 20X3 are under finalisation and the following matters are under consideration:

BL's plant was commissioned and became operational on 1 April 20W8 at a cost of Rs. 130 million. At the time of commissioning its useful life and present value of decommissioning liability was estimated at 20 years and Rs. 19 million respectively.

BL's discount rate is 10%.

There has been no change in the above estimates till 30 September 20X3 except for the decommissioning liability whose present value as at 1 April 20X3 was estimated at Rs. 25 million.

Required: Compute the related amounts as they would appear in the statements of financial position and comprehensive income of Bravo Limited for the year ended 30 September 20X3 in accordance with IFRS. (Ignore corresponding figures).

► **ANSWER:**

Particulars	PPE	Provision	PL	Workings
	Rs in million			
1 April 20W8	149	19		[130+19]
Depreciation for 4.5 years	(33.53)			[(149 / 20 years) x 4.5 years]
Interest for 4.5 years		10.18		(balancing)
1 October 20X2	115.47	29.18		[19 x 1.10 ^{4.5}]
Depreciation 6/12	(3.73)		3.73	[(149 / 20 years) x 0.5 years]
Interest 6 /12		1.42	1.42	(balancing)
		30.60		[19 x 1.10 ⁵]
Decrease in Provision	(5.60)	(5.60)		
1 April 20X3	106.14	25		
Depreciation 6/12	(3.54)		3.54	[(106.15 / 15 years) x 0.5 years]
Interest 6/12		1.22	1.22	(balancing)
30 September 20X3	102.60	26.22	9.91	[25 x 1.10 ^{0.5}]
Total depreciation 20X3 (SPL)			7.27	[3.54 + 3.73]
Total interest 20X3 (SPL)			2.64	[1.42 + 1.22]

► **Example 87:**

Waste Management Limited (WML) had installed a plant in 20W5 for generation of electricity from garbage collected by the civic agencies. WML had signed an agreement with the government for allotment of a plot of land, free of cost, for 10 years. However, WML has agreed to restore the site, at the end of the agreement.

Other relevant information is as under:

- Initial cost of the plant was Rs. 80 million. It is estimated that the site restoration cost would amount to Rs. 10 million.
- It is the policy of the company to measure its plant and machinery using the revaluation model.
- When the plant commenced its operations i.e. on April 1, 20W5 the prevailing market based discount rate was 10%.
- On March 31, 20W7 the plant was revalued at Rs. 70 million including site restoration cost.
- On March 31, 20W9 prevailing market based discount rate had increased to 12%.
- On March 31, 20X1 estimate of site restoration cost was revised to Rs. 14 million.
- Useful life of the plant is 10 years and WML follows straight line method of depreciation.
- Appropriate adjustments have been recorded in the prior years i.e. up to March 31, 2010.

Required

Prepare accounting entries for the year ended March 31, 20X1 based on the above information, in accordance with International Financial Reporting Standards. (Ignore taxation.)

► **ANSWER:****Journal entries**

Date	Particulars	Debit Rs. m	Credit Rs. m
31 Mar 20X1	Depreciation	8.75	
	Accumulated Depreciation		8.75
31 Mar 20X1	Revaluation Surplus	0.461	
	Retained earnings		0.461
31 Mar 20X1	Finance cost	0.681	
	Provision for site restoration		0.681
31 Mar 20X1	Other comprehensive income	1.843	
	Profit or loss	0.699	
	Provision for site restoration		2.542

Particulars	PPE	Provision	PL (Rev. loss)	RS/OCI	Workings
	Rs in Million				
1 April 20W5	83.855	3.855			[80+3.855 i.e. 10m x 1.10 ⁻¹⁰]
Depreciation	(8.386)				[83.855 / 10 years]
Interest		0.386			[3.855 x 10%]
31 March 20W6	75.470	4.241			
Depreciation	(8.386)				[75.470 / 9 years]
Interest		0.424			[4.241 x 10%]
31 March 20W7	67.084	4.665			
Revaluation effect	2.916			2.916	
31 March 20W7	70.000	4.665		2.916	
Depreciation	(8.750)				[70 / 8 years]

Particulars	PPE	Provision	PL (Rev. loss)	RS/OCI	Workings
	Rs in Million				
Incremental dep.				(0.364)	[2.916 / 8 years]
Interest		0.467			[4.665 x 10%]
31 March 20W8	61.250	5.132		2.551	
Depreciation	(8.750)				[61.250 / 7 years]
Incremental dep.				(0.364)	[2.551 / 7 years]
Interest		0.513			[5.132 x 10%]
31 March 20W9	52.500	5.645		2.187	
Decrease in provision		(0.578)		0.578	[(10m x 1.12 ⁻⁶) - (10m x 1.10 ⁻⁶)]
31 March 20W9	52.500	5.066		2.765	
Depreciation	(8.750)				[52.5 / 6 years]
Incremental dep.				(0.461)	[2.765 / 6 years]
Interest		0.608			[5.066 x 12%]
31 March 2010	43.750	5.674		2.304	
Depreciation	(8.750)				[43.75 / 5 years]
Incremental dep.				(0.461)	[2.304 / 5 years]
Interest		0.681			[5.573 x 12%]
31 March 20X1	35.000	6.355		1.843	
Increase in provision		2.542	0.699	(1.843)	[(14m x 1.12 ⁻⁴) - (10m x 1.12 ⁻⁴)]
31 March 20X1	35.000	8.897	0.699	0	

► **Example 88:**

On 1 January 2020, Grateful Industries Limited (GIL) completed installation of a plant which will be required to be dismantled at the end of its ten years' useful life. GIL paid Rs. 2,000 million for the plant. On 1 January 2020, it was estimated that the cost of dismantling would amount to Rs. 200 million. Applicable discount rate was 10% per annum when initial estimate of dismantling costs was made.

The fair value of the plant as on 31 December 2020 was assessed at Rs. 1,845 million (including dismantling cost).

Estimates of dismantling cost and applicable discount rate were reviewed as at 31 December 2021 and were revised to Rs. 150 million and 12% per annum respectively.

GIL has a policy to subsequently measure plant using the revaluation model and depreciation is provided on straight line basis.

Required: Prepare accounting entries in the books of GIL, for the year ended 31 December 2021 in accordance with IFRSs.

► **Answer:**

General Journal

Date	Particulars	Debit	Credit
		Rs. m	Rs. m
31-Dec-21	Depreciation	205	
	Accumulated depreciation		205
31-Dec-21	Finance cost (PL)	8.48	
	Provision for dismantling		8.48
31-Dec-21	Provision for dismantling	32.72	
	Profit or loss		21.69
	Other comprehensive income		11.03

Working / Calculation:

Particulars	PPE	Provision	Revaluation		Other	Working
			OCI (RS)	PL	PL	
	Rs. million					
1 Jan 2020	2,077.11	77.11				[2,000 + 200 x 1.10 ⁻¹⁰]
Depreciation	(207.71)				(207.71)	[2,077.11 / 10 years]
Interest		7.71			(7.71)	[77.11 x 10%]
31 Dec 2020	1,869.40	84.82				
Revaluation	(24.40)			(24.40)		
31 Dec 2020	1,845			(24.40)		
Depreciation	(205)				(205.00)	[1,845 / 9 years]
Dep. Decrease				2.71		[24.40 / 9 years]
Interest		8.48			(8.48)	[84.82 x 10%]
31 Dec 2021	1,640	93.30		(21.69)		
Prov. Decrease		(32.72)	11.03	21.69		(balancing)
31 Dec 2021	1,640	60.58	11.03	0		[150 x 1.12 ⁻⁸]

Tutorial note: Revaluation surplus of Rs. 11.03 million as at 31 December 2021, may also be calculated as difference between carrying amount under revaluation model of Rs. 1,640 million (see above) and carrying amount under cost model, had the asset been never revalued, of Rs. 1628.97 million (see next example).

► **Example 89:**

On 1 January 2020, Gratified Industries Limited (GIL) completed installation of a plant which will be required to be dismantled at the end of its ten years' useful life. GIL paid Rs. 2,000 million for the plant. On 1 January 2020, it was estimated that the cost of dismantling would amount to Rs. 200 million. Applicable discount rate was 10% per annum when initial estimate of dismantling costs was made.

Estimates of dismantling cost and applicable discount rate were reviewed as at 31 December 2021 and were revised to Rs. 150 million and 12% per annum respectively.

GIL has a policy to subsequently measure plant using the cost model and depreciation is provided on straight line basis.

Required: Prepare accounting entries in the books of GIL, for the year ended 31 December 2021 in accordance with IFRSs.

► **Answer:****General Journal**

Date	Particulars	Debit	Credit
		Rs. m	Rs. m
31-Dec-21	Depreciation	207.71	
	Accumulated depreciation		207.71
31-Dec-21	Finance cost (PL)	8.48	
	Provision for dismantling		8.48
31-Dec-21	Provision for dismantling	32.72	
	PPE (Plant)		32.72

Working / Calculation:

Particulars	PPE	Provision	Other	Working
			PL	
	Rs. million			
1 Jan 2020	2,077.11	77.11		[2,000 + 200 x 1.10 ⁻¹⁰]
Depreciation	(207.71)		(207.71)	[2,077.11 / 10 years]
Interest		7.71	(7.71)	[77.11 x 10%]
31 Dec 2020	1,869.40	84.82		
Depreciation	(207.71)		(207.71)	
Interest		8.48	(8.48)	[84.82 x 10%]
31 Dec 2021	1,661.69	93.30		
Prov. Decrease	(32.72)	(32.72)		(balancing)
31 Dec 2021	1,628.97	60.58		[150 x 1.12 ⁻⁸]

► **Example 90:**

For the purpose of this question, assume that the date today is 31 August 2022.

Financial statements of Cone Motors Limited (CML) for the year ended 31 July 2022 are under preparation. Following matter is under consideration:

At year-end, certain orders against which the customers have paid full amount in advance are still undelivered. These orders were booked at old prices but production cost of these vehicles have increased enormously due to fluctuation in exchange rates and inflation in local market.

CML can cancel these orders by refunding the full amount alongwith additional penalty of Rs. 85 million but would result in loss of reputation and goodwill in the market. Therefore, CML is considering to fulfil these orders on their delivery dates in October 2022 which would result in loss of Rs. 150 million.

CML's management is of the view that loss on these orders is a future loss and does not need to be accounted for at year-end.

Required: Comment on the CML's management view about the impact of above matters in the financial statements for the year ended 31 July 2022, in accordance with the IFRSs.

► **Answer:**

CML's management view is incorrect as per IAS 37. This is an onerous contract because the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. The unavoidable costs under the contract reflect the least net cost of exiting from the contract which is the lower of the cost of fulfilling it i.e. Rs. 150 million and any penalties arising from failure to fulfil it i.e. Rs. 85 million. So CL should recognize a provision of Rs. 85 million irrespective of the management's decision of fulfilling the contract.

► **Example 91:**

On 1 January 2020, Uranium Limited (UL) completed installation of a manufacturing plant which will be required to be dismantled at the end of its eight years' useful life. UL paid Rs. 3,000 million for the plant. On 1 January 2020, it was estimated that the cost of dismantling would amount to Rs. 500 million. Applicable discount rate at the time of initial estimate of dismantling cost was 10% per annum.

Estimates of dismantling cost and applicable discount rate were reviewed as at 31 December 2021 and were revised to Rs. 475 million and 15% per annum respectively.

The fair value of the plant including dismantling cost as at 31 December 2022 was assessed at Rs. 1,900 million.

UL has a policy to subsequently measure plant using the revaluation model and provide depreciation on straight line basis.

Required: Prepare relevant extracts from UL's statement of profit or loss and other comprehensive income for the year ended 31 December 2022 and statement of financial position on that date. (Show comparative figures)

► *Answer:*

Uranium Limited

Statement of comprehensive income (extracts)		2022	2021
For the year ended 31 December 2022		Rs. m	Rs. m
Depreciation		(404.16)	(404.16)
Finance cost		(30.80)	(25.66)
Revaluation loss	W1	(56.72)	0
Other comprehensive income			
Revaluation gain (loss) / Change in provision	W1	(64.07)	76.88
Statement of financial position (extracts)		2022	2021
As at 31 December 2022		Rs. m	Rs. m
<u>Non-current assets</u>			
Plant		1,900	2,424.94
<u>Liabilities</u>			
Provision for dismantling		236.16	205.36
<u>Equity</u>			
Revaluation surplus		0	76.88

Working / Calculation:

Particulars	PPE	Provision	Revaluation		Other	Working
			OCI (RS)	PL	PL	
	Rs. million					
1 Jan 2020	3,233.25	233.25				[3,000 + 500 x 1.10 ⁻⁸]
Depreciation	(404.16)				(404.16)	[3,233.25 / 8 years]
Interest		23.33			(23.33)	[233.25 x 10%]
31 Dec 2020	2,829.10	256.58				
Depreciation	(404.16)				(404.16)	[2,829.10 / 7 years]
Interest		25.66			(25.66)	[256.58 x 10%]
31 Dec 2021	2,424.94	282.24				
Decrease in provision		(76.88)	76.88			
31 Dec 2021	2,424.94	205.36	76.88			[475 x 1.15 ⁻⁶]
Depreciation	(404.16)				(404.16)	[2,424.94 / 6 years]
Transfer to RE			(12.81)			[76.88 / 6 years]
Interest		30.80			(30.80)	[205.36 x 15%]
31 Dec 2022	2,021	236.16	64.07			
Revaluation loss	(121)		(64.07)	(56.72)		(balancing)
31 Dec 2022	1,900	236.16	0	(56.72)		

► **Example 92:**

On 1 January 2020, Uraninite Limited (UL) completed installation of a manufacturing plant which will be required to be dismantled at the end of its eight years' useful life. UL paid Rs. 3,000 million for the plant. On 1 January 2020, it was estimated that the cost of dismantling would amount to Rs. 500 million. Applicable discount rate at the time of initial estimate of dismantling cost was 10% per annum.

Estimates of dismantling cost and applicable discount rate were reviewed as at 31 December 2021 and were revised to Rs. 475 million and 15% per annum respectively.

UL has a policy to subsequently measure plant using the cost model and provide depreciation on straight line basis.

Required: Prepare relevant extracts from UL's statement of profit or loss and other comprehensive income for the year ended 31 December 2022 and statement of financial position on that date. (Show comparative figures)

► **Answer:****Uraninite Limited**

Statement of comprehensive income (extracts)	2022	2021
For the year ended 31 December 2022	Rs. m	Rs. m
Depreciation	(391.34)	(404.16)
Finance cost	(30.80)	(25.66)
Statement of financial position (extracts)	2022	2021
As at 31 December 2022	Rs. m	Rs. m
Non-current assets		
Plant	1,956.72	2,348.06
Liabilities		
Provision for dismantling	236.16	205.36

Working / Calculation:

Particulars	PPE	Provision	Other	Working
			PL	
	Rs. million			
1 Jan 2020	3,233.25	233.25		[3,000 + 500 x 1.10 ⁻⁸]
Depreciation	(404.16)		(404.16)	[3,233.25 / 8 years]
Interest		23.33	(23.33)	[233.25 x 10%]
31 Dec 2020	2,829.10	256.58		
Depreciation	(404.16)		(404.16)	[2,829.10 / 7 years]
Interest		25.66	(25.66)	[256.58 x 10%]
31 Dec 2021	2,424.94	282.24		
Decrease in provision	(76.88)	(76.88)		[475 x 1.15 ⁻⁶]
31 Dec 2021	2,348.06	205.36		
Depreciation	(391.34)		(391.34)	[2,348.06 / 6 years]
Interest		30.80	(30.80)	[205.36 x 15%]
31 Dec 2022	1,956.72	236.16		

► **Example 93:**

For the purpose of this question, assume that the date today is 1 September 2023.

Jahlar Cosmetics Limited (JCL) is currently in the process of finalising its financial statements for the year ended 30 June 2023.

In May 2023, JCL was on the verge of launching an innovative line of beauty products. However, the launch was cancelled due to alarming reports that employees involved in internal testing of the new cosmetics experienced adverse skin reactions, ranging from minor irritations to serious allergic responses. The situation worsened as news of these reactions spread through media outlets, highlighting potential risks, damaging JCL's reputation, and causing public doubt.

As a result of the above, JCL has incurred a net loss for the first time. Additionally, JCL has encountered the following matters:

- (i) In July 2023, affected employees filed a lawsuit against JCL for damages. Legal advisors anticipate that these suits could result in potential liability of Rs. 120 million. However, due to legal complexities, the actual payout remains uncertain. The legal advisors estimate a 70% likelihood of incurring the full liability and a 30% likelihood of incurring only half the amount.
- (ii) In June 2023, the JCL's board of directors approved a detailed restructuring plan involving the reduction of operations in two cities due to high cost and low profitability. The plan was announced and communicated to the employees in the same month. The implementation of this plan will span over a six-months period, resulting in employee redundancies, lease termination charges, and retraining cost amounting to Rs. 150 million, Rs. 24 million and Rs. 18 million, respectively. Further, an expected disposal of assets is projected to generate a gain of Rs. 18 million.
- (iii) As of 30 June 2023, JCL was in breach of one of the loan covenants related to revenue target, which would have led to the entire long term loan becoming payable immediately. However, JCL contacted the banks and obtained a waiver from them for compliance with the given covenant on 26 July 2023.
- (iv) JCL plans to raise finance from the issuance of bonds in October 2023. Due to the challenges, it is estimated that the bond issuance will yield Rs. 100 million less than the original estimates. Further, the interest rates would need to be increased by 2% per annum to make the issue possible. This additional interest would result in an annual loss of Rs. 14 million, which has a present value of Rs. 70 million.

Required: Discuss the effect of the above matters on JCL's financial statements for the year ended 30 June 2023.

► **Answer:****Part (i)**

JCL has a present obligation as a result of a past event i.e., skin reactions due to testing. It is probable that an outflow of resources would be required as both possibilities would result in payment of damages. A reliable estimate can be made. As it is a single instance, the most likely outcome of 70% should be considered. So, JCL should make a provision for Rs. 120 million.

Part (ii)

A constructive obligation for restructuring has arisen as the formal plan has been approved by the Board, and has been communicated to all concerned before the end of reporting period. Therefore, a provision of Rs. 174 (150+24) million should be recognized comprising of redundancy costs and lease termination charges. Retraining cost would not be included in the provision for restructuring, as it relates to future conduct of the business. Gains on the expected disposal of assets are not taken into account in measuring a restructuring provision, even if the sale of assets is envisaged as part of the restructuring process.

Part (iii)

JCL shall classify the bank loan as current since JCL does not have an unconditional right to defer settlement of the loan for at least twelve months after the reporting period. Obtaining the waiver after the year-end is a non-adjusting event and will not change the classification of loan from current to non-current liabilities. However, the fact of obtaining waiver may be disclosed in the notes.

Part (iv)

The issuance of bond at a lower amount and increase in finance cost represents future operating losses for which provision shall not be recognized in the financial statements for the year ended 30 June 2023.

► **Example 95:**

For the purpose of this question, assume that the date today is 1 September 2024.

Weekday Limited (WL) is currently in the process of finalizing its financial statements for the year ended 30 June 2024. The following matters are under consideration:

- (i) On 20 June 2024, WL experienced a significant cybersecurity breach, resulting in the loss of customers' critical data. WL made a public announcement of the breach on 31 August 2024. The full extent of the breach and its financial impact is not yet known, but it is expected to be substantial and will result in significant claims by customers for damages in the coming months.
- (ii) On 29 June 2024, Sigma Tech (ST), a key supplier of WL, had gone bankrupt, potentially disrupting the supply chain for several critical components used by WL. The bankruptcy of ST is resulting in significant delays and additional costs for WL to source alternative suppliers. Financial impact of these potential delays and additional costs is expected to be Rs. 16 million of which Rs. 12 million has already been incurred in the past two months.
- (iii) WL sells Product Leo with a one-year warranty. The warranty arrangement with the manufacturer i.e. Kappa Tech (KT) is as follows:
 - If a defect arises in the first six months, WL is responsible to customers for repairing or replacing the items. WL then submits the details of warranty claims to KT, which reimburses 75% of the costs incurred by WL. Historically, KT has always honoured these claims.
 - If a defect arises in the next six months, KT is responsible to customers for repairing or replacing the items. However, KT charges 10% of the costs incurred, to WL.

The average costs of repairing each minor and major defect are Rs. 10,000 per unit and Rs. 55,000 per unit respectively. The probability of a claim arising for a unit sold is as follows:

Nature of defect	First six months	Next six months
Minor	4%	7%
Major	5%	11%

During the year ended 30 June 2024:

- WL sold a total of 20,400 units of the Product Leo.
- the total repair costs for first six months' claims incurred by WL were Rs. 36 million, of which Rs. 27 million has been recovered from KT.
- KT has claimed Rs. 7 million from WL for next six months' claims.

Required: Discuss how the above issues should be dealt with in the financial statements of WL for the year ended 30 June 2024. Support your answers in the context of relevant IFRSs.

► **Answer:****Part (i)**

On 30 June 2024, WL has a present obligation as a result of the breach which has occurred before 30 June though public announcement has been made after 30 June 2024. The full extent of the financial impact is unknown, it is expected to be substantial and might result in claims by customers. So, a provision cannot be made. It should be disclosed as a contingent liability in the notes to the financial statements, describing the nature of the event and an estimate of its financial effect, if possible, or state that an estimate cannot be made.

Part (ii)

Potential delays and additional costs for WL are resulting from the bankruptcy of the supplier but there was no present obligation for these as at 30 June 2024. These are future operating losses for which the provision should not be recognized.

Part (iii)

A provision for warranties should be recognized when the entity has a present obligation as a result of a past event (sale of product Leo). WL is liable for the entire amount of warranty costs for claims arising in the first six months, although WL will be reimbursed 75% of the cost by KT. WL should recognize a provision for warranty claims arising in the first six months amounting to Rs. 28.26 million computed as follows:

Nature of defect		Rs. in million
Minor	$20,400 \times 4\% \times 10,000$	8.16
Major	$20,400 \times 5\% \times 55,000$	56.10
		64.26
Already claimed		(36.00)
Provision to be made		28.26

As KT has always honoured the claims for reimbursement, so it is virtually certain that these would be received. WL should recognize a receivable for the reimbursements amounting to Rs. 21.2 million ($28.26 \times 75\%$). This receivable should be treated as separate assets in the statement of financial position, however, in the statement of profit or loss, the expense related to warranty claims may be netted off with the amount recognized for reimbursement. WL should also recognize a provision for warranty claims arising in the next six months amounting to Rs. 6.77 million computed as follows:

Nature of defect		Rs. in million
Minor	$20,400 \times 7\% \times 10,000$	14.28
Major	$20,400 \times 11\% \times 55,000$	123.42
		137.70
WL's share of cost	$137.7 \times 10\%$	13.77
Already paid		(7.00)
Provision to be made		6.77

8. OBJECTIVE BASED Q&A

- 01.** Iron Limited (IL) deals extensively with foreign entities, and its financial statements reflect these foreign currency transactions. After SFP date, and before the “date of authorization” of the issuance of financial statements, there were abnormal fluctuations in foreign currency rates. IL should:
- Adjust the foreign exchange year-end balances to reflect the abnormal adverse fluctuations in foreign exchange rates.
 - Adjust the foreign exchange year-end balances to reflect all abnormal fluctuations in foreign exchange rates (and not just abnormal movements).
 - Disclose the post-SFP event in the notes as a non-adjusting event.
 - Ignore the post-SFP event.
- 02.** Which of the following events arising after the year end is an adjusting event?
- The discovery of fraud or error which shows that financial statements are incorrect.
 - Announcement of a plan to discontinue an operation.
 - Destruction of a major production plant by fire.
 - Restructuring of a major loan
- 03.** Which TWO of the following events which occur after the reporting date of an entity but before the financial statements are authorised for issue are classified as adjusting events in accordance with IAS 10 Events after the Reporting Period?
- A change in tax rate announced after the reporting date, but affecting the current tax liability
 - The discovery of a fraud which had occurred during the year
 - The determination of the sale proceeds of an item of plant sold before the year end
 - The destruction of a factory by fire
- 04.** Which one of the following events taking place after the year end but before the financial statements were authorised for issue would require adjustment in accordance with IAS 10?
- Inventory held at year end was destroyed by flooding in the warehouse
 - The board of directors announced a major restructuring
 - Half the inventory held at the year-end was discovered to have faults rendering them unsalable
 - The value of company’s investment fell sharply.
- 05.** At year end of 31 December 20Y1, Afzal Limited (AL) carried a receivable from Zia Limited (ZL), a major customer at Rs. 10 million. The proposed date of authorisation of financial statements is February 16, 20Y2. Zia Limited declared bankruptcy on February 14, 20Y2. AL will:
- Disclose the fact that ZL has declared bankruptcy in notes to the financial statements
 - Make a provision of Rs. 10 million in financial statements (as opposed to disclosure in the notes)
 - Ignore the event and wait for outcome of the bankruptcy because event took place after the year end
 - Reverse the sale pertaining to this receivable in the comparatives for the prior period and treat this as an error in accordance with IAS 8

- 06.** Which two of the following events after the statement of financial position (SFP) date would normally require adjustment in the amount recognised in the financial statements in accordance with IAS 10?
- (a)** Determination of cost of assets purchased before the SFP date
 - (b)** Announcement of changes in tax rate
 - (c)** Declaration of dividend on ordinary shares
 - (d)** Bankruptcy of a customer with outstanding amount at the balance sheet date
- 07.** Which of the following would NOT be valid reason for recording a provision?
- (a)** A company has a policy of cleaning up any environmental contamination caused by its operations but is not legally obliged to do so.
 - (b)** A company is leasing an office building for which it has no further use. However, it is tied into the lease for another year.
 - (c)** A company is closing down a division. The Board has prepared detailed closure plans which have been communicated to customers and employees.
 - (d)** A company has acquired a machine which requires a major overhaul every three years. The cost of the first overhaul is reliably estimated at Rs. 1,200,000.
- 08.** Which of the following statements are correct in accordance with IAS 37 Provisions, contingent liabilities and contingent assets?
- (i)** Provisions should be made for both constructive and legal obligations.
 - (ii)** Discounting may be used when estimating the amount of a provision.
 - (iii)** A restructuring provision must include the estimated costs of retraining or relocating continuing staff.
 - (iv)** A restructuring provision may only be made when a company has a detailed plan for the restructuring and has communicated to interested parties a firm intention to carry it out.
- (a)** All four statements are correct
 - (b)** (i), (ii) and (iv) only
 - (c)** (i), (iii) and (iv) only
 - (d)** (ii) and (iii) only
- 09.** Talal Limited (TL) year end is 30 September 20X4 and the following potential liabilities have been identified:
- Which TWO of the following should TL recognise as liabilities as at 30 September 20X4?
- (a)** The signing of a non-cancellable contract in September 20X4 to supply goods in the following year on which, due to a pricing error, a loss will be made.
 - (b)** The cost of a reorganisation which was approved by the board in August 20X4 but has not yet been implemented, communicated to interested parties or announced publicly
 - (c)** A company is closing down a division. The Board has prepared detailed closure plans which have been communicated to customers and employees.
 - (d)** The balance on the warranty provision which related to products for which there are no outstanding claims and whose warranties had expired by 30 September 20X4.

- 10.** The following information has been extracted from the records of Simple Limited (SL):
1. SL operates a chemical plant which has polluted the surrounding countryside. The Board of Directors has decided to clean up the environmental damage. This decision has been published in the local press on 15 June 20X8. However, SL is not legally required to clean up the environmental damage.
 2. SL has decided to close down one of its operating segment. However, the decision was made public after 30 June 20X8.

In the financial statements for the year ended 30 June 20X8, SL should recognize a provision for the best estimate of costs in respect of:

- (a) (1) only
- (b) (2) only
- (c) Neither (1) nor (2)
- (d) Both (1) and (2)

- 11.** In a review of its provisions for the year ended 31 March 20X5, entity's assistant accountant has suggested the following accounting treatments:
- (i) Based on past experience, a Rs. 200,000 provision for unforeseen liabilities arising after the year end.
 - (ii) The partial reversal (as a credit to the statement of profit or loss) of the accumulated depreciation provision on an item of plant because the estimate of its remaining useful life has been increased by three years.

Which of the above suggested treatments is/are permitted by IFRS Standards?

- (a) (i) only
- (b) (ii) only
- (c) (i) and (ii) both
- (d) Neither (i) nor (ii)

- 12.** Canon Limited (CL) is being sued by a customer for Rs. 2 million for breach of contract over a cancelled order. CL has obtained legal opinion that there is a 20% chance that CL will lose the case. Accordingly, CL has provided Rs. 400,000 (Rs. 2 million × 20%) in respect of the claim. The unrecoverable legal costs of defending the action are estimated at Rs. 100,000. These have not been provided for as the case will not go to court until next year.

What is the amount of the provision/other liability that should have been made by CL in respect of above information?

- (a) Rs. 2,000,000
- (b) Rs. 400,000
- (c) Rs. 100,000
- (d) Rs. 500,000

13. During the year Platinum Limited acquired an iron ore mine at a cost of Rs. 600 million. In addition, when all the ore has been extracted (estimated ten years' time) the company will face estimated costs for landscaping the area affected by the mining that have a present value of Rs. 200 million. These costs would still have to be incurred even if no further ore was extracted.

At which amount the mine should be recognised?

- (a) Rs. 200 million
(b) Rs. 400 million
(c) Rs. 600 million
(d) Rs. 800 million
14. Titanium Limited (TL) is preparing its financial statements for the year ended 30 September 20X7. TL is facing a number of legal claims from its customers with regards to a faulty product sold. The total amount being claimed is Rs. 3.5 million. TL's lawyers say that the customers have an 80% chance of being successful. According to IAS 37 Provisions, Contingent Liabilities and Contingent Assets, what amount, if any, should be recognised in respect of the above in TL's statement of financial position as at 30 September 20X7?
- (a) Rs. Nil
(b) Rs. 0.7 million
(c) Rs. 2.8 million
(d) Rs. 3.5 million
15. Alpha Limited has a year end of 31 December 20X4. On 15 December 20X4 the directors publicly announced their decision to close an operating unit and make a number of employees redundant. Some of the employees currently working in the unit will be transferred to other operating units within Alpha Limited.

The estimated costs of the closure are as follows:	Rs. 000
Redundancy costs	800
Lease termination costs	200
Relocation of continuing employees to new locations	400
Retraining of continuing employees	300
	1,700

What is the amount of provision for closure/restructuring that should be recognised?

- (a) Rs. 800,000
(b) Rs. 1,000,000
(c) Rs. 1,400,000
(d) Rs. 1,700,000

16. On 1 October 20X3, X Limited commenced drilling for oil in an undersea oilfield. The extraction of oil causes damage to the seabed which has a restorative cost (ignore discounting) of Rs. 10,000 per million barrels of oil extracted. X Limited extracted 250 million barrels of oil in the year ended 30 September 20X4.

X Limited is also required to dismantle the drilling equipment at the end of its five-year licence. This has an estimated cost of Rs. 30 million on 30 September 20X8. X Limited's cost of capital is 8% per annum and Re. 1 has a present value of 68 paise in five years' time.

What is the total provision (extraction plus dismantling) which X Limited would report in its statement of financial position as at 30 September 20X4 in respect of its oil operations?

- (a) Rs. 20.400 million
- (b) Rs. 22.032 million
- (c) Rs. 22.500 million
- (d) Rs. 24.532 million

17. A customer filed a suit against Maria Limited for damages of Rs. 300,000 in relation to a delivery of goods made on June 1, 20Y2 which were of poor quality. This was an isolated incident with a fault with one of the production machines and the goods should not have been delivered to the customer. The company's legal advisor is of this opinion that claim is highly likely to be successful. Such cases are normally decided at 40% to 60% of the amount claimed. Legal advisor is trying his best to settle the matter out of court and his best estimate of amount of damages is Rs. 100,000.

At what amount the provision should be recognised in the financial statements for the year ended 30 June 20Y2?

- (a) Rs. Nil
- (b) Rs. 100,000
- (c) Rs. 150,000 (i.e. 50% being average of 40% and 60%)
- (d) Rs. 300,000

18. During June 20Y2 Jazib Limited (JL) entered into a contract for supply of 5000 units of product J to customer in September 20Y2 at a fixed per unit price of Rs. 25. At that time purchase cost to JL was Rs. 20 per unit thus a profit of Rs. 5 per unit was expected. In last week of June, as a result of adverse movement in market purchase price of product J increased to Rs. 28 per unit. However JL cannot change the committed sale price. At year end, JL has not yet purchased any of product J.

At what amount the provision should be recognised in the financial statements for the year ended 30 June 20Y2?

- (a) Rs. Nil
- (b) Rs. 15,000
- (c) Rs. 125,000
- (d) Rs. 140,000

19. During the year Kaghan Limited (KL) sold a special product with one-year warranty with its luxury products. If minor repairs were required for all goods sold, the cost would be Rs. 150,000, compared to Rs. 450,000 if major repairs were required for all goods. KL estimates that 20% of the goods sold will require minor repairs and 5% will require major repairs. No provision was recognized in respect of warranties as no goods had been returned by year end.

At what amount the provision should be recognised in the financial statements for the year ended 30 June 20Y2?

- (a) Rs. Nil
 - (b) Rs. 30,000
 - (c) Rs. 52,500
 - (d) Rs. 600,000
20. Which of the following statements is incorrect in relation to IFRIC 1 Changes in existing decommissioning, restoration and similar liabilities?
- (a) The periodic unwinding of the discount shall be recognised in profit or loss as a finance cost as it occurs.
 - (b) IAS 37 contains requirements on how to measure decommissioning, restoration and similar liabilities. IFRIC 1 provides guidance on how to account for the effect of changes in the measurement of existing decommissioning, restoration and similar liabilities.
 - (c) Once the related asset has reached the end of its useful life, all subsequent changes in the liability shall be recognised in profit or loss as they occur.
 - (d) Capitalisation of interest is permitted in accordance with IAS 23.
21. Which TWO of the following are non-adjusting events?
- (a) Directors approved the plan to close down the major segment before year-end but announcement to public was made after year-end.
 - (b) A company made an out of court settlement with a customer after year-end, for defective products supplied before year-end.
 - (c) The discovery of fraud after year-end which shows that financial statements are incorrect.
 - (d) A change in income tax rate announced after year-end.
22. Which TWO of the following are the adjusting events?
- (a) A company made an out of court settlement with a customer after reporting date, for a case that was lodged before the reporting date
 - (b) A decline in the fair value of investments between the end of the reporting period and the date when the financial statements are authorized for issue
 - (c) A company made a provision for damages in respect of a pending suit, which was decided by the court after the reporting date with the same amount of damages
 - (d) Directors approved the plan to close down the major segment before the reporting date but the announcement to public was made after the reporting date

ANSWERS

01.	(c)	This is non-adjusting event, however, being material, it should be disclosed.
02.	(a)	The fraud existed at year end, it was only discovered after the year end.
03.	(b) & (c)	The change in tax rate and the fire will be non-adjusting events as the conditions did not exist at the reporting date.
04.	(c)	The faults in inventory existed at year end. All other events have taken place after the year-end.
05.	(b)	This is an adjusting event as bankruptcy circumstances are usually not created overnight unless there is clearly some event after year-end which caused the bankruptcy specifically.
06.	(a) & (d)	The information received in these two circumstances indicates the existence of condition at year-end, therefore, an adjustment will be recognised.
07.	(d)	The cost of the overhaul will be capitalised when it takes place. No obligation exists before the overhaul is carried out. The other options would all give rise to valid provisions.
08.	(b)	A restructuring provision must not include the costs of retraining or relocating staff.
09.	(a) & (c)	In (b) the obligation does not exist as it has not been communicated to those affected by it. In (d) there is no obligation as warranty period has expired.
10.	(a)	In (2) the decision was made public after year end, so it is non-adjusting event.
11.	(d)	In case of (i), there is no present obligation arising from past event and in case of (ii), no adjustment is needed for previously recognised accumulated depreciation, the only effect would be decreased depreciation from current year due to increase in useful life.
12.	(c)	Loss of the case is not 'probable', so no provision is made, but the legal costs will have to be paid so should be provided for.
13.	(d)	Rs. 600 million + Rs. 200 million = Rs. 800 million
14.	(d)	The amount payable relates to a past event (the sale of faulty products) and the likelihood of pay-out is probable (i.e. more likely than not). Hence, the full amount of the pay-out should be provided for.
15.	(b)	The costs associated with ongoing activities (relocation and retraining of employees) should not be provided for.
16.	(d)	Extraction provision at 30 September 20X4 is Rs. 2.5 million (250×10). Dismantling provision at 1 October 20X3 is Rs. 20.4 million ($30,000 \times 0.68$). This will increase by an 8% finance cost by 30 September 20X4 = Rs. 1.632 million. Hence, total provision is Rs. 24.532 million
17.	(b)	There is a present obligation to pay damages as a result of past events as faulty goods were sold to customers. Moreover, outflow is probable as claim is highly likely to be successful. Therefore, a provision for damages should be recognized at Rs. 100,000 being the best estimate for expenditure.

18.	(b)	Purchase cost has increased to Rs. 28 but JL is bound to sell at Rs. 25 therefore it becomes an onerous contract. Therefore, a provision for loss on onerous contract should be recognized at Rs. 15,000 $[(28-25) \times 5,000]$.
19.	(c)	There is a present obligation to incur repair cost as a result of past events as goods were sold on one – year – warranty. Moreover, outflow is probable at 25% of goods are expected to return for warranty claim. Therefore a provision for warranty repairs should be recognized at Rs. 52,500 $[Rs. 150,000 \times 20\% + Rs. 450,000 \times 5\%]$.
20.	(d)	Capitalisation of borrowing costs is not permitted.
21.	(a) and (d)	Directors approved the plan to close down the major segment before year-end but announcement to public was made after year-end. A change in income tax rate announced after year-end.
22.	(a) and (c)	A company made an out of court settlement with a customer after reporting date, for a case that was lodged before the reporting date A company made a provision for damages in respect of a pending suit, which was decided by the court after the reporting date with the same amount of damages.

STICKY NOTES

Events after the reporting period are those events, favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements are authorised for issue.

Two types of events can be identified:

- a) **Adjusting events:** those that provide evidence of conditions that existed at the end of the reporting period. These are **recognised/adjusted** in financial statements and relevant disclosures are updated.
- b) **Non-adjusting events:** those that are indicative of conditions that arose after the reporting period. These are not adjusted/recorded. However, **disclosure** is required if such events are material.

Provision is a liability of uncertain timing or amount.

Recognition Criteria:

- Present obligation (legal or constructive)
- Probable outflow of resources
- Reliable estimate

Measurement (best estimate)

- Expected value or most likely outcome
- Time value of money
- Impact of future events

Contingent liabilities (possible obligations) are not recognised, but are disclosed unless the possibility of an outflow of economic resources is remote.

Contingent assets (possible asset) are not recognised, but are disclosed where an inflow of economic benefits is probable.

Specific Scenarios

- Future operating losses
- Onerous contracts
- Restructuring
- Future repairs and replacements
- Warranty claims
- Loan guarantees / joint obligations
- Decommissioning, restoration and similar liabilities

FINANCIAL INSTRUMENTS

IN THIS CHAPTER:

AT A GLANCE

SPOTLIGHT

1. Introduction
2. Classification
3. Measurement
4. Impairment of financial assets
5. Comprehensive Examples
6. Objective Based Q&A

AT A GLANCE

Financial instruments are contracts that give rise to financial asset of an entity and financial liability or equity instrument of another entity.

Financial instruments are recognised, when, and only when, the entity becomes party to the contractual provisions of the instrument.

Financial assets may be investment in equity instruments or debt instruments. Investment in equity instrument is classified into two classifications: fair value through other comprehensive income or fair value through profit or loss. Investments in debt instruments is classified on the basis of business model and cash flow characteristics of the instrument, with an additional classification of 'at amortised cost'.

Financial liabilities are usually measured at amortised cost with few exceptions when these are measured at fair value.

All financial instruments are initially measured at fair value plus or minus, in the case of a financial asset or financial liability respectively, transaction costs. Transaction costs are expensed in case of fair value through profit or loss classification.

Subsequent measurement is based on classification and accordingly affects profit or loss or other comprehensive income.

The impairment requirements of IFRS 9 are applicable to debt instruments measured either at amortized cost or at fair value through other comprehensive income and entities are required to determine a loss allowance for these financial assets. The changes in the loss allowance, whether increases or decreases, are recognized in profit or loss.

The loss allowance should correspond to:

- 12-month expected credit losses if the credit risk has not significantly increased.
- Lifetime expected credit losses if the credit risk has significantly increased.

1. INTRODUCTION

1.1 Relevant IFRSs

The rules on financial instruments are set out in three accounting standards:

- IFRS 9: Financial Instruments
- IAS 32: Financial Instruments: Presentation
- IFRS 7: Financial Instruments: Disclosure

1.2 Definitions [IAS 32: 11]

A “**financial instrument**” is a contract that gives rise to both:

- A financial asset in one entity; and
- A financial liability or equity instrument in another entity.

A “**financial asset**” is any asset that is:

- Cash; or
- An equity instrument of another entity; or
- A contractual right to receive cash or another financial asset from another entity; or
- A contractual right to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity.

Examples include:

- cash in hand or at bank;
- investment in equity shares;
- receivables;
- investment in debentures; and
- favourable forward currency contracts.

A “**financial liability**” is any liability that is :

- A contractual obligation to deliver cash or another financial asset to another entity; or
- A contractual obligation to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity.

Examples include:

- Payables;
- bank loans;
- debentures issued; and
- unfavourable forward currency contracts.

An “**equity instrument**” is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities. Examples include equity shares and equity share options issued by an entity.

Note: Derivatives are not part of the syllabus at CAF Level.

1.3 Substance over form [IAS 32: 15]

Some financial instruments have the legal form of equity but are, in substance, liabilities. For example, an issuer (company) has contractual obligation to deliver cash in case of redeemable preference shares.

Therefore, dividend on redeemable preference shares is treated as finance cost in profit or loss while dividend on ordinary shares is presented in statement of changes in equity.

► *Example 01:*

Item	Financial instrument or otherwise
Trade payable	A financial liability (to be settled in cash)
Investment in loan notes of another entity	A financial asset
Bank loan obtained	A financial liability
Ordinary shares issued	An equity instrument
Irredeemable preference shares issued	An equity instrument
Unfavourable forward currency contract	A financial liability
Redeemable preference shares issued	A financial liability
Investment in redeemable preference shares	A financial asset
Prepaid rent	A non-financial asset
Current tax payable	A non-financial liability (statutory obligation)
Inventory	A non-financial asset

1.4 Recognition [IFRS 9: 3.1.1]

An entity shall recognize a financial asset or a financial liability in its statement of financial position, when, and only when, the entity becomes party to the contractual provisions of the instrument.

A financial asset might be an investment in debt or in equity.

2. CLASSIFICATION

2.1 Financial assets: investment in equity instruments [IFRS 9: 4.1]

The financial assets which are equity instruments of another entity are classified as follows:

Classification	Requirements
Amortised cost	Not applicable.
Fair value through OCI	This classification applies when equity instrument is not held for trading and is only possible (at the choice of the entity) at initial recognition and irrevocable (i.e. subsequent reclassification is not allowed).
Fair value through PL	A financial asset must be measured at fair value through profit or loss if it is held for trading or if it is not measured at fair value through other comprehensive income.

► **Example 02:**

Identify the classification of following financial assets:

- Investments in shares held for trading purposes.
- Investment in equity shares. The entity has no intention of selling these shares in foreseeable future.

► **ANSWER:**

- Fair value through profit or loss
- Fair value through other comprehensive income

2.2 Financial assets: investment in debt instruments [IFRS 9: 4.1]

The financial assets which are debt instruments of another entity are classified as follows:

Classification	Requirements
Amortised cost (AC)	A financial asset is classified at amortized cost if both of the following conditions are met: - the asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows (i.e. no intention to trade in the instruments); and - the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding (Investments in equity instruments e.g. ordinary shares fail this test since they do not offer contractual cash flows at all, hence equity investments are never classified as financial assets at amortized cost). Exception: Even if both of above requirements are met, a financial asset may be designated as FVPL instead, if classifying at AC would have caused an accounting mismatch.
Fair value through OCI	A financial asset (debt instrument) is classified at fair value through other comprehensive income if both of the following conditions are met:

Classification	Requirements
	- the asset is held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets; and - the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding. Exception: Even if both of above requirements are met, a financial asset may be designated as FVPL instead, if classifying at FVOCI would have caused an accounting mismatch.
Fair value through PL	A financial asset must be measured at fair value through profit or loss unless it is measured at amortized cost or at fair value through other comprehensive income.

► **Example 03:**

XYZ Limited makes a large bond issue to the market. Three companies (A Limited, B Limited and C Limited) each buy identical Rs. 10,000,000 bonds. The following further information is available:

- A Limited holds bonds for the purpose of collecting contractual cash flows to maturity.
- B Limited holds bonds for the purpose of collecting contractual cash flows but sells them on the market when prices are favourable.
- C Limited buys bonds to trade in them.

Required:

How A Limited, B Limited and C Limited should classify their financial asset based on their respective business model?

► **ANSWER:**

- Classification by A Limited: Amortised Cost
- Classification by B Limited: Fair value through OCI
- Classification by C Limited: Fair value through PL

► **Example 04:**

Identify the classification of following financial assets?

- Investment in interest bearing debt instruments. The instrument is redeemable in five years. The intention is to collect cash flows (which are interest and principal amounts only).
- Investment in interest bearing debt instruments. The instrument is redeemable in five years. The intention is to collect cash flows (which are interest and principal amounts only). However, the entity may sell the loan notes earlier if any good offer is received.
- Investment in loan notes. The objective is to collect contractual cash flows which consist of interest, changes in oil prices in next five years and principal amount at the end of year 5.
- Investment in loan notes. The objective is to collect contractual cash flows which consist of interest, changes in oil prices in next five years and principal amount at the end of year 5. However, the entity may sell the loan notes earlier if any good offer is received.

► **ANSWER:**

- a) Amortised Cost (Business model is to hold for collection of cash flows solely consisting of principal and interest)
- b) Fair value through OCI (Business model is to hold for collection of cash flows solely consisting of principal and interest or to sell)
- c) Fair value through PL (contractual cash flows also include payments other than principal and interest)
- d) Fair value through PL (contractual cash flows also include payments other than principal and interest)

2.3 Financial liabilities [IFRS 9: 4.2]

Classification	Requirements
Amortised cost	All financial liabilities are measured at amortised cost with certain exceptions including those measured at fair value. The other exceptions are not examinable at this level.
Fair value	Some financial liabilities are measured at fair value, for example, those held for trading and those measured at fair value through profit or loss to eliminate accounting mismatch.

► **Example 05:**

Identify the classification of following financial liabilities?

- a) A 12% bank loan obtained by A Limited payable in 5 years' time.
- b) 8% loan notes issued by C Limited.
- c) A short term currency swaps agreement entered into by B4-Bank Limited which is currently unfavourable. These types of transactions are usual feature of B4-Bank Limited's business.
- d) Trade payable.

► **ANSWER:**

- a) Amortised Cost
- b) Amortised Cost
- c) Fair value
- d) Amortised Cost

3. MEASUREMENT

3.1 Transaction costs [IFRS 9: 5.1.1, B5.4.8, Appendix A]

Transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability. Examples of transaction costs are:

- fees and commissions paid to agents, advisers, brokers and dealers;
- levies by regulatory agencies and securities exchanges;
- transfer taxes and duties;
- credit assessment fees;
- registration charges and similar costs.

An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument. Examples of costs that do not qualify as transaction costs are financing costs, internal administration costs and holding costs.

Transaction costs are expensed in case of fair value through profit or loss classification. Non-transaction costs are always charged to profit or loss. For all financial instruments that are not measured at fair value through profit or loss, the treatment of transaction costs is made on an instrument-by-instrument basis as follows:

- Fair value of financial asset plus transaction cost
- Fair value of financial liability minus transaction cost

3.2 Measurement: financial assets (equity instruments) [IFRS 9: 5.1 & 5.2]

The financial assets which are equity instruments of another entity are measured as follows:

Classification	Requirements
Amortised cost	Not applicable.
Fair value through OCI	These are initially measured at fair value plus transaction costs and then subsequently measured at fair value. The changes in fair value are recognised in other comprehensive income and accumulated in fair value reserve. Dividend earned is recognised in profit or loss.
Fair value through PL	These are measured at fair value initially and subsequently. The change in fair value is recognised in profit or loss. Dividend earned is also recognised in profit or loss.

Note: Derecognition of financial instruments is specifically excluded in the syllabus.

► Example 06:

An equity investment is purchased for Rs. 30,000 plus 1% transaction costs on 1 January 20X6. It is classified as at fair value through other comprehensive income. At the end of the financial year (31 December 20X6) the investment is revalued to its fair value of Rs. 40,000. On 31 December 20X7, the fair value had declined to Rs. 38,000.

Required: Prepare journal entries from acquisition to 31 December 20X7.

► **ANSWER:**

Date	Particulars	Debit Rs.	Credit Rs.
1 Jan 20X6	Financial asset [Rs. 30,000 + 1%]	30,300	
	Bank		30,300
31 Dec 20X6	Financial asset [Rs. 40,000 – 30,300]	9,700	
	Gain (OCI & FV reserve)		9,700
31 Dec 20X7	Loss (OCI & FV reserve)	2,000	
	Financial asset [Rs. 38,000 – 40,000]		2,000

► **Example 07:**

Momin Limited (ML) purchased 5000 shares for Rs. 100 each on 1st January 2009. Transaction costs are 2% (in both buying and selling). Fair values at different dates are as follows:

1 January 2009	Rs.100
31 December 2009	Rs.108
30 June 2010	Rs.111
31 December 2010	Rs.110

Dividend amounting Rs. 4 per share was declared on 30 June 2010. ML year-end is 31 December.

Required: Prepare necessary entries assuming ML classifies the shares under:

- Fair Value Through PL
- Fair Value Through OCI

► **ANSWER:****Part (a) Classified and measured at fair value through profit or loss**

Date	Particulars	Debit Rs.	Credit Rs.
1 Jan 2009	Financial asset [5,000 shares x Rs. 100]	500,000	
	Profit or loss [Rs. 500,000 x 2%]	10,000	
	Bank		510,000
31 Dec 2009	Financial asset [5,000 x Rs. (108 – 100)]	40,000	
	Gain (profit or loss)		40,000
30 Jun 2010	Dividend receivable [5,000 x Rs. 4]	20,000	
	Dividend income (PL)		20,000
31 Dec 2010	Financial asset [5,000 x Rs. (110 – 108)]	10,000	
	Gain (profit or loss)		10,000

Part (b) Classified and measured at fair value through other comprehensive income			
Date	Particulars	Debit Rs.	Credit Rs.
1 Jan 2009	Financial asset [5,000 x Rs. 100 x 102%]	510,000	
	Bank		510,000
31 Dec 2009	Financial asset [5,000 x Rs. (108 – 102)]	30,000	
	Gain (OCI)		30,000
30 Jun 2010	Dividend receivable [5,000 x Rs. 4]	20,000	
	Dividend income (PL)		20,000
31 Dec 2010	Financial asset [5,000 x Rs. (110 – 108)]	10,000	
	Gain (OCI)		10,000

► **Example 08:**

On 15 October 2016, Rashid Industries Limited (RIL) made the following investments:

Name of Investees	No. of shares	Percentage of shareholding acquired	*Cost of investment (Rs. in million)
Karim Limited (KL)	155,000	4%	20
Bashir Limited (BL)	135,000	2%	65

***including transaction cost**

Investment in KL was irrevocably elected at initial recognition as measured at fair value through OCI.

Investments in BL was designated as measured at fair value through profit or loss.

On 31 December 2016, the market price of shares of KL and BL as on 31 December 2016 was Rs. 80 and Rs. 600 respectively.

RIL's broker normally charges transaction costs of 0.2%.

Required: Explain the accounting treatment of above transactions in accordance with International Financial Reporting Standards.

► **ANSWER:**

Investment in KL

Initial measurement: According to IFRS 9, RIL has made irrevocable election to present subsequent changes in fair value in equity investment in other comprehensive income instead of profit or loss account. Investment in KL would initially be recognized at fair value plus transaction costs i.e. Rs. 20 million.

Subsequent measurement: On 31 December 2016, , investment in KL should be measured at fair value of Rs. 12.4 million (155,000 shares x Rs.80/share) and a loss of Rs. 7.6 million [20–12.4(155,000×80)] should be booked through other comprehensive income.

Investment in BL

Initial measurement: Since the investment in BL has been designated as measured at fair value through profit or loss, hence the same shall be measured at fair value of Rs. 64.87 million (65÷1.002) and transaction cost of Rs. 0.13 million should be charged to profit and loss account.

Subsequent measurement: On 31 December 2016, investment in BL should be measured at fair value of Rs. 81 million (135,000 shares x Rs.600/share) and a gain of Rs. 16.13 million [81–64.87] should be booked through profit or loss account.

3.3 Measurement: financial assets (debt instruments) [IFRS 9: 5.1 & 5.2]

The financial assets which are debt instruments of another entity are measured as follows:

Classification	Requirements
Amortised cost	These are initially measured at fair value plus transaction costs and then subsequently measured at amortised cost. The effective interest is recognised in profit or loss. Amortised cost is present value of future cash flows using effective interest rate. Effective interest rate is often described as internal rate of return (IRR) for investment in debt securities. However, trade receivables are an exception to this treatment. Trade receivables are measured in accordance with IFRS 15.
Fair value through OCI	These are initially measured at fair value plus transaction costs and then subsequently measured at fair value. The amounts (interest income) that are recognised in profit or loss are the same as the amounts that would have been recognised in profit or loss if the financial asset had been measured at amortised cost. Any difference due to remeasurement at fair value is recognised in other comprehensive income and accumulated in fair value reserve.
Fair value through PL	These are measured at fair value initially and subsequently. The change in fair value is recognised in profit or loss. Interest earned is also recognised in profit or loss.

The amount of expense or income to be recognised in profit or loss is the amount of effective interest that can be calculated as applying effective interest rate (IRR) to the outstanding balance.

The amount of interest paid or received may differ and is calculated by applying coupon rate to par value of the instrument.

Note: For debt instruments measured at amortised cost or at fair value through other comprehensive income, a loss allowance must also be recognised. The detail on loss allowances is covered later in this chapter.

► **Example 09:**

Jalal Limited invested in a debt instrument with a nominal value of Rs.10,000. The instrument is redeemable in two years at a premium of Rs.2,100 and has been classified as 'at amortised cost'. The coupon rate is 0% while the effective interest rate is 10%.

Required: How will this be reported in the financial statements of Jalal Limited over the period to redemption?

► **ANSWER:**

Year	Opening balance	Effective interest 10%	Cash @ 0%	Closing balance
		[PL]	[cash flows]	[SFP]
	Rs.			
1	10,000	1,000	0	11,000
2	11,000	1,100	(10,000) (2,100)	0

► **Example 10:**

Bilal Limited invested in a debt instrument with a nominal value of Rs.10,000. The instrument is redeemable in two years at a premium of Rs. 1,680 and has been classified as 'at amortised cost'. The coupon rate is 2% while the effective interest rate is 10%.

Required: How will this be reported in the financial statements of Bilal Limited over the period to redemption?

► **ANSWER:**

Year	Opening balance	Effective interest 10%	Cash @ 2%	Closing balance
		[PL]	[cash flows]	[SFP]
	Rs.			
1	10,000	1,000	(200)	10,800
2	10,800	1,080	(200) (10,000) (1,680)	0

► **Example 11:**

MK Limited has invested in a debt instrument, details of which are as follows:

Face Value	Rs. 10,000
Premium paid on the investment	Rs. 800
Transaction cost paid on the investment	Rs. 200
Coupon rate of the Instrument	12%
Term of the instrument	4 years

MK Limited has a policy to classify investment in debt instruments at Amortized Cost. Effective rate of instrument is approximately 8.92%.

Required: Calculate initial and subsequent measurement amounts of above investment and prepare the journal entries.

► **ANSWER:**

Initial recognition	Rs.
Par value	10,000
Add: Premium	800
Fair value	10,800
Add: Transaction costs	200
	11,000

Year	Opening balance	Effective interest 8.92%	Cash @ 12%	Closing balance
		[PL]	[cash flows]	[SFP]
		Rs.		
1	11,000	981	(1,200)	10,781
2	10,781	962	(1,200)	10,543
3	10,543	940	(1,200)	10,283
4	10,283	917	(1,200)	0
			(10,000)	

Journal entries

Date	Particulars	Debit Rs.	Credit Rs.
Acquisition	Financial asset	11,000	
	Bank		11,000
Year 1	Financial asset	981	
	Interest income (PL)		981
	Bank	1,200	
	Financial asset		1,200
Year 2	Financial asset	962	
	Interest income (PL)		962
	Bank	1,200	
	Financial asset		1,200
Year 3	Financial asset	940	
	Interest income (PL)		940
	Bank	1,200	
	Financial asset		1,200
Year 4	Financial asset	917	
	Interest income (PL)		917
	Bank	11,200	
	Financial asset		11,200

► **Example 12:**

Kaalaam Limited has invested in a debt instrument, details of which are as follow:

Face Value of the Instrument	Rs. 10,000
Premium paid on the investment	Rs. 1,245
Transaction cost paid on the investment	Rs. 325
Coupon rate of the instrument	16%
Term of the instrument	4 years
IRR of the Instrument	10.95%

Kaalaam Limited has a policy to classify Investment in debt instruments at fair value through other comprehensive income.

Fair values of the instrument at each year end is as follows:

Year 1	Rs. 11,500
Year 2	Rs. 11,200
Year 3	Rs. 10,700

Required: Calculate initial and subsequent measurement amounts of above investment and prepare the journal entries.

► **ANSWER:**

Initial recognition	Rs.
Par value	10,000
Add: Premium	1,245
Fair value	11,245
Add: Transaction costs	325
	11,570

Year	Opening balance	Effective interest 10.95%	Cash @ 16%	Closing balance
		[PL]	[cash flows]	Before FV Adj.
	Rs.			
1	11,570	1,267	(1,600)	11,237
2	11,237	1,230	(1,600)	10,867
3	10,867	1,190	(1,600)	10,457
4	10,457	1,143	(1,600) (10,000)	0

Year	Opening balance	Effective interest (as above)	Cash (as above)	Sub-total	Gain / (loss)*	Fair value
		[PL]	[cash flows]		[OCI]	[SFP]
	Rs.					
1	11,570	1,267	(1,600)	11,237	263	11,500
2	11,500	1,230	(1,600)	11,130	70	11,200
3	11,200	1,190	(1,600)	10,790	(90)	11,700
4	10,700	1,143	(1,600) (10,000)	243	(243)	0

*difference of sub-total and fair value

Journal entries

Date	Particulars	Debit Rs.	Credit Rs.
Acquisition	Financial asset	11,570	
	Bank		11,570
Year 1	Financial asset	1,267	
	Interest income (PL)		1,267
	Bank	1,600	
	Financial asset		1,600
	Financial asset	263	
	Gain (OCI)		263
Year 2	Financial asset	1,230	
	Interest income (PL)		1,230
	Bank	1,600	
	Financial asset		1,600
	Financial asset	70	
	Gain (OCI)		70
Year 3	Financial asset	1,190	
	Interest income (PL)		1,190
	Bank	1,600	
	Financial asset		1,600
	Loss (OCI)	90	
	Financial asset		90
Year 4	Financial asset	1,143	
	Interest income (PL)		1,143
	Bank	11,600	
	Financial asset		11,600
	Loss (OCI)	243	
	Financial asset		243

► **Example 13:**

Haseena Limited has invested in a debt instrument, details of which are as follows:

Face Value of the instrument	Rs. 100,000
Premium paid on the investment	Rs. 8,000
Transaction cost paid on the investment	Rs. 5,800
Coupon rate of the Instrument	12%
Term of the instrument	3 years
IRR of the Instrument	8.848%

Haseena Limited has a policy to classify investment in debt instrument at fair value through PL. Market value of the Instrument at the end of year 1 is Rs. 107,000

Required: Prepare the relevant journal entries for 1st year.

► **ANSWER:**

Initial recognition	Rs.
Par value	100,000
Add: Premium	8,000
Fair value	108,000
Add: Transaction costs (will be charged as expense)	0
	108,000

Journal entries

Date	Particulars	Debit Rs.	Credit Rs.
Acquisition	Financial asset	108,000	
	Expense (PL)	5,800	
	Bank		113,800
Year 1	Bank [Rs. 100,000 x 12%]	12,000	
	Interest income (PL)		12,000
	Loss (PL) [Rs. 108,000 – 107,000]	1,000	
	Financial asset		1,000

3.4 Measurement: financial liabilities [IFRS 9: 5.1 & 5.3]

The financial liabilities are measured as follows:

Classification	Requirements
Amortised cost	These are initially measured at fair value minus transaction costs and then subsequently measured at amortised cost. The effective interest is recognised in profit or loss.
Fair value	These are measured at fair value initially and subsequently. The change in fair value is recognised in profit or loss except the change in fair value due to entity's own credit risk is recognised in other comprehensive income. Credit risk is the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation.

► **Example 14:**

On 1 January 2021, Kashif Limited (KL) issued a deep discount debenture with a Rs. 100,000 nominal value. The discount rate was 16% of nominal value, and the costs of issue were Rs. 4,000.

Interest of 5% on par value is payable annually in arrears. The debenture must be redeemed on 31 December 2025 (after 5 years) at a premium of Rs. 9,223. The effective interest rate is 12% per annum.

Required: Calculate the amounts to be reported in the financial statements of KL over the period to redemption?

► **ANSWER:**

Initial recognition	Rs.
Par value	100,000
Less: discount at 16%	(16,000)
Fair value	84,000
Less: Cost of issue (transaction costs)	(4,000)
	80,000

Year	Opening balance	Effective interest 12%	Cash @ 5%	Closing balance
		[PL]	[cash flows]	[SFP]
	Rs.			
2021	80,000	9,600	(5,000)	84,600
2022	84,600	10,152	(5,000)	89,752
2023	89,752	10,770	(5,000)	95,522
2024	95,522	11,463	(5,000)	101,985
2025	101,985	12,238	(5,000) (100,000) (9,223)	0
Total		54,223	134,223	

Notice that total expense recognised in profit or loss (i.e. effective interest over five years) is Rs. 54,223. This is also difference of total payments of Rs. 134,223 and initial loan proceeds of Rs. 80,000 (i.e. Rs. 54,223 = Rs. 134,223 – 80,000). The total effective interest expense comprises of following components:

	Rs.
Discount on issue	16,000
Issue costs (transaction costs)	4,000
Coupon interest (Rs. 5,000 x 5 years)	25,000
Premium on redemption	9,223
	54,223

► **Example 15:**

Adeel Limited (AL) regularly invests in assets that are measured at fair value through profit or loss. On January 1, 2018 AL issued 9% debentures at nominal value of Rs. 80,000 to finance a similar investment in assets. The management has decided to classify these debentures to be measured at fair value through profit or loss in order to avoid accounting mismatch.

The fair value of debentures was Rs. 88,000 on 31 December 2018, there was no change in own credit risk of AL in this time period.

The fair value of debentures was Rs. 82,000 on 31 December 2019, and AL has estimated that it includes Rs. 4,000 due to change in own credit risk as AL's credit rating was dropped during the year.

Required: Prepare journal entries.

► **ANSWER:**

Date	Particulars	Debit Rs.	Credit Rs.
1 Jan 2018	Bank	80,000	
	Debentures (financial liability)		80,000
31 Dec 2018	Interest expense [9% x Rs. 80,000]	7,200	
	Cash		7,200
31 Dec 2018	Profit or loss	8,000	
	Debentures (financial liability)		8,000
31 Dec 2019	Interest expense [9% x Rs. 80,000]	7,200	
	Cash		7,200
31 Dec 2019	Debentures (financial liability)	6,000	
	Other comprehensive income		4,000
	Profit or loss		2,000

4. IMPAIRMENT OF FINANCIAL ASSETS

4.1 Key Definitions [IFRS 9: Appendix A]

Credit loss: The difference between all contractual cash flows that are due to an entity in accordance with the contract and all the cash flows that the entity expects to receive (i.e. all cash shortfalls), discounted at the original effective interest rate.

Expected credit losses: The weighted average of **credit losses** with the respective risks of a default occurring as the weights.

12-month expected credit losses: The portion of lifetime expected credit losses that represent the expected credit losses that result from default events on a financial instrument that are possible within the 12 months after the reporting date.

Lifetime expected credit losses: The expected credit losses that result from all possible default events over the expected life of a financial instrument.

► **Example 16:**

On 1 January 2025, Kashif Textile Limited (KTL) purchased a debenture for Rs. 10 million which is measured at amortised cost. Interest of 10% is payable in arrears, the same as the effective rate of interest. Repayment is due on 31 December 2027.

On 31 December 2025, KTL received interest of Rs. 1 million.

It estimated that the probability of default on the debenture within the next 12 months would be 0.6%. If default occurs within the next 12 months, then KL estimated that no further interest will be received and that only 60% of the capital will be repaid on 31 December 2027.

The asset's credit risk at 31 December 2025 is low.

Required: Calculate for KTL the credit loss and 12-month expected credit loss of the above financial asset at 31 December 2025.

► **ANSWER:**

The credit loss on the asset is Rs. 5,041,332 (W1). This represents the present value of the difference between the contractual cash flows and the expected receipts if a default occurs.

W1: Credit loss

Date	Expected cash Shortfall	Discount factor 10%	Present value
	Rs.		Rs.
31 Dec 2025	1,000,000	1.10^{-1}	909,091
31 Dec 2026	1,000,000	1.10^{-2}	826,446
31 Dec 2027	4,000,000	1.10^{-2}	3,305,785
			5,041,332

The 12-month expected credit loss is Rs. 302,480 (Rs. 5,041,232 credit loss (W1) $\times$ 0.6% probability of occurrence).

► **Example 17:**

Adeel Textile Limited (ATL) has total trade receivables of Rs. 60 million which do not have a significant financing component. ATL constructs a provision matrix to calculate expected life time losses of trade receivable. The break-up of receivables and default rates of ATL's provision matrix are as follows:

Number of days past due	Gross receivables Rs.	Default rate
Current (not past due)	30,000,000	0.3%
1 to 30 days	15,000,000	1.6%
31 to 60 days	8,000,000	3.6%
61 to 90 days	5,000,000	6.6%
More than 90 days	2,000,000	10.6%
	60,000,000	

Required: Calculate the life time expected credit loss from above data for ATL.

► **ANSWER:****Life time expected credit losses**

Number of days past due	Gross receivables Rs.	Default rate	Lifetime expected credit loss Rs.
Current	30,000,000	0.3%	90,000
1 to 30 days	15,000,000	1.6%	240,000
31 to 60 days	8,000,000	3.6%	288,000
61 to 90 days	5,000,000	6.6%	330,000
More than 90 days	2,000,000	10.6%	212,000
	60,000,000		1,160,000

4.2 General approach [IFRS 9: 5.5]

General approach requires assessment of expected credit losses at initial recognition and re-assessment at three stages as the credit risk of financial assets is increased. Investments in debt instruments measured at either amortised cost or fair value through other comprehensive income is subject to recognition of loss allowance as follows:

Situation	Requirement
Initial recognition	Create a credit loss allowance/impairment allowance. This is calculated by multiplying the probability of a default occurring in the next 12 months by the total lifetime expected credit losses that would result from that default (i.e. 12-month expected credit losses). Note: This is not the same as the expected cash shortfalls over the next 12 months.
Credit risk on financial asset has NOT increased significantly since initial recognition (Stage 1)	The loss allowance should be equal to the 12-month expected credit losses. Calculate interest income is on the asset's gross carrying amount, without deducting the loss allowance.

Situation	Requirement
Credit risk on financial asset has increased significantly since initial recognition (Stage 2)	The loss allowance should be equal to the lifetime expected credit losses. There is rebuttable presumption that credit risk has increased significantly if contractual payments are more than 30 days overdue at the reporting date. Calculate interest income is on the asset's gross carrying amount, without deducting the loss allowance.
There is objective evidence at reporting date that financial asset has been impaired (Stage 3)	The loss allowance should be based on the lifetime expected credit losses. The expected credit losses should be measured as the difference between the asset's gross carrying amount and the present value of the estimated future cash flows when discounted at the original effective rate of interest. The following events may suggest the asset is credit impaired: • significant financial difficulty of the issuer or the borrower • a breach of contract, such as a default • the borrower being granted concessions • it is probable that the borrower will enter bankruptcy Calculate interest income on the asset's net carrying amount i.e. gross carrying amount after deducting the loss allowance.

All instruments measured at fair value through profit or loss are not required to be assessed for impairment because any fair value movements are already reflected in profit or loss.

4.3 Simplified approach for certain financial assets [IFRS 9: 5.5]

The following simplified approach is applicable for trade receivables, contract assets and lease receivables:

Item	Requirements
Trade receivables and contract assets NOT having significant financing component	The loss allowance is measured at the lifetime expected credit losses, from initial recognition.
Trade receivables and contract assets having significant financing component	The entity can choose (as a separate accounting policy for trade receivables and for lease receivables) to apply either:
Lease receivable	• the general approach; or • recognize an allowance for lifetime expected credit losses from initial recognition.

4.4 Recording impairment [IFRS 9: 5.5]

Impairment loss is recorded as follows:

Financial asset	Recognition and presentation
Amortised cost	Debit: Impairment loss (PL) Credit: Loss allowance (contra asset) Loss allowance is offset against the carrying amount of the financial asset so that a net position is presented in the statement of financial position.
Fair value through OCI	Debit: Impairment loss (PL) Credit: Other comprehensive income The carrying amount of financial asset remains at fair value in the statement of financial position.

At each reporting date, the loss allowance is reassessed. Previously, it might have been equivalent to lifetime credit losses, but due to a decrease in credit risk, it may now only need to reflect 12-month expected credit losses. Consequently, a significant reduction in the required allowance could occur. Adjustments to the loss allowance, whether gains or losses, are recognized in profit or loss.

► **Example 18:**

M Limited (ML) purchased a bond for Rs. 2,000,000 on 1 January 2026 and classified it at amortised cost. The bond pays interest at 5% (same as effective rate) and is to be redeemed at par in 5 years' time. At this time, 12-month expected credit losses have been assessed at Rs. 50,000.

On 31 December 2026, interest is collected at its due date and there is no significant change in credit risk. At this time, 12-month expected credit losses have been assessed at Rs. 60,000.

Required: Journal entries on initial recognition and at 31 December necessary to account for the bond and the loss allowance.

► **ANSWER:**

General Journal

Date	Particulars	Debit Rs.	Credit Rs.
1 Jan 2026	Financial asset	2,000,000	
	Bank		2,000,000
1 Jan 2026	Impairment of financial asset (PL)	50,000	
	Loss allowance		50,000
31 Dec 2026	Financial asset	100,000	
	Interest income 5%		100,000
31 Dec 2026	Bank (interest received)	100,000	
	Financial asset		100,000
31 Dec 2026	Impairment of financial asset (PL)	10,000	
	Loss allowance [60,000 – 50,000]		10,000

► *Example 19:*

Aqeel Limited (AL) purchased a bond for Rs. 2,000,000 on 1 January 2026 and classified it at fair value through other comprehensive income. The bond pays interest at 5% (same as effective rate) and is to be redeemed at par in 5 years' time. At this time, 12-month expected credit losses have been assessed at Rs. 50,000.

On 31 December 2026, the fair value of bond is Rs. 1,880,000. Interest has been collected at its due date and there is no significant change in credit risk. At this time, 12-month expected credit losses have been assessed at Rs. 60,000.

Required: Journal entries on initial recognition and at 31 December necessary to account for the bond and the loss allowance.

► *ANSWER:***General Journal**

Date	Particulars	Debit Rs.	Credit Rs.
1 Jan 2026	Financial asset	2,000,000	
	Bank		2,000,000
1 Jan 2026	Impairment of financial asset (PL)	50,000	
	Other comprehensive income		50,000
31 Dec 2026	Financial asset	100,000	
	Interest income 5%		100,000
31 Dec 2026	Bank (interest received)	100,000	
	Financial asset		100,000
31 Dec 2026	Other comprehensive income	120,000	
	Financial asset [2m – 1.88m]		120,000
31 Dec 2026	Impairment of financial asset (PL)	10,000	
	OCI [60,000 – 50,000]		10,000

► *Example 20:*

Amin Limited (AL) is one of many investors in debentures issued by Sadiq Limited (SL) in Pakistan. On purchase, AL deemed the debenture to have a low credit risk due to SL's strong capacity to fulfil its short-term obligations. It was perceived, however, that adverse changes in the economic environment could have a detrimental impact on SL's liquidity. AL classified its investment at amortised cost.

On 31 December 2026, AL's year-end, it has access to the following information about SL:

- sales have declined 18% over the last year
- credit rating has not changed yet but is under review by credit rating agencies
- PSX debenture prices have remained static, but SL's debenture price has fallen dramatically.

Required: Discuss the accounting treatment of the debentures in AL's financial statements as at 31 December 2026.

► **ANSWER:**

AL must determine if the credit risk of the debenture has risen significantly since its inception.

It appears that SL's declining performance may adversely affect its liquidity. External agencies' review of SL's credit rating indicates broader concerns regarding SL's overall performance and standing. Additionally, the stability in market debenture prices suggests that the drop in SL's debenture price is specific to the entity. This decrease likely reflects SL's increased credit risk.

Consequently, the credit risk associated with the debenture no longer appears to be low. Therefore, it can be concluded that the credit risk has increased significantly since inception, necessitating AL to recognize a loss allowance equivalent to lifetime expected credit losses on the debenture.

► **Example 21:**

On 1 January 2026, Ehsan Limited (EL) made a four-year loan of Rs. 10 million to Faramosh Limited (FL) and classified it as at amortised cost. The coupon rate on the loan is 11%, the same as the effective rate of interest. Interest is received at the end of each year on 31 December.

On 1 January 2029, EL obtains objective evidence that FL is in significant financial difficulties. At this time the current market interest rate is 12%.

EL estimates that it will receive no more interest from FL. It also estimates that only Rs. 6 million of the capital will be repaid on the maturity date.

EL has already recognised a loss allowance of Rs. 1,200,000 in respect of its loan to FL.

Required: Briefly explain and calculate impairment loss on the above financial asset on 1 January 2029. Also calculate the carrying amount of financial asset at 31 December 2029 before redemption.

► **ANSWER:**

Evidence about the significant financial difficulties of FL mean that the asset is now credit impaired.

Because the coupon and the effective interest rate are the same, the carrying amount of the asset will remain constant at Rs. 10 million.

Impairment loss	Rs.
Carrying amount	10,000,000
The present value of the future cash flows discounted using the original effective rate [Rs. $6,000,000 \times 1.11^{-1}$]	(5,405,405)
Expected losses (i.e. loss allowance)	4,594,595
Opening balance	(1,200,000)
Expense charged to profit or loss (i.e. increase in allowance)	3,394,595

Carrying amount	Rs.
Carrying amount as at 1 January 2029	5,405,405
Interest income for year 2029 [Rs. $5,405,405 \times 11\%$]	594,595
Carrying amount at 31 December 2029 (before redemption)	6,000,000

5. COMPREHENSIVE EXAMPLES

► Example 23:

Bilal has recently joined your organization. He has prepared a summary of classification and measurement requirements of financial assets which will help him in handling the transactions related to the financial assets. He has requested you to review the following summary:

	Amortized cost	FV through OCI	FV through P/L
Business model	Hold to collect and sell	Hold to collect	Hold to sell
Cash flows	Solely payment of principal and interest	No condition	No condition
Categories	Debt and equity securities	Debt securities	Equity securities
Initial measurement	Fair value plus transaction cost	Fair value	Fair value plus transaction cost
Subsequent measurement	Amortized cost	Fair value less transaction cost	Fair value

Required: Prepare the corrected summary in the light of IFRSs.

► ANSWER:

	Amortized Cost	FV through OCI	FV through P/L
Business model	Hold to collect	Hold to collect and sell	Hold to sell
Cash flows	Solely payment of principal and interest	Solely payment of principal and interest	No condition
Categories	Only debt securities	Debt and equity securities	Debt and equity securities
Initial measurement	Fair value plus transaction cost	Fair value plus transaction cost	Fair value
Subsequent measurement	Amortized cost	Fair value	Fair value

► Example 24:

On 1 July 2018, Gypsum Limited purchased 5,000 debentures issued by Iron Limited at par value of Rs. 100 each. The transaction cost associated with the acquisition of the debentures was Rs. 24,000. The coupon interest rate is 11% per annum payable annually on 30 June. On 1 July 2018, the effective interest rate was worked out at 9.5% per annum whereas the market interest rate on similar debentures was 11% per annum.

As on 30 June 2019, the debentures were quoted on Pakistan Stock Exchange at Rs. 96 each.

Required: Prepare journal entries for the year ended 30 June 2019 if the investment in debentures is subsequently measured at:

- amortized cost
- fair value through profit or loss

► **ANSWER:****Part (a) Amortised cost**

Date	Particulars	Debit Rs.	Credit Rs.
1-Jul-18	Investment in debentures	500,000	
	Bank		500,000
1-Jul-18	Investment in debentures	24,000	
	Bank		24,000
30-Jun-19	Investment in debentures	49,780	
	Interest income (PL)		49,780
	[Rs. 524,000×9.5%]		
30-Jun-19	Bank [Rs. 500,000×11%]	55,000	
	Investment in debentures		55,000

Part (b) Fair value through profit or loss

Date	Particulars	Debit Rs.	Credit Rs.
1-Jul-18	Investment in debentures	500,000	
	Bank		500,000
1-Jul-18	Transaction costs (PL)	24,000	
	Bank		24,000
30-Jun-19	Bank [Rs. 500,000×11%]	55,000	
	Interest income (PL)		55,000
30-Jun-19	Loss on fair value change (PL)	20,000	
	Investment in debentures		20,000
	[(5,000 x Rs. 96) – Rs. 500,000]		

► **Example 25:**

Rabbi Limited (RL) has made the following investments for the first time:

- RL purchased 1 million ordinary shares of Kholas Limited at the fair value of Rs. 23 per share. RL also incurred transaction cost of Rs. 0.5 million. RL considers this investment as a strategic equity investment and not held for trading.
- RL also purchased 1 million bonds of Barhi Limited having face value of Rs. 100 each at Rs. 95. These bonds are redeemable in five years' time. RL also incurred transaction cost of Rs. 0.8 million. RL intends to hold the bonds till maturity in order to collect contractual cash flows.

Required: In respect of each of the above investments, discuss the possible classification option(s) available to RL for accounting purposes. Also compute the amount at which these investments would be initially recognised under each option.

► **ANSWER:****Part (a)****Option (i)**

As this investment is not “held for trading”, the investment can be irrevocably elected to measure at fair value through other comprehensive income. In this case, investment should initially be measured at fair value plus transaction cost i.e. Rs. 23.5 million.

Option (ii)

If election under option (i) is not made then it should be classified as measured at fair value through profit or loss and will initially be measured at fair value i.e. Rs. 23 million.

Part (b)**Option (i)**

Since the objective of business model is to hold the investment till maturity, the investment can be classified as financial asset at amortized cost and will initially be measured at fair value plus transaction cost i.e. Rs. 95.8 million.

Option (ii)

The investment can be designated as financial asset at fair value through profit or loss if classifying at amortized cost would have caused an accounting mismatch. In this option, the bonds will initially be measured at fair value i.e. Rs. 95 million.

► **Example 26:**

On 1 January 2019, Jannat Limited (JL) issued 1.6 million debentures of Rs. 100 each at a premium of Rs. 10 each. The transaction cost associated with the issuance of these debentures was Rs. 5.5 per debenture. The coupon interest rate is 16% per annum payable annually on 31 December. Khushi Limited (KL) purchased 0.32 million of these debentures on 1 January 2019.

On 1 January 2019, the approximate effective interest rates were 15% and 14% per annum for JL and KL respectively. As on 31 December 2019, the debentures were quoted on Pakistan Stock Exchange at Rs. 112 each.

Debentures are subsequently measured at amortized cost by JL and fair value through profit or loss by KL.

Required: Prepare journal entries in the books of JL and KL for the year ended 31 December 2019.

► **ANSWER:****JL Books: General Journal**

Date	Description	Debit	Credit
		----- Rs. in m -----	
1-Jan-19	Bank [1.6m x (Rs. 100+10)]	176	
	Debenture – amortized cost		176
1-Jan-19	Debenture – amortized cost	8.8	
	Bank [1.6m x Rs. 5.5]		8.8
31-Dec-19	Interest exp. [(176m – 8.8m) x 15%]	25.08	
	Debenture – amortized cost		25.08
31-Dec-19	Debenture – amortized cost	25.6	
	Bank [1.6m x Rs. 100 x 16%]		25.6

KL Books: General Journal

Date	Description	Debit	Credit
		----- Rs. in '000 -----	
1-Jan-19	Investment/Debenture – FVTPL	35.2	
	Bank [0.32m x (Rs. 100+10)]		35.2
31-Dec-19	Bank [0.32m x 100 x 16%]	5.12	
	Interest income		5.12
31-Dec-19	Investment/Debenture –FVTPL	0.64	
	Gain on fair value (PL)		0.64
	[0.32m x (Rs. 112 -110)]		

► **Example 27:**

Adeel Steel Limited (ASL) operates a building material store in Multan. ASL's trade receivables are short term and do not contain a significant financing component. Using historical observed default rates, updated for changes in forward-looking estimates, ASL estimates the following default rates for its trade receivables that are outstanding as at 30 June 2026:

	Not overdue	1-45 days overdue	46-90 days overdue	91+ days overdue
Default rate	1%	2%	6%	16%

The trade receivables of ASL as at 30 June 2026, the reporting date, are as follows:

	Gross carrying amount Rs. m
Not overdue	20
1 – 45 days overdue	8
46 – 90 days overdue	3
91 + days overdue	2

There is a loss allowance brought forward from the previous financial year of Rs. 0.6 million in respect of trade receivables.

Required: Calculate expected credit losses for ASL for the year ended 30 June 2026. Also, briefly explain the accounting treatment.

► **ANSWER:**

As these trade receivables do not have significant financing component, simplified approach shall be applied and life time expected credit losses shall be calculated. Further, discounting will not be required as the receivables are short term.

Calculation: Lifetime expected credit losses

	Rs. m
Not overdue [Rs. 20m x 1%]	0.20
1 – 45 days overdue [Rs. 8m x 2%]	0.16
46 – 90 days overdue [Rs. 3m x 6%]	0.18
91 + days overdue [Rs. 2m x 16%]	0.32
	0.86

The allowance required is Rs. 0.86 million. The current allowance of Rs. 0.6 million must be increased by Rs. 0.26 million. An expense of Rs. 0.26 million shall be charged to the statement of profit or loss.

► **Example 28:**

While reviewing the draft financial statements of Hexagon Industries (HI) for the year ended 30 June 2022, following mistake was identified:

Investment in bonds of Oval Limited (OL) was accounted for as a financial asset subsequently measured at fair value through profit or loss instead of measuring the investment at amortised cost. On 1 July 2021, HI purchased 1 million bonds of OL of Rs. 100 each at a discount of Rs. 5 each with maturity in three years. Transaction cost of Rs. 2 million was also incurred on purchase of these bonds. The coupon interest rate is 12% per annum payable annually on 30 June while the approximate effective interest rate was 13.28% per annum. The fair value of each bond of OL was Rs. 99 on 30 June 2022.

Required: Prepare correcting entries in the books of HI for the year ended 30 June 2022.

► **Answer:****Correcting entries**

Sr #	Particulars	Debit Rs. 000	Credit Rs. 000
(i)	Investment / Financial asset	2,000	
	Transaction costs		2,000
(ii)	Investment / Financial asset	882	
	Interest income (PL) W1		882
(iii)	Gain on fair value (PL) W2	4,000	
	Investment / Financial asset		4,000

W1: $(Rs. 97m \times 13.28\%) - (Rs. 100m \times 12\%) = Rs. 882,000$

W2: $1m \text{ bonds} \times Rs. 4 \text{ [i.e. } Rs. 99 - (100 - 5)] = Rs. 4,000,000$

► **Example 29:**

Zinc Limited (ZL) has entered into the following transactions:

- (i) On 1 January 2022, ZL purchased 1.5 million bonds of Copper Limited having face value of Rs. 100 each at a premium of Rs. 5 each with maturity of five years. The transaction cost associated with the purchase of these bonds was Rs. 2 each. The coupon interest rate is 13% per annum payable annually on 31 December while the effective interest rate was approximately 11.1% per annum. The investment was classified at fair value through other comprehensive income. At 31 December 2022, the bonds were quoted at Rs. 103 each on stock exchange.
- (ii) On 1 July 2022, ZL issued 2 million 10% redeemable preference shares having face value of Rs. 100 each at a discount of Rs. 10 each. The transaction cost associated with the issuance of these shares was Rs. 3 million. ZL measured preference shares at fair value through profit or loss. At 31 December 2022, the shares were quoted at Rs. 80 each on stock exchange and ZL has estimated that 70% reduction in the fair value is due to drop in ZL's credit rating. No dividend was declared during 2022 in respect of these shares.

Required: Prepare journal entries in the books of ZL for the year ended 31 December 2022 in accordance with IFRSs.

► *Answer:***General Journal – Transaction (i)**

Date	Particulars	Debit Rs. m	Credit Rs. m
1 Jan 22	Investment/Financial asset [1.5 x (100+5)]	157.50	
	Bank		157.50
1 Jan 22	Investment/Financial asset [1.5 x 2]	3.00	
	Bank		3.00
31 Dec 22	Investment/Financial asset W1	17.82	
	Interest income (PL)		17.82
31 Dec 22	Bank [150 x 13%]	19.50	
	Investment/Financial asset		19.50
31 Dec 22	OCI / FV reserve W2	4.32	
	Investment/Financial asset		4.32

W1: $157.5 + 3 = 160.5 \times 11.1\% = 17.82$

W2: 154.5 (i.e. 1.5×103) – 158.82 (i.e. $157.5 + 3 + 17.82 - 19.5$) = 4.32

General Journal – Transaction (ii)

Date	Particulars	Debit Rs. m	Credit Rs. m
1 Jul 22	Bank [2 x (100 – 10)]	180.00	
	Financial liability		180.00
1 Jul 22	Transaction costs (PL)	3.00	
	Bank		3.00
31 Dec 22	Interest expense (PL) [200 x 10% x 6/12]	10.00	
	Financial liability		10.00
31 Dec 22	Financial liability [180 + 10 – (80 x 2)]	30.00	
	OCI / FV reserve [30 x 70%]		21.00
	Gain on fair value adj. (PL) (bal.)		9.00

► *Example 30:*

While reviewing the draft financial statements of Heavenly Limited (HL) for the year ended 31 December 2023, the following mistake was identified:

Bonds issued by HL have been treated as equity instruments. On 1 April 2023, HL issued 40,000 bonds of Rs. 1,000 each at a premium of Rs. 300, redeemable in 8 years. The transaction cost associated with the issuance of these bonds was Rs. 20 per bond, which was expensed out. The coupon interest rate is 20% per annum, payable annually on 31 March. The approximate effective interest rate was 16% per annum. HL measures financial liabilities at amortized cost.

Required: Prepare correcting entries in the books of HL for the year ended 31 December 2023.

► *Answer:***Correcting entries**

Sr #	Particulars	Debit Rs. 000	Credit Rs. 000
(i)	Equity (capital and share premium)	52,000	
	Financial liability [1300 x 40]		52,000
(ii)	Financial liability [20 x 40]	800	
	Transaction cost (PL)		800
(iii)	Interest expense (PL) W1	6,144	
	Financial liability		6,144

W1: $[(52,000 - 800) \times 16\% \times 9 \div 12 = 6,144]$

6. OBJECTIVE BASED Q&A

- 01.** For a debt investment to be held under amortized cost, it must pass two tests. One of these is the contractual cash flow characteristics test.
What is the other test which must be passed?
- (a) The purchase agreement test
 - (b) The amortized cost test
 - (c) The business model test
 - (d) The fair value test
- 02.** What is the default classification for an equity investment?
- (a) Fair value through profit or loss
 - (b) Fair value through other comprehensive income
 - (c) Amortized cost
 - (d) Net proceeds
- 03.** Diamond Limited purchased 10,000 shares on 1 September 2014, making the election to use the alternative treatment under IFRS 9. The shares cost Rs. 35 each. Transaction costs associated with the purchase were Rs. 5,000.
At 31 December 2014, the shares are trading at Rs. 45 each.
What is the gain to be recognized on these shares for the year ended 31 December 2014?
- (a) Rs. 100,000
 - (b) Rs. 450,000
 - (c) Rs. 95,000
 - (d) Rs. 350,000
- 04.** Copper Limited has purchased an investment of 15,000 shares on 1 August 2016 at a cost of Rs. 65 each. Copper Limited intend to sell these shares in the short term and are holding them for trading purposes. Transaction costs on the purchase amounted to Rs. 15,000.
As at the year-end 30 September 2016, these shares are now worth Rs. 77.5 each.
What is the gain on this investment during the year ended 30 September 2016, and where in the Financial Statements will it be recognized?
- (a) Rs. 187,500 in Other Comprehensive Income
 - (b) Rs. 187,500 in Profit or Loss
 - (c) Rs. 172,500 in Other Comprehensive Income
 - (d) Rs. 172,500 in Profit or Loss
- 05.** For which category of financial instruments are transaction costs excluded from the initial value, and instead expensed to profit or loss?
- (a) Financial Liabilities at amortized cost
 - (b) Financial Assets at fair value through profit or loss
 - (c) Financial Assets at fair value through other comprehensive income
 - (d) Financial Assets at amortized cost

06. If a company had incurred transaction costs in issuing debentures, how should these have been accounted for?
- Added to the proceeds of the debentures
 - Deducted from the proceeds of the debentures
 - Amortized over the life of the debentures
 - Charged to finance costs
07. Sodium Limited (SL) purchased a debt instrument which will mature in five years' time. SL intends to hold the debt instrument to maturity to collect interest payments. How should this debt instrument be measured in the financial statements of SL?
- As a financial liability at fair value through profit or loss
 - As a financial liability at amortized cost
 - As a financial asset at fair value through profit or loss
 - As a financial asset at amortized cost
08. A 5% debenture was issued on 1 April 2010 at total face value of Rs. 20 million. Direct costs of the issue were Rs. 500,000. The debenture will be redeemed on 31 March 2013 at a substantial premium. The effective interest rate applicable is 10% per annum.
At what amount will the debenture appear in the statement of financial position as at 31 March 2012?
- Rs. 21,000,000
 - Rs. 20,450,000
 - Rs. 22,100,000
 - Rs. 21,495,000
09. How does IFRS 9 *Financial Instruments* require investments in equity instruments to be measured and accounted for (in the absence of any election at initial recognition)?
- Fair value with changes going through profit or loss
 - Fair value with changes going through other comprehensive income
 - Amortized cost with changes going through profit or loss
 - Amortized cost with changes going through other comprehensive income
10. On 1 January 2011 Oxygen Limited purchased a debt instrument for its fair value of Rs. 500,000. It had a principal amount of Rs. 550,000 and was due to mature in five years. The debt instrument carries fixed interest of 6% paid annually in arrears and has an effective interest rate of 8%. It is held at amortized cost. At what amount will the debt instrument be shown in the statement of financial position of Oxygen Limited as at 31 December 2012?
- Rs. 514,560
 - Rs. 566,000
 - Rs. 564,560
 - Rs. 520,800
11. Which of the following are **not** classified as financial instruments under IAS 32?
- Share options
 - Intangible assets
 - Trade receivables
 - Redeemable preference shares

12. In order to hold a debt instrument at amortized cost, which TWO of the following tests must be applied?
- (a) Fair value test
 - (b) Contractual cash flow characteristics test
 - (c) Investment appraisal test
 - (d) Business model test
13. Nickel Limited is uncertain of how to treat professional fees. For which of the following investments should professional fees NOT be capitalized as part of initial value of the asset?
- (a) Acquisition of a patent
 - (b) Acquisition of investment property
 - (c) Acquisition of fair value through other comprehensive income investments
 - (d) Acquisition of fair value through profit or loss investments
14. Iron Limited has 5% Rs. 30 million redeemable preference shares in issue which will be redeemed in 5 years' time.
How should the preference share capital and preference dividend be presented in the financial statements of Iron Limited?
- (a) Preference share capital as equity and preference dividend in the statement of changes in equity
 - (b) Preference share capital as equity and preference dividend in the statement of profit or loss
 - (c) Preference share capital as a liability and preference dividend in the statement of changes in equity
 - (d) Preference share capital as a liability and preference dividend in the statement of profit or loss
15. Mercury Limited purchased 1 million shares in Jupiter Limited, a listed company, for Rs. 40 million on 1 January 2017. By the year end, 31 December 2017, the fair value of a Jupiter Limited's share had moved to Rs. 48. If Mercury Limited were to dispose of the shares, broker fees of Rs. 500,000 would be incurred.
What is the correct treatment for shares at year end?
- (a) Hold shares in investments at Rs.47.5 million, with Rs. 7.5 million gain being taken to the statement of profit or loss
 - (b) Hold shares in investments at Rs. 48 million, with Rs. 8 million gain being taken to the statement of profit or loss
 - (c) Hold shares in investments at Rs. 48 million, with Rs. 8 million gain shown in the statement of changes in equity
 - (d) Hold shares in investments at Rs. 48 million, with Rs. 7.5 million gain shown in the statement of changes in equity
16. Gold Limited's draft statement of financial position as at 31 March 2018 shows financial assets at fair value through profit or loss with a carrying amount of Rs. 12.5 million as at 1 April 2017. These financial assets are held in a fund whose value changes directly in proportion to a specified market index. At 1 April 2017 the relevant index was 1,200 and at 31 March 2018 it was 1,296. What amount of gain or loss should be recognized at 31 March 2018 in respect of these assets?
- (a) Rs. 1,000,000 gain
 - (b) Rs. 960,000 gain
 - (c) Rs. 1,000,000 loss
 - (d) Rs. 960,000 loss

17. On 1 January 2018 Silver Limited purchased 40,000 Rs. 10 listed equity shares at a price of Rs. 30 per share. An irrevocable election was made to recognize the shares at fair value through other comprehensive income.
Transaction costs were Rs. 30,000. At the year-end of 31 December 2018, the shares were trading at Rs. 60 per share.
What amount in respect of these shares will be shown under 'investments in equity instruments' in the statement of financial position as at 31 December 2018?
- (a) Rs. 2,430,000
 - (b) Rs. 2,400,000
 - (c) Rs. 2,370,000
 - (d) Rs. 3,000,000
18. An entity acquires a 6% Rs. 1,000 Term Finance Certificate (TFC), a financial asset, for Rs. 970 at the beginning of Year 1. Interest is receivable annually in arrears.
The TFC is redeemable at the end of Year 3 at a premium of 3%. The financial asset is measured at amortized cost. The effective interest rate of the financial instrument has been calculated at 8.1%.
Calculate the closing statement of financial position figure at the end of Year 2. Work to the nearest Rupee.
- (a) Rs. 970
 - (b) Rs. 989
 - (c) Rs. 1,009
 - (d) Rs. 1,000
19. Wasim Limited issued Rs. 10 million 5% debentures on 1 January 2019, incurring issue costs of Rs.400,000. The debentures are redeemable at a premium, giving them an effective interest rate of 8%.
What expense should be recorded in relation to the debentures for the year ended 31 December 2019?
- (a) Rs. 480,000
 - (b) Rs. 800,000
 - (c) Rs. 500,000
 - (d) Rs. 768,000
20. Platinum Limited issues Rs.100 million 5% debentures on 1 January 2014, incurring issue costs of Rs.3 million.
These debentures are redeemable at a premium, meaning that the effective rate of interest is 8% per annum.
What is the finance cost to be shown in the statement of profit or loss for the year ended 31 December 2015?
- (a) Rs. 7.98 million
 - (b) Rs. 8 million
 - (c) Rs. 8.24 million
 - (d) Rs. 7.76 million

21. Which of the following statements is/are correct?
- (I) An investment in equity instruments of another entity cannot be classified as subsequently measured at amortized cost.
 - (II) An investment in debt instruments of another entity cannot be classified as subsequently measured at fair value through other comprehensive income.
- (a) Only (I) is correct
 - (b) Only (II) is correct
 - (c) Both are correct
 - (d) None is correct
22. Siri Limited (SL) purchased 1 million ordinary shares of another company at the fair value of Rs. 23 per share. SL also incurred transaction cost of Rs. 0.5 million. SL considers this investment as a strategic equity investment and not held for trading.
- Which of the following statements is/are correct in this regard?
- (I) On initial recognition, the investment can be recognised at Rs. 23 million or Rs. 23.5 million depending on classification.
 - (II) On subsequent measurement, the investment must be carried at fair value only.
- (a) Only (I) is correct
 - (b) Only (II) is correct
 - (c) Both are correct
 - (d) None is correct
23. On 1 July 2022, a company issued 5% debentures with a par value of Rs. 15 million for Rs. 20 million, incurring issue costs of Rs. 0.5 million. The debentures are redeemable at a premium, giving them an effective interest rate of 8% per annum.
- What expense should be recorded in relation to the debentures for the year ended 30 June 2023?
- (a) Rs. 2,400,000
 - (b) Rs. 1,600,000
 - (c) Rs. 975,000
 - (d) Rs. 1,560,000

ANSWERS

01.	(c)	The business model test must also be passed, which means that the objective is to hold the instrument to collect the cash flows rather than to sell the asset.																	
02.	(a)	The default position for equity investments is fair value through profit or loss, meaning the investment is revalued each year end, with the gain or loss being taken to the statement of profit or loss.																	
03.	(c)	The investment should be classified as Fair Value through other comprehensive income. As such, they will initially be valued inclusive of transaction costs. Therefore, the initial value is $10,000 \times \text{Rs. } 35 = \text{Rs. } 350,000 + \text{Rs. } 5,000 = \text{Rs. } 355,000$. At year-end, these will be revalued to fair value of Rs. 45 each, therefore $10,000 \times \text{Rs. } 45 = \text{Rs. } 450,000$. The gain is therefore $\text{Rs. } 450,000 - \text{Rs. } 355,000 = \text{Rs. } 95,000$.																	
04.	(b)	Financial Assets held for trading will be valued at Fair Value through Profit or Loss. These are therefore valued excluding any transaction costs (which will be expensed to profit or loss). The initial value of the investment is therefore $15,000 \times \text{Rs. } 65 = \text{Rs. } 975,000$ The shares will be revalued to fair value as at year end, and the gain will be taken to profit or loss. The year-end value of the shares is $15,000 \times \text{Rs. } 77.5 = \text{Rs. } 1,162,500$, giving a gain of Rs. 187,500. This is recognized within profit or loss.																	
05.	(b)	Transaction costs are included when measuring all financial assets and liabilities at amortized costs, and when valuing financial assets valued at fair value through other comprehensive income. Financial assets valued at fair value through profit or loss are expensed through the profit or loss account on initial valuation and not included in the initial value of the asset.																	
06.	(b)	Deducted from the proceeds of the debentures. The effective interest rate is then applied to the net amount.																	
07.	(d)	As a financial asset at amortized cost																	
08.	(d)	<table><tr><th></th><th>Rs. '000</th></tr><tr><td>Proceeds (20m – 0.5m)</td><td>19,500</td></tr><tr><td>Interest 10%</td><td>1,950</td></tr><tr><td>Interest paid (20m × 5%)</td><td>(1,000)</td></tr><tr><td>Balance 31 March 2011</td><td>20,450</td></tr><tr><td>Interest 10%</td><td>2,045</td></tr><tr><td>Interest paid (20m × 5%)</td><td>(1,000)</td></tr><tr><td>Balance 31 March 2012</td><td>21,495</td></tr></table>		Rs. '000	Proceeds (20m – 0.5m)	19,500	Interest 10%	1,950	Interest paid (20m × 5%)	(1,000)	Balance 31 March 2011	20,450	Interest 10%	2,045	Interest paid (20m × 5%)	(1,000)	Balance 31 March 2012	21,495	
	Rs. '000																		
Proceeds (20m – 0.5m)	19,500																		
Interest 10%	1,950																		
Interest paid (20m × 5%)	(1,000)																		
Balance 31 March 2011	20,450																		
Interest 10%	2,045																		
Interest paid (20m × 5%)	(1,000)																		
Balance 31 March 2012	21,495																		
09.	(a)	Fair value with changes going through profit or loss. Fair value through OCI would be correct if an election had been made to recognize changes in value through other comprehensive income. Amortized cost is used for debt instruments, not equity instruments.																	
10.	(a)	<table><tr><th></th><th>Rs.</th></tr><tr><td>1 January 2011</td><td>500,000</td></tr><tr><td>Interest 8%</td><td>40,000</td></tr><tr><td>Interest received (550,000 × 6%)</td><td>(33,000)</td></tr><tr><td>31 December 2011</td><td>507,000</td></tr><tr><td>Interest 8%</td><td>40,560</td></tr><tr><td>Interest received</td><td>(33,000)</td></tr><tr><td>31 December 2012</td><td>514,560</td></tr></table>		Rs.	1 January 2011	500,000	Interest 8%	40,000	Interest received (550,000 × 6%)	(33,000)	31 December 2011	507,000	Interest 8%	40,560	Interest received	(33,000)	31 December 2012	514,560	
	Rs.																		
1 January 2011	500,000																		
Interest 8%	40,000																		
Interest received (550,000 × 6%)	(33,000)																		
31 December 2011	507,000																		
Interest 8%	40,560																		
Interest received	(33,000)																		
31 December 2012	514,560																		

11.	(b)	Intangible assets. These do not give rise to a present right to receive cash or other financial assets. The other options are financial instruments	
12.	(b) & (d)	The other options are irrelevant.	
13.	(d)	Transactions costs including professional fees are expensed in case of investments classified as fair value through profit or loss	
14.	(d)	Redeemable preference shares will be shown as a liability, with the payments being shown as finance costs.	
15.	(b)	The default category for equity investments is fair value through profit or loss so the investments should be revalued to fair value (not fair value less costs to sell), with the gain or loss taken to the statement of profit or loss.	
16.	(a)		Rs. '000
		Rs. $12,500 \times 1,296 / 1,200$	13,500
		Carrying amount	(12,500)
		Gain	1,000
17.	(b)	40,000 shares @ Rs. 60 = Rs. 2,400,000	
18.	(c)		Rs.
		1 January Y1	970
		Interest 8.1%	79
		Interest received (1,000 × 6%)	(60)
		31 December y1	989
		Interest 8.1%	80
		Interest received (1,000 × 6%)	(60)
		31 December Y2	1,009
19.	(d)	The initial liability should be recorded at the net proceeds of Rs. 9.6 million. The finance cost should then be accounted for using the effective rate of interest of 8%. Therefore, the finance cost for the year is Rs. 768,000 (Rs. 9.6 million × 8%).	
20.	(a)	Initial recognition Rs. 100 million – Rs. 3 million = Rs. 97 million	
			Rs. million
		1 January 2014	97
		Interest 8%	7.76
		Interest received (100 × 5%)	(5)
		31 December 2014	99.76
		Interest 8%	7.98
21.	(a)	Only (I) is correct	
22.	(c)	Both are correct	
23.	(d)	(Fair value Rs. 20 million – issue costs 0.5 million) × 8% effective rate = Rs. 1,560,000	

STICKY NOTES

CLASSIFICATION

FINANCIAL ASSETS – INVESTMENT IN EQUITY INSTRUMENTS

Classification	Requirement
Amortised cost	Not Applicable
Fair value through OCI	Instrument not held for trading. The designation as FVTOCI is irrevocable choice.
Fair value through PL	Default residual category i.e. instruments held for trading.

FINANCIAL ASSETS – INVESTMENT IN DEBT INSTRUMENTS

Classification	Business Model Test	Cash Flows Test
Amortised cost	Hold to collect contractual cash flows	Solely payment of Principal and Interest on specified dates
Fair value through OCI	Hold to collect contractual cash flows and/or sell if beneficial	Solely payment of Principal and Interest on specified dates
Fair value through PL	Default residual category. Allowed even if conditions for other classification are met, if doing so eliminates accounting mismatch.	

FINANCIAL LIABILITIES

Classification	Requirement
Amortised cost	All financial liabilities other than those measured at FV.
Fair value	Held for trading OR to eliminate accounting mismatch OR held for hedging purposes

MEASUREMENT: INVESTMENT IN EQUITY INSTRUMENTS

Classification	Initial measurement	Subsequent measurement	Changes
Amortised cost	Not applicable		
Fair value through OCI	Fair value + transaction costs	Fair value	Dividend in PL Change in FV in OCI
Fair value through PL	Fair value	Fair value	Dividend in PL Change in FV in PL

MEASUREMENT: INVESTMENT IN DEBT INSTRUMENTS			
Classification	Initial measurement	Subsequent measurement	Changes
Amortised cost	Fair value + transaction costs	Amortised cost	Effective Interest in PL
Fair value through OCI	Fair value + transaction costs	Fair value	Effective Interest in PL
		(after effective interest)	Change in FV in OCI
Fair value through PL	Fair value	Fair value	Interest in PL
		(after interest)	Change in FV in PL

MEASUREMENT: FINANCIAL LIABILITIES			
Classification	Initial measurement	Subsequent measurement	Changes
Amortised cost	Fair value – transaction costs	Amortised cost	Effective Interest in PL
Fair value	Fair value	Fair value	Change due to own credit risk in OCI
			Remaining change in PL

IMPAIRMENT OF FINANCIAL ASSETS

The following table summarises the general approach for impairment of financial assts:

	Stage 1	Stage 2	Stage 3
When?	Initial recognition and subsequently if no significant increase in credit risk.	Credit risk increases significantly (presumption if past due for more than 30 days)	Objective evidence of impairment at reporting date
ECL	12-month ECL	Lifetime ECL	Lifetime ECL
Calculation of effective interest	On gross carrying amount	On gross carrying amount	On carrying amount net of loss allowances

AT A GLANCE

SPOTLIGHT

STICKY NOTES

IFRS 16 LEASES

IN THIS CHAPTER:

AT A GLANCE

SPOTLIGHT

1. Identifying a lease
2. Definitions and concepts
3. Accounting by lessee
4. Accounting by lessor
5. Comprehensive Examples
6. Objective Based Q&A

STICKY NOTES

AT A GLANCE

IFRS 16 provides comprehensive guidance on accounting for leases for lessor and lessee both, in terms of recognition, measurement, presentation and disclosure. It includes guidance on how to identify a lease contract and determining the lease term.

The key objective of IFRS 16 is to ensure that lessees recognise assets and liabilities for their major leases unless it chooses to apply recognition exemptions available in case of short term leases and leases of low value items.

The recognised asset is called right of use asset and it is depreciated over useful life when ownership is to be transferred to lessee, otherwise such asset is depreciated over shorter of useful life and lease term.

The lease liability is initially measured at present value of lease payments to be made over the lease term and is subsequently increases with accrual of interest and decreases with the payments.

The expense of short term leases and leases of low value items is recognised on straight line basis over the lease term.

Lessor is required to classify its leases as either finance lease or operating lease. A finance lease is accounted for as if lessor is providing finance to lessee for acquisition of underlying asset. A manufacturer or dealer recognises revenue when it gives its inventory asset under finance lease.

Under operating lease, a lessor does not derecognise the underlying asset and records the lease rental income on straight line basis.

1. IDENTIFYING A LEASE

1.1 Definitions [IFRS 16: Appendix A]

The following definitions are relevant for basic understanding:

“Lease” is a contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration.

“Lessee” is an entity that obtains the right to use an underlying asset for a period of time in exchange for consideration.

“Lessor” an entity that provides the right to use an underlying asset for a period of time in exchange for consideration.

1.2 Identifying a lease [IFRS 16: 9]

IFRS 16 requires that at inception of a contract, an entity shall assess whether the contract is, or contains, a lease. A contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration.

1.2.1 Is the asset identified? [IFRS 16: B13 & B14]

Asset is usually identified by being explicitly specified but may be implicitly specified at the time asset is made available.

An asset is not considered identified if supplier (i.e. potential lessor) has substantive right of substitution, that is the case when:

- Supplier has practical ability to substitute (e.g. assets of specialized nature may not be substituted); and
- Supplier would benefit economically if it substituted the asset (i.e. benefits exceed expected costs).

1.2.2 Right to control the use [IFRS 16: B9 & B10]

An entity shall assess whether, throughout the period of use, the customer (i.e. potential lessee) has both of the following:

- the right to obtain substantially all of the economic benefits from use of the identified asset; and
- the right to direct the use of the identified asset.

If the customer has the right to control the use of an identified asset for only a portion of the term of the contract, the contract contains a lease for that portion of the term.

1.2.3 Lease identification criteria [IFRS 16: B31]

The contract contains a lease if all of the following criteria are met:

- (a) The underlying asset is identified.
- (b) The customer (i.e. potential lessee) have the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use.
- (c) The customer (and not the supplier) has the right to direct how and for what purpose the asset is used throughout the period of use. If neither party has such right then the customer:
 - has the right to operate the asset throughout the period of use, without the supplier having the right to change those operating instructions; or
 - design the asset in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

► *Example 01:*

ABC Ltd enters into a 5 year contract with a freight carrier (XYZ Limited) to transport a specified quantity of goods.

XYZ Limited uses rail cars of a particular specification and has a large pool of similar rail cars that can be used to fulfil the requirements of the contract. The rail cars and engines are stored at XYZ Limited's premises when they are not being used to transport goods.

Costs associated with substituting the rail cars are minimal for XYZ Limited.

Required: Whether the contract contains a lease?

► *ANSWER:*

In this case, because the rail cars are stored at XYZ Limited's premises, and it has a large pool of similar rail cars and substitution costs are minimal, the benefits to XYZ Limited of substituting the rail cars would exceed the costs of substituting the cars.

Therefore, XYZ Limited's substitution rights are substantive, and the arrangement does not contain a lease.

► *Example 02:*

Capri Ice, a notable ice cream parlour, enters into a contract with Yardley Limited (YL) to use a space in a shopping mall owned by YL for a period of five years. The contract specifies the dimensions of space and location. However, YL has discretion to relocate the space to any other floor to accommodate other customers who would be conducting promotional events and activities in the mall.

Required: Discuss whether the contract between Capri Ice and Yardley Limited constitute lease or not.

► *ANSWER:*

In this contract, the dimension of space and location in shopping mall are specified but still Capri Ice does not have the right to use the identified space because YL has the substantive right to substitute the space on following grounds:

- YL has the discretion to relocate Capri to any other floor.
- YL would benefit economically from substituting the space i.e. accommodate other customers for conducting promotional events and activities in the mall.

Moreover, one of the elements of lease is "exchange of consideration". In given scenario consideration for YL has not been mentioned.

In light of the above, this contract does not constitute a lease.

2. DEFINITIONS AND CONCEPTS

2.1 Recognition requirement for lessee [IFRS 16: 22]

A lessee is required to recognise a right-of-use asset representing its right to use the underlying leased asset and a lease liability representing its obligation to make lease payments.

2.1.1 Recognition Exemptions [IFRS 16: 5, 6 & 8]

A lessee may avail exemption from above recognition requirements in following cases:

- (a) **Short term leases:** A lease that, at commencement date, has a lease term of 12 months or less (including extension option etc.). A lease that contains a purchase option is not a short-term lease. This exemption is available to lessee by class of assets.
- (b) **Leases of low value items (whether or not material to lessee):** The leases for which the underlying asset is of low value (e.g. telephones, laptop computers, and office furniture). If a lessee subleases an asset, or expects to sublease an asset, the head lease does not qualify as a lease of a low-value asset. A lease of an underlying asset does not qualify as a lease of a low-value asset if the nature of the asset is such that, when new, the asset is typically not of low value. This exemption is available to lessee on lease by lease basis.

The lease payments associated with short term and low value item leases are charged as an expense on either a straight-line basis over the lease term or another systematic basis (only if more representative).

2.2 Lease classification by lessor [IFRS 16: 61 & 62]

A lessor classifies lease contract as either finance lease or operating lease.

A lease is classified as a “finance lease” if it transfers substantially all the risks and rewards incidental to ownership of an underlying asset. A lease is classified as an “operating lease” if it does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset.

► Example 03:

According to a lease contract, the ownership of asset shall be transferred to lessee at no cost at the end of lease term.

Required: Briefly discuss type of lease from lessor’s perspective.

► ANSWER:

This is finance lease as transfer of ownership implies that all (or substantial) risk and rewards shall be borne by the lessee.

2.3 Inception date & commencement date [IFRS 16: Appendix A]

Inception date of the lease

The earlier of the date of a lease agreement and the date of commitment by the parties to the principal terms and conditions of the lease. The type of lease is identified on this date.

Commencement date of the lease

The date on which a lessor makes an underlying asset available for use by a lessee. The accounting treatment is applied from this date.

► Example 04:

J Limited enters into a contract for the lease of a car with K Leasing Limited on January 18th. K Leasing Limited agrees to transfer the car in the name of J Limited on February 3rd. However, J Limited would have the right to use the car as at February 22nd.

Required: Identify the inception date and commencement date of lease.

► **ANSWER:**

Inception date: January 18th

Commencement date of lease: February 22nd

2.4 Lease Term [IFRS 16: 18]

Lease term is the non-cancellable period for which a lessee has the right to use an underlying asset, together with both:

- periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option; and
- periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option.

► **Example 05:**

S Limited acquired a plant on lease for a non-cancellable period of 6 years. S Limited has right to extend the period of lease further 4 years at the end of first 6 years.

Required:

Determine the lease term assuming that:

- It is reasonably certain that S Limited will not exercise extension option.
- It is reasonably certain that S Limited will exercise extension option.

► **ANSWER:**

- 6 years
- 10 years

► **Example 06:**

Sher Khan Limited (lessee) enters in to lease over a plant. Consider the following independent scenarios:

Scenario 1: The lease is non-cancellable for a period of 3 years from commencement date after which Sher Khan Limited then has the option to extend the lease for a further 2 years. Sher Khan Limited is reasonably certain that it will exercise the renewal option.

Scenario 2: The lease is non-cancellable for a period of 3 years from commencement date after which Sher Khan Limited then has the option to extend the lease for a further 2 years. Sher Khan Limited is reasonably certain that it will not exercise the renewal option.

Scenario 3: The lease is for a 10-year period during which the first 7 years is non-cancellable. At the end of the 7-year period, Sher Khan Limited has the option to terminate the lease. Sher Khan Limited is reasonably certain that it will exercise the termination option.

Scenario 4: The lease is for a 10-year period during which the first 7 years is non-cancellable. At the end of the 7-year period, Sher Khan Limited has the option to terminate the lease. Sher Khan Limited is reasonably certain that it will not exercise the termination option.

Scenario 5: The lease is for a 10-year period during which the first 7 years is non-cancellable. At the end of the 7-year period, both Sher Khan Limited and the lessor have the option to terminate the lease. Sher Khan Limited is reasonably certain that it will not exercise the termination option.

Required: Determine lease term for each of the scenarios along with explanation.

► **ANSWER:**

Scenario 1: Lease term is 5 years. The optional extension period is included because lessee is reasonably certain that it will exercise the option to extend the lease.

Scenario 2: Lease term is 3 years. The optional extension period is excluded because lessee is not reasonably certain that it will exercise the option to extend the lease.

Scenario 3: Lease term is 7 years. The optional cancellable period is excluded since it is only included if there is reasonable certainty that the option to cancel (terminate) the lease would not be exercised. However, in this case, lessee is reasonably certain that it will exercise its option to cancel.

Scenario 4: Lease term is 10 years. The optional cancellable period is included because we include it if we are reasonably certain that we would not exercise our option to cancel (terminate) the lease. In this case, lessee is reasonably certain that it will not wish to cancel the lease.

Scenario 5: Lease term is 7 years. The optional cancellable period is excluded. Although we normally include the cancellable periods if we are reasonably certain that the option to cancel (terminate) will not be exercised, and in this case, lessee is reasonably certain that it will not wish to cancel the lease, however, the cancellable period is excluded because the lessor also has the option to cancel the lease during this period.

2.5 Economic life and useful life [IFRS 16: Appendix A]

Economic life is either:

- the period over which an asset is expected to be economically usable by one or more users; or
- the number of production or similar units expected to be obtained from the asset by one or more users.

Useful life is either:

- the period over which an asset is expected to be available for use by an entity; or
- the number of production or similar units expected to be obtained from an asset by an entity.

Notice that useful life is entity specific concept and economic life is not. Useful life is relevant to calculation of depreciation while economic life is one of the factors considered while classifying the lease contract.

► **Example 07:**

B Limited acquired a second hand plant. The total maximum use of such plant is expected to be 12 years by one or more users. The plant has already been used for 4 years by previous owners. B Limited intends to use the plant for 5 years and then wants to sell it to someone else.

Required: Determine economic life and useful life.

► **ANSWER:**

Total economic life is 12 years (remaining 8 years).

Total useful life for B Limited is 5 years.

2.6 Lease payments (including residual value guarantee) [IFRS 16: Appendix A]

Lease payments are payments made by a lessee to a lessor relating to the right to use an underlying asset during the lease term, comprising the following:

- fixed payments (including in-substance fixed payments), less any lease incentives;
- variable lease payments that depend on an index or a rate;
- the exercise price of a purchase option if the lessee is reasonably certain to exercise that option; and
- payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease.

Lease payments also include:

- for the lessee, amounts expected to be payable by the lessee under residual value guarantees.
- for the lessor, any residual value guarantees provided to the lessor by the lessee, a party related to the lessee or a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee.

“Residual value guarantee” is a guarantee made to a lessor by a party unrelated to the lessor that the value (or part of the value) of an underlying asset at the end of a lease will be at least a specified amount.

► **Example 08:**

Adeel Limited (AL) acquired a machine on lease from Kashif Limited (KL) on following terms:

Down Payment	Rs. 5 million
Annual Payments (in arrears)	Rs. 8 million
Lease Term	5 years

In addition to above information consider the following three independent scenarios:

Scenario 1: AL has guaranteed residual value of Rs. 10 million, although it expects to pay Rs. Nil as machine has expected residual value of Rs. 15 million.

Scenario 2: AL has guaranteed residual value of Rs. 10 million, although it expects to pay only Rs. 3 million as machine has expected to have market value of Rs. 7 million at end of lease term.

Scenario 3: AL has not guaranteed any residual value, however, M Limited (manufacturer of machine) has guaranteed KL to purchase the machine at the end of lease term at Rs. 13 million if KL so desire.

Required: Calculate total lease payments for AL and KL for each of the above scenarios.

► **ANSWER:**

Scenario 1:

For AL (Lessee):	$[5m + (8m \times 5 \text{ years}) + \text{Nil}] = \text{Rs. } 45 \text{ m}$
For KL (Lessor):	$[5m + (8m \times 5 \text{ years}) + 10m] = \text{Rs. } 55m$

Scenario 2:

For AL (Lessee):	$[5m + (8m \times 5 \text{ years}) + 3m] = \text{Rs. } 48 \text{ m}$
For KL (Lessor):	$[5m + (8m \times 5 \text{ years}) + 10m] = \text{Rs. } 55m$

Scenario 3:

For AL (Lessee):	$[5m + (8m \times 5 \text{ years}) + \text{Nil}] = \text{Rs. } 45 \text{ m}$
For KL (Lessor):	$[5m + (8m \times 5 \text{ years}) + 13m] = \text{Rs. } 58m$

2.7 Definitions relating to finance lease calculation [IFRS 16: Appendix A]

“Initial direct costs” (IDC) are incremental costs for obtaining a lease that would not have been incurred if the lease had not been obtained, except for such costs incurred by a manufacturer or dealer lessor in connection with a finance lease.

“Gross investment in the lease” (GI) is the sum of:

- the lease payments receivable by a lessor under a finance lease; and
- any unguaranteed residual value accruing to the lessor.

“Unguaranteed residual value” (URV) is that portion of the residual value of the underlying asset, the realisation of which by a lessor is not assured or is guaranteed solely by a party related to the lessor.

“Net investment in the lease” (NI) is the gross investment in the lease discounted at the interest rate implicit in the lease.

“Unearned finance income” (UFI) is the difference between:

- the gross investment in the lease; and
- the net investment in the lease.

“Interest rate implicit in the lease” is the discount rate that, at the inception of the lease, causes (for lessor):

$$\text{PV of lease payments} + \text{PV of URV} = \text{Fair value of leased asset} + \text{Initial direct cost}$$

“Lessee’s incremental borrowing rate of interest” is the rate of interest that a lessee would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the right-of use asset in a similar economic environment.

► **Example 09:**

Maria Leasing Limited (MLL) leased an asset (fair value Rs. 285,000) to XYZ Limited for use at annual rental (in arrears) of Rs. 80,000 for five years. MLL incurred initial direct costs of Rs. 5,227 on inception of lease. MLL estimated the residual value of Rs. 30,000 at the end of lease term, however, only Rs. 20,000 is guaranteed by XYZ Limited. Interest rate implicit in lease is 14%.

Required: Calculate amounts relevant to finance lease from the above information for MLL.

► **ANSWER:**

Residual value guarantee		= Rs. 20,000
Lease payments	$[(80,000 \times 5) + 20,000]$	= Rs. 420,000
Unguaranteed residual value	$[30,000 - 20,000]$	= Rs. 10,000
Gross investment in lease	$[420,000 + 10,000]$	= Rs. 430,000
PV of rentals	$[80,000 \times (1 - 1.14^{-5}) / 0.14]$	= Rs. 274,646
PV of RV guarantee	$[20,000 \times 1.14^{-5}]$	= Rs. 10,387
PV of URV	$[10,000 \times 1.14^{-5}]$	= Rs. 5,194
Net investment in lease	$[274,646 + 10,387 + 5,194]$	= Rs. 290,227
Unearned finance income	$[430,000 - 290,227]$	= Rs. 139,773
Implicit rate (proof)	Rs. 290,227	= Rs. 285,000 + 5,227

The interest rate implicit in the lease and the equation that it achieves can be used to determine amount of periodic rentals if not known.

► **Example 10:**

Sani Limited (SL) leased an asset having fair value of Rs. 3,500,000 from Khan Limited (KL) for a lease term of 5 years. SL incurred initial direct costs of Rs. 60,000 and KL incurred initial direct costs of Rs. 40,000 separately.

KL estimates the residual value of the asset at the end of lease term to be Rs. 500,000 out of which 200,000 is guaranteed by SL.

KL incorporates interest rate implicit in the lease of 15% while incremental borrowing rate of SL is 14%.

Required: Calculate annual rentals (equal) to be paid in arrears in the above lease arrangement.

► **ANSWER:**

Using the equations (from lessor's perspective):

PV of lease payments + PV of URV = Fair value of leased asset + Initial direct cost

PV of lease payment = PV of annual rentals + PV of residual value guarantee

Annual Rentals = PV of annual rentals / Annuity discount factor

	Rs.
Fair value of lease asset	3,500,000
Initial direct cost for lessor	40,000
PV of lease payment + PV of URV	3,540,000
Less: PV of URV (Rs. 500,000 – 200,000) x (1.15 ⁻⁵)	(149,153)
PV of lease payments	3,390,847
Less: PV of residual value guarantee (Rs. 200,000 x 1.15 ⁻⁵)	(99,435)
PV of annual rentals	3,291,412
Annual rental [Rs. 3,291,412 / (1-1.15 ⁻⁵)/0.15]	981,879

3. ACCOUNTING BY LESSEE

3.1 Initial recognition and measurement [IFRS 16: 22 to 24 & 26]

A lease is capitalised at the commencement date of the lease term. This involves the recognition of the asset that is subject to the lease and a liability for the future lease payment.

A lessee shall record the following journal entry at the commencement date (to the extent relevant):

Debit Right of use [Note 1]

Credit Bank [Note 2]

Credit Bank/accrual [Note 3]

Credit Lease liability [Note 4]

Credit Provision for dismantling [Note 5]

Note 1: The right of use asset is measured at cost. The cost of right of use assets is equal to aggregate of all the items credited.

Note 2: Any lease payments made at or before the commencement date, less any lease incentives.

Note 3: Initial direct costs for lessee. Examples of initial direct costs of a lessee include commissions, legal fees (if contingent on origination of the lease), costs of negotiating lease, costs of arranging collateral and payments made to existing tenants to obtain the lease.

Note 4: At the commencement date of the lease, a lessee recognises a lease liability for the unpaid portion of payments (and amount expected to be payable for guaranteed residual value, if any), discounted at the rate implicit in the lease or, if this is not readily determinable, the incremental rate of borrowing.

Note 5: This is measured in accordance with IAS 37.

► **Example 11:**

On 1 January 2020, Multan Limited (ML) acquired a machine on lease from Vehari Leasing Limited (VLL) for 3 years. The first annual instalment amounting to Rs. 35 million was paid on 1 January 2020 and two more subsequent annual instalments of Rs. 35 million are payable on 1 January each year.

ML incurred initial direct cost of Rs. 5 million. ML uses similar owned machines for 7 years and depreciates them on straight line basis.

Interest rate implicit in the lease is not known to ML. However, ML's incremental borrowing rate is 12%.

The machine shall be returned to VLL at the end of lease term. The estimated residual value of the machine at the end of 3 years is estimated at Rs. 30 million, out of which ML has guaranteed Rs. 20 million.

ML is also obliged to incur decommissioning cost of Rs. 4 million at the end of the lease term. The pre-tax rate that reflects current market assessments of the time value of money and the risks specific to such obligation is 10%.

Required: Prepare the journal entry at commencement date of lease in the books of ML.

► **ANSWER:**

Date	Particulars	Debit Rs. m	Credit Rs. m
1 Jan 2020	Right of use asset	102.16	
	Bank (first instalment)		35
	Bank (initial direct cost)		5
	Lease liability $(35 \times (1 - 1.12^{-2}) / 0.12)$		59.15
	Provision for decommissioning (Rs. 4m $\times 1.10^{-3}$)		3.01

Note: Nothing is expected to be paid for residual value guarantee as expected residual value is more than the amount guaranteed.

3.2 Subsequent measurement – right of use asset [IFRS 16: 29 to 35]

After the commencement date, a lessee shall measure the right-of-use asset in one of the following ways:

Cost model (IAS 16)	Revaluation Model (IAS 16)	Fair value model (IAS 40)
Lessee applies cost model unless it applies other measurement models.	If right-of-use assets relate to a class of PPE to which the lessee applies the revaluation model in IAS 16, a lessee may elect to apply that revaluation model to all of the right-of-use assets that relate to that class of PPE.	If a lessee applies the fair value model in IAS 40 Investment Property to its investment property, the lessee shall also apply that fair value model to right-of-use assets that meet the definition of investment property in IAS 40.
Depreciation period is the useful life of the asset if the lease transfers ownership of the underlying asset (including when purchase option is to be exercised by lessee); otherwise earlier of the asset's useful life and lease term.		
A lessee shall apply IAS 36 Impairment of Assets to determine whether the right-of-use asset is impaired and to account for any impairment loss identified.		

► **Example 12:**

Use the data from previous example on Multan Limited (ML).

Required: Prepare journal entries reflecting subsequent measurement of right of use asset and provision for decommissioning (assuming that provision was settled as estimated).

► **ANSWER:**

Date	Particulars	Debit Rs. m	Credit Rs. m
31 Dec 2020	Depreciation (Rs. 102.16m / 3 years)	34.05	
	Accumulated depreciation (ROU)		34.05
31 Dec 2020	Finance cost (Rs. 3.01m x 10%)	0.30	
	Provision for decommissioning		0.30
31 Dec 2021	Depreciation (Rs. 102.16m / 3 years)	34.05	
	Accumulated depreciation (ROU)		34.05
31 Dec 2021	Finance cost (Rs. 3.31m x 10%)	0.33	
	Provision for decommissioning		0.33
31 Dec 2022	Depreciation (Rs. 102.16m / 3 years)	34.06	
	Accumulated depreciation (ROU)		34.06
31 Dec 2022	Finance cost (Rs. 3.64m x 10%)	0.36	
	Provision for decommissioning		0.36
31 Dec 2022	Accumulated depreciation (ROU)	102.16	
	Right of use asset		102.16
31 Dec 2022	Provision for decommissioning	4	
	Bank		4

3.3 Subsequent measurement – lease liability [IFRS 16: 36 to 38]

After the commencement date, a lessee re-measures the lease liability by:

Increasing the carrying amount to reflect interest on the lease liability.	Dr. Interest expense Cr. Lease liability
Reducing the carrying amount to reflect the lease payments made.	Dr. Lease liability Cr. Bank
Variable lease payments that have not been included in the initial measurement of the lease liability are recognised in the period in which the event or condition that triggers the payments occurs.	Dr. Expense (PL) Cr. Bank / Accrual

► **Example 13:**

Use the data from previous examples on Multan Limited (ML).

Required: Prepare journal entries reflecting subsequent measurement of lease liability (assuming that no payment was required to be paid at the end of lease term for residual value guarantee as expected earlier).

► **ANSWER:**

Date	Particulars	Debit Rs. m	Credit Rs. m
31 Dec 2020	Interest expense	7.10	
	Lease liability		7.10
1 Jan 2021	Lease liability	35	
	Bank		35
31 Dec 2021	Interest expense	3.75	
	Lease liability		3.75
1 Jan 2022	Lease liability	35	
	Bank		35

W1 - Lease schedule (Payment in advance)					
Payment Date	Opening balance	Payment	Net Balance	Interest @ 12%	Closing Balance
	Rs. m				
01-Jan-20	94.15	(35)	59.15	7.10	66.25
01-Jan-21	66.25	(35)	31.25	3.75	35
01-Jan-22	35	(35)	0	0	0

3.4 Accounting for short term and low value item leases [IFRS 16: 6]

The lease payments associated with short term and low value item leases are charged as an expense on either a straight-line basis over the lease term or another systematic basis (only if more representative).

► **Example 14:**

An entity leased a car under a ten months lease at Rs. 40,000 per month for first five months and Rs. 30,000 for next five months. The asset had fair value of Rs. 3,000,000. The ownership will not transfer to the lessee.

Required: Briefly explain the accounting treatment assuming that the entity wants to apply recognition exemption under IFRS 16.

► **ANSWER:**

The above lease meets short term lease definition as lease term is less than 12 months and ownership will not be transferred at the end of lease term. The monthly expense on straight line basis would be:

$[(Rs. 40,000 \times 5 \text{ months}) + (Rs. 30,000 \times 5 \text{ months})] / 10 \text{ months} = Rs. 35,000 \text{ per month}$

Date	Particulars	Debit Rs.	Credit Rs.
For each of first five months	Lease rental expense	35,000	
	Prepayment	5,000	
	Cash/Bank		40,000
For each of next five months	Lease rental expense	35,000	
	Cash/Bank		30,000
	Prepayment		5,000

► **Example 15:**

Saima Limited (SL) leased a laptop computer under a 24 months lease at Rs. 2,500 per month. A sum of Rs. 4,800 was also deposited as non-refundable down payment. The fair value of the laptop computer is Rs. 95,000. SL determines that it is low value asset.

Required: Briefly discuss the accounting treatment assuming that SL want to apply recognition exemption under IFRS 16.

► **ANSWER:**

When the lessee makes payments to lessor over 24 months, the lessee shall account for the payments in equal instalments (straight line basis). The monthly expense on straight line basis would be:

$[Rs. 4,800 + (Rs. 2,500 \times 24 \text{ months})] / 24 \text{ months} = Rs. 2,700 \text{ per month}$

Date	Particulars	Debit Rs.	Credit Rs.
On down payment	Prepaid lease rental	4,800	
	Cash/Bank		4,800
For each monthly payment and expense	Lease rental expense	2,700	
	Cash/Bank		2,500
	Prepaid lease rental		200

3.5 Presentation [IFRS 16: 47 to 50]

Statement of Financial Position (or Notes)	Right-of-use assets ▪ Present right-of-use assets separately from other assets; or ▪ Include right-of-use assets within the same line item as the underlying asset and disclose which line item includes right of use assets. The above requirement is not applicable to right-of-use-assets that meet the definition of (and presented as) investment property. Lease liabilities ▪ Present separately from other liabilities; or ▪ Disclose the line item in which they are included.
Statement of Comprehensive Income	Interest expense on the lease liability is presented separately from depreciation of the right-of-use asset, as a component of finance costs.
Statement of Cash Flows	Principal payments on the lease liability as financing activities. Payments of interest in accordance with guidance for interest paid in IAS 7 (operating or financing activities). Short-term and low-value asset leases and variable lease payments that are not included in the measurement of lease liabilities are classified within operating activities.

3.6 Disclosure [IFRS 16: 52 to 58 & 60]

3.6.1 Requirement

A lessee shall disclose information about its leases for which it is a lessee in a single note or separate section in its financial statements. However, a lessee need not duplicate information that is already presented elsewhere in the financial statements, provided that the information is incorporated by cross-reference in the single note or separate section about leases.

3.6.2 Specific amounts to be disclosed

A lessee shall disclose the following amounts for the reporting period:

- depreciation charge for right-of-use assets by class of underlying asset;
- interest expense on lease liabilities;
- the expense relating to short-term leases. This expense need not include the expense relating to leases with a lease term of one month or less;
- the expense relating to leases of low-value assets. This expense shall not include the expense relating to short-term leases of low-value assets;
- the expense relating to variable lease payments not included in the measurement of lease liabilities;
- income from subleasing right-of-use assets;
- total cash outflow for leases;
- additions to right-of-use assets;
- gains or losses arising from sale and leaseback transactions; and
- the carrying amount of right-of-use assets at the end of the reporting period by class of underlying asset.

3.6.3 Tabular Format

A lessee shall provide the disclosures specified in a tabular format, unless another format is more appropriate. The amounts disclosed shall include costs that a lessee has included in the carrying amount of another asset during the reporting period.

3.6.4 Requirements of other Standards

If right-of-use assets meet the definition of investment property, a lessee shall apply the disclosure requirements in IAS 40.

If a lessee measures right-of-use assets at revalued amounts applying IAS 16, the lessee shall disclose the information specified in relevant disclosure of IAS 16 for those right of use assets.

3.6.5 Maturity Analysis

The lessee is required to disclose maturity analysis of lease liability for future lease payments (without discounting). A lessee uses its judgment to determine an appropriate number of time bands.

► **Example 16:**

On 1 Jan 2017, Pervez Limited (PL) leases a plant from a bank. PL is required to pay an annual instalment of Rs. 1 million at the end of each year for nine years. First payment was made on 31 December 2017.

Required: Prepare two possible versions of maturity analysis disclosure for PL assuming any reasonable judgements as to appropriate number of time bands.

► **ANSWER:**

Option 1

As at 31 December 2017	2017
Maturity analysis	Rs. in 000
Less than one year	1,000
More than one and not later than five years	4,000
More than five years	3,000
Total	8,000

Option 2

As at 31 December 2017	2017
Maturity analysis	Rs. in 000
Less than one year	1,000
One to two years	1,000
Two to three years	1,000
Three to four years	1,000
Four to five years	1,000
More than five years	3,000
Total	8,000

3.6.6 Short term leases commitments and Portfolio

A lessee shall disclose the amount of its lease commitments for short-term leases accounted if the portfolio of short-term leases to which it is committed at the end of the reporting period is dissimilar to the portfolio of short-term leases to which the short-term lease expense disclosed.

A lessee that accounts for short-term leases or leases of low-value assets using recognition exemption shall disclose that fact.

► **Example 17:**

X Limited acquired a machine on lease. The terms of the lease are as follows:

- (i) The lease period is for four years from 1 January 2016 with an annual rental of Rs.4,000,000 payable on 31 December each year.
- (ii) The lessee is required to pay all repairs, maintenance and other incidental costs.
- (iii) The interest rate implicit in the lease is 15% p.a.

Note: Estimated useful economic life span of the machine is four years.

Required:

- (a) Prepare a schedule of the allocation of the finance charges in the books of X Limited for the entire lease period.
- (b) Prepare an extract of the Statement of Financial Position of X Limited for the year ended 31 December 2016.

► **ANSWER:**

Part (a)		
Present value of lease payments		Rs.
Lease rental		4,000,000
Annuity factor	$[(1 - 1.15^{-4}) / 0.15]$	2.855
		11,420,000

Lease liability schedule (Payment in arrears)				
Payment Date	Opening Balance	Interest @ 15%	Payment	Closing Balance
	Rs.			
31-Dec-16	11,420,000	1,713,000	(4,000,000)	9,133,000
31-Dec-17	9,133,000	1,369,950	(4,000,000)	6,502,950
31-Dec-18	6,502,950	975,443	(4,000,000)	3,478,393
31-Dec-19	3,478,393	521,608	(4,000,000)	0

Part (b)			
Statement of financial position			
As at 31 December 2016			Rupees
Non-current assets			
Right of use asset	[11,420,000 - 2,855,000]		8,565,000
Non-current liabilities			
Lease liability		(a)	6,502,950
Current liabilities			
Lease liability	[9,133,000 - 6,502,950]	(a)	2,630,050
Statement of profit or loss			
For the year ended 31 December 2016			
Depreciation	[11,420,000 / 4 years]		2,855,000
Interest expense		(a)	1,713,000

► **Example 18:**

On 1 July 2014, Miracle Textile Limited (MTL) acquired a machine on lease, from a bank.

Details of the lease are as follows:

- Cost of machine is Rs. 20 million.
- The lease term and useful life is 4 years and 10 years respectively.
- Instalment of Rs. 5.80 million is to be paid annually in advance on 1 July.
- The interest rate implicit in the lease is 15.725879%.
- At the end of lease term, MTL has an option to purchase the machine on payment of Rs. 2 million. The fair value of the machine at the end of lease term is expected to be Rs. 3 million.

MTL depreciates the machines on the straight line method. It has a nil residual value.

Required: Prepare the relevant extracts of statement of comprehensive income, statement of financial position and related notes to the financial statements for the year ended 30 June 2016 along with comparative figures, ignore taxation.

► **ANSWER:**

Miracle Textile Limited					
Statement of Comprehensive Income				2016	2015
For the year ended 30 June 2016				Rs.	Rs.
Depreciation	[Rs. 20 m / 10 years]			2,000,000	2,000,000
Interest expense		W1		1,672,144	2,233,075
Statement of financial position					
As at 30 June 2016					
Non-current assets					
Right of use asset		N1		16,000,000	18,000,000
Non-current liabilities					
Lease liability		N2 (W1)		6,505,219	10,633,075
Current liabilities					
Lease liability		N2 (W1)		5,800,000	5,800,000

Note 1: PPE (Right of use assets)			2016	2015
			Rs.	Rs.
Opening balance			18,000,000	-
Additions			-	20,000,000
Depreciation			(2,000,000)	(2,000,000)
Balance as at June 30			16,000,000	18,000,000

Note 2: Maturity Analysis (Lease)			2016	2015
Contractual undiscounted lease payments			Rs.	Rs.
Less than one year			5,800,000	5,800,000
One to two years	[5,800,000 + 2,000,000]		7,800,000	13,600,000
			13,600,000	19,400,000

Lease of machine: The company has entered into a lease agreement with a bank in respect of a machine. The lease liability bears interest at the rate of 15.725879% per annum. The company has option to purchase the machine by paying an amount of Rs.2 million at the end of lease term. The lease rentals are payable in annual instalments in advance. There are no financing restrictions in the lease agreement.

W1 - Lease schedule (Payment in advance)					
Payment Date	Opening balance	Payment	Net Balance	Interest @ 15.725879%	Closing Balance
	Rs.				
01-Jul-14	20,000,000	(5,800,000)	14,200,000	2,233,075	16,433,075
01-Jul-15	16,433,075	(5,800,000)	10,633,075	1,672,144	12,305,219
01-Jul-16	12,305,219	(5,800,000)	6,505,219	1,023,003	7,528,222
01-Jul-17	7,528,222	(5,800,000)	1,728,222	271,778	2,000,000
30-Jun-18	2,000,000	(2,000,000)	0	0	0

Present value	Cash flow	PV / Annuity factor	Present value
	Rs.		Rs.
Rental 1	5,800,000	1	5,800,000
Rental 2 to 4	5,800,000	$(1 - 1.15725879^{-3}) / 0.15725879$	13,084,915
Purchase option	2,000,000	1.15725879^{-4}	1,115,085
			20,000,000

► **Example 19:**

On 1 April 2015 Acacia Ltd entered into the following lease agreement.

- Plant with a fair value of Rs. 275,000 was leased under an agreement which requires Acacia Ltd to make annual payments of Rs. 78,250 on 1 April each year, commencing on 1 April 2015, for four years. After the four years Acacia Ltd has the option to continue to lease the plant at a nominal rent for a further three years and is likely to do so as the asset has an estimated useful life of six years. The present value of the lease payments is Rs. 272,850. Acacia Ltd is responsible for insuring and maintaining the plant during the period of the lease.

- (ii) Office equipment with a fair value of Rs. 24,000 was leased under a non-cancellable agreement which requires Acacia Ltd to make annual payments of Rs. 6,000 on 1 April each year, commencing on 1 April 2015, for three years. The lessor remains responsible for insuring and maintaining the equipment during the period of the lease. The equipment has an estimated useful life of ten years. The present value of the lease payments is Rs. 16,415. This lease is considered low value item lease by Acacia Ltd.

Acacia Ltd allocates finance charges on an actuarial basis. The interest rate implicit in the lease is 10%.

Required: Prepare all relevant extracts from Acacia Ltd.'s financial statements for the year ended 31 March 2016.

► **ANSWER:**

ACACIA Limited					
Statement of Comprehensive Income					
For the year ended 31 March 2016					
					Rs.
Depreciation	[272,850 / 6 years]				45,475
Interest expense			W1		19,460
Lease rental expense	(low value item lease)				6,000
ACACIA Limited					
Statement of financial position					
As at 31 March 2016					
					Rs.
Non-current assets					
Right of use	[272,850 - 45,475]				227,375
Non-current liabilities					
Lease liability			W1		135,810
Current liabilities					
Lease liability			W1		78,250
Notes to the financial statements					
Maturity Analysis					
					Rs.
Less than one year					78,250
Two to five years	[78,250 x 2 years]				156,500
					234,750
W1 - Lease schedule (Payment in advance)					
Payment Date	Opening balance	Payment	Net Balance	Interest @ 10%	Closing Balance
	Rs.				
01-Apr-15	272,850	(78,250)	194,600	19,460	214,060
01-Apr-16	214,060	(78,250)	135,810		

► **Example 20:**

Progress Limited acquired a machine from Fine Rentals Limited on January 3, 2016 under a lease agreement extending over three years.

The agreement required them to make an initial deposit of Rs. 1,280,000 to be followed by three annual payments of Rs.800,000 on 31 December each year starting from 2016.

The cash price of the machinery was Rs. 3,200,000 and Fine Rentals Limited added 12% interest which was duly communicated to Progress Limited.

Required:

- (a) Compute the interest element and the capital portion of the annual repayments; and
- (b) Show the journal entries that will record the transaction resulting from the lease agreement (excluding depreciation entries).

► **ANSWER:**

Part (a)					
Lease schedule (Payment in arrears)					
Payment Date	Opening balance	Interest @ 12%	Rental payment	Closing Balance	Capital repayment
	Rs.				Rs.
03-Jan-16	3,201,465		(1,280,000)	1,921,465	1,280,000
31-Dec-16	1,921,465	230,576	(800,000)	1,352,041	569,424
31-Dec-17	1,352,041	162,245	(800,000)	714,286	637,755
31-Dec-18	714,286	85,714	(800,000)	0	714,286
		478,535	(3,680,000)		3,201,465

Present value	Cash flow	PV / Annuity factor	Present value
	Rs.		Rs.
Initial deposit	1,280,000	1	1,280,000
Annual rentals	800,000	$(1 - 1.12^{-3}) / 0.12$	1,921,465
			3,201,465

Part (b) Journal entries			
Date	Particulars	Dr. Rs.	Cr. Rs.
03-Jan-16	Right of use (Plant & Machinery)	3,201,465	
	Bank		1,280,000
	Lease liability		1,921,465
31-Dec-16	Interest expense	230,576	
	Lease liability		230,576
31-Dec-16	Lease liability	800,000	
	Bank		800,000
31-Dec-17	Interest expense	162,245	
	Lease liability		162,245
31-Dec-17	Lease liability	800,000	
	Bank		800,000
31-Dec-18	Interest expense	85,714	
	Lease liability		85,714
31-Dec-18	Lease liability	800,000	
	Bank		800,000

► **Example 21:**

Chain Limited (CL) is preparing its financial statements for the year ended 30 June 2019. Following information is available:

On 1 January 2019, CL acquired a machine on lease from a bank. Fair value of machine on acquisition was Rs. 70 million. CL incurred initial direct cost of Rs. 5 million and received lease incentives of Rs. 2 million.

The terms agreed with the bank are as follows:

- (i) The lease term and useful life are 4 years and 10 years respectively.
- (ii) Instalment of Rs. 17 million is to be paid annually in advance on 1 January.
- (iii) The rate implicit in the lease is 15.096% per annum.
- (iv) At the end of the lease term, CL has an option to purchase the machine at its estimated fair value of Rs. 25 million. It is not reasonably certain that CL will exercise this option.

Required: Prepare extracts from CL's statement of financial position and related notes to the financial statements for the year ended 30 June 2019 for the above.

► **ANSWER:**

Chain Limited			
Statement of financial position (extracts)			
As at 30 June 2019			Rs. million
Non-current assets			
Right of use asset		W2	51.41
Non-current liabilities			
Lease liability		W1	27.60
Current liabilities			
Lease liability	[41.67 - 27.60]	W1	14.08
Notes to the financial statements			
For the year ended 30 June 2019			
Maturity Analysis			Rs. million
Less than one year			17
One to two years			17
Two to three years			17
			51

W1: Lease liability					Rs. m
PV of Lease payments		Rs. 17m x [(1 - 1.15096 ⁻⁴⁺¹) / 0.15096] + 1]			55.75
Lease schedule (Payment in advance)					
Payment Date	Opening balance	Payment	Net Balance	Interest @ 15.096% x 6/12	Closing Balance
	Rs. million				
01-Jan-19	55.75	(17)	38.75	2.92	41.67
				2.92	44.60
01-Jan-20	44.60	(17)	27.60		

W2: Right of use asset			Rs. million
Amount already paid			17
Initial direct costs less incentive	[5 – 2]		3
Lease liability			38.75
			58.75
Depreciation	[58.75 / 4 years x 6/12 months]		(7.34)
			51.41

4. ACCOUNTING BY LESSOR

4.1 Lease Classification [IFRS 16: 61 to 66]

A lessor shall classify each of its leases as either an operating lease or a finance lease at the inception date. A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership of an underlying asset. Otherwise, the lease is classified as operating lease.

It is important to note that whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract.

Examples of situations that individually or in combination would normally lead to a lease being classified as a finance lease (not always conclusive) are:

- Transfer of ownership to lessee at the end of lease term;
- The purchase option that is reasonably certain to be exercised;
- The lease term is major part of asset's economic life;
- PV of lease payments substantially covers all of FV of asset; and/or
- The leased asset is of such specialized nature that only lessee can use it without major modification.

Indicators of situations that individually or in combination could also lead to a lease being classified as a finance lease (not always conclusive) are:

- Lessor's losses associated with the cancellation of lease are borne by the lessee;
- Gain or losses from the fluctuation in fair value accrue to the lessee; and/or
- The lessee has the ability to continue the lease for secondary period at a rent that is substantially lower than market rent.

Classification is not changed due to:

- change in estimates (economic life, residual value etc.); and/or
- change in circumstances (e.g. default by lessee).

► Example 22:

Consider the following independent scenarios:

- E Limited acquired a special customized engine on lease. The engine can only be used by E Limited unless substantial modifications are made to the engine.
- P Limited acquired an asset on lease with fair value of Rs. 10 million and present value of lease payments is Rs. 9.7 million.
- M Limited acquired an asset on lease economic life of 20 years while M Limited wants to use the asset only for 17 years. The company has no intention to purchase the asset at the end of its lease term.
- T Limited acquired an asset on lease with an option to buy the asset at the end of lease term for Rs. 12 million. The fair value of the asset at the end of lease term is expected to be at least Rs. 55 million.

Required: Identify the above leases as either finance or operating leases from the perspective of lessor.

► ANSWER:

All of the above leases are likely to be classified as finance lease because:

- The underlying assets is of such specialised nature that only lessee can use it without major modifications.
- The present value of lease payments amounts to substantially all of the fair value of underlying asset.
- The lease term is for the major part of the economic life of the underlying asset.
- As purchase options is sufficiently lower than the fair value at the date of option, it is reasonably certain that this option will be exercised by the lessee.

► **Example 23:**

Jhang Construction has leased a cement lorry. The cash price of the lorry would be Rs.3,000,000. The lease is for 6 years at an annual rental (in arrears) of Rs.600,000. The asset is believed to have an economic life of 7 years. The interest rate implicit in the lease is 7%.

Jhang Construction is responsible for maintaining and insuring the asset.

Required: Identify the type of lease from lessor's perspective and state the reasons.

► **ANSWER:**

The lease is a finance lease. The reasons are:

- The lease is for a major part of the life of the asset (6 out of 7 years).
- Jhang Construction must insure the asset. It is exposed to one of the major risks of ownership of the asset (its loss).
- The present value of the lease payments is 95.3% $[(600,000 \times (1 - 1.07^{-6}) / 0.07)] / 3,000,000$ of the fair value of the asset at the inception of the lease.

4.2 Accounting for finance lease (general) [IFRS 16: 67 to 69 & 75]

A lessor, other than manufacturer or dealer lessor, shall account for the finance lease as follows:

Initial recognition – at commencement date of lease.	Dr. Net Investment in lease Cr. Asset (Bank) [At fair value or amount paid for acquisition] Cr. Bank / Accrual [Initial direct costs]
Accrual of interest.	Dr. Net Investment in lease Cr. Interest income
Receipts of lease payments.	Dr. Bank Cr. Net Investment in lease
The net investment in lease is presented in SFP, separated into current assets and non-current assets. The lease schedules are prepared similarly as that of lessee.	

► **Example 24:**

Shoaib Leasing Limited (the lessor) has entered into a three year agreement with Sarfaraz Limited (the lessee) to lease a machine with an expected useful life of 4 years. The cost of machine is Rs. 2,100,000.

The following information relating to lease transaction is available:

- Date of commencement of lease is July 1, 2016.
- The lease contains a purchase bargain option at Rs. 100,000. At the end of the lease term, the value of the machine will be Rs. 300,000.
- Lease instalments of Rs. 860,000 are payable annually, in arrears, on June 30.
- The implicit interest rate is 12.9972%.

Required:

- Prepare the journal entries for the years ending June 30, 2017, 2018 and 2019 in the books of lessor. Ignore tax.
- Produce extracts from the statement of financial position including relevant notes as at June 30, 2017 to show how the transactions carried out in 2017 would be reflected in the financial statements of the lessor. (Disclosure notes are not required.)

► ANSWER:

Answer: Part (a)			
Date	Particulars	Dr. Rs.	Cr. Rs.
01-Jul-16	Net Investment in lease	2,100,000	
	Machine / Bank		2,100,000
30-Jun-17	Net Investment in lease	272,940	
	Finance income		272,940
30-Jun-17	Bank	860,000	
	Net investment in lease		860,000
30-Jun-18	Net Investment in lease	196,639	
	Finance income		196,639
30-Jun-18	Bank	860,000	
	Net investment in lease		860,000
30-Jun-19	Net Investment in lease	110,421	
	Finance income		110,421
30-Jun-19	Bank	860,000	
	Net investment in lease		860,000
30-Jun-19	Bank (Purchase option)	100,000	
	Net investment in lease		100,000

Answer: Part (b)			
Statement of financial position (extracts)			
As at 30 June 2017			Rs.
Non-current assets			
Net investment in lease		W1	849,579
Current assets			
Net investment in lease	[1,512,940 - 849,579]	W1	663,361

W1 - Lease schedule (Payment in arrears)				
Payment Date	Opening balance	Interest @ 12.9972%	Payment	Closing Balance
Rs.				
30-Jun-17	2,100,000	272,940	(860,000)	1,512,940
30-Jun-18	1,512,940	196,639	(860,000)	849,579
30-Jun-19	849,579	110,421	(860,000) (100,000)	0

Receipts	Cash flow	PV / Annuity factor	Present value
	Rs.		Rs.
Annual rentals	860,000	$(1 - 1.129972^{-3}) / 0.129972$	2,030,690
Purchase option	100,000	1.129972^{-3}	69,310
			2,100,000

4.3 Accounting for finance lease (manufacturer or dealer lessor) [IFRS 16: 71 to 75]

A manufacturer or dealer lessor shall account for the finance lease as follows:

Initial recognition – at commencement date of lease.

Dr. Net Investment in lease
 Dr. Cost of Sales [Cost – PV of URV]
 Cr. Sales [Lower of fair value & PV of lease payments]
 Cr. Inventory [at Cost]

Note 1: Selling profit or loss [Revenue – Cost of Sales] is recognised in PL regardless of whether the lessor transfers the underlying asset as described in IFRS 15

Note 2: Manufacturer or dealer lessors sometimes quote artificially low rates of interest in order to attract customers. The use of such a rate would result in a lessor recognising an excessive portion of the total income from the transaction at the commencement date. If artificially low rates of interest are quoted, a manufacturer or dealer lessor shall restrict selling profit to that which would apply if a market rate of interest were charged.

Direct costs incurred

Dr. Expense (PL)
 Cr. Bank

Accrual of interest.

Dr. Net Investment in lease
 Cr. Interest income

Receipts of lease payments.

Dr. Bank
 Cr. Net Investment in lease

The net investment in lease is presented in SFP, separated into current assets and non-current assets. The lease schedules are prepared similarly as that of lessee.

► Example 25:

Multan Motors (MM) is a car dealer. It sells cars on cash and also offers a certain model for sale by lease. MM sold a car on lease on 1 January 2022. The following information is relevant:

Price of the car in a cash sale	Rs. 2,000,000
Cost of the car to MM	Rs. 1,500,000
Lease option:	
Annual rental	Rs. 764,018
Lease term	3 years
Interest rate implicit in the lease	10%
Estimated residual value (unguaranteed)	Rs. 133,100
Costs incurred by MM in setting up the lease	Rs. 20,000

The market rate of interest is also 10%.

Required: Prepare journal entries at commencement date of lease term for MM.

► **ANSWER:**

Date	Particulars	Dr. Rs.	Cr. Rs.
1 Jan 2022	Net investment in lease	2,000,000	
	Cost of sales [1,500,000 – 100,000]	1,400,000	
	Revenue		1,900,000
	Inventory		1,500,000
1 Jan 2022	Selling expenses	20,000	
	Bank		20,000

Workings	Rs.
Present value of lease payments [Rs. 764,018 x (1-1.10 ⁻³)/0.10]	1,900,000
Revenue shall be recognised at lower of fair value (Rs. 2,000,000) and PV of lease payments (Rs. 1,900,000).	
Present value of unguaranteed residual value [Rs. 133,100 x 1.10 ⁻³]	100,000
Net investment in lease (Rs. 1,900,000 + 100,000)	2,000,000
Note: The lease schedule shall be made using 10% rate.	

► **Example 26:**

Karachi Motors (KM) is a car dealer. It sells cars on cash and also offers a certain model for sale by lease. KM sold a car on lease on 1 January 2022. The following information is relevant:

Price of the car in a cash sale	Rs. 2,000,000
Cost of the car to KM	Rs. 1,500,000
Lease option:	
Annual rental	Rs. 764,018
Lease term	3 years
Interest rate implicit in the lease	10%
Estimated residual value (unguaranteed)	Rs. 133,100
Costs incurred by KM in setting up the lease	Rs.20,000

The market rate of interest is 15%. KM has quoted artificially low rate to attract customers.

Required: Prepare journal entries at commencement date of lease term for KM.

► **ANSWER:**

Date	Particulars	Dr. Rs.	Cr. Rs.
1 Jan 2022	Net investment in lease	1,831,940	
	Cost of sales [1,500,000 – 87,515]	1,412,485	
	Revenue		1,744,425
	Inventory		1,500,000
1 Jan 2022	Selling expenses	20,000	
	Bank		20,000

Workings	Rs.
Present value of lease payments [Rs. 764,018 x (1-1.15 ⁻³)/0.15]	1,744,425
Revenue shall be recognised at lower of fair value (Rs. 2,000,000) and PV of lease payments (Rs.1,744,425) using market interest rate as lower rate has been quoted.	
Present value of unguaranteed residual value [Rs. 133,100 x 1.15 ⁻³]	87,515
Net investment in lease (Rs. 1,744,425 + 87,515)	1,831,940
Note: The lease schedule shall be made using 15% rate.	

4.4 Accounting for operating lease [IFRS 16: 81 to 86 & 88]

Lease income	Lease income from operating lease shall be recognized on a straight-line basis over the lease term unless another systematic basis is more representative of benefit derived from the leased asset.
Related costs	A lessor shall recognise costs, including depreciation, incurred in earning the lease income as an expense.
Depreciation and impairment	The depreciation is to be charged as per normal depreciation policy as per IAS 16 or IAS 38. Similarly, IAS 36 shall be applied for impairment.
Initial direct costs	A lessor shall add initial direct costs incurred in obtaining an operating lease to the carrying amount of the underlying asset and recognise those costs as an expense over the lease term on the same basis as the lease income.
Presentation in SFP	A lessor shall present underlying assets subject to operating leases in its statement of financial position according to the nature of the underlying asset.
Manufacturer or dealer lessor	A manufacturer or dealer lessor does not recognise any selling profit on entering into an operating lease because it is not the equivalent of a sale.

► Example 27:

Jay Limited entered into an operating lease agreement with Mojo Limited on 1 January 2021 incurring the initial direct cost of Rs. 30,000.

The lease was over a plant (which Jay Limited had bought on 1 January 2020 for Rs. 1,600,000).

The terms of the lease are as follows:

Commencement date:	1 January 2021
Lease term	3 years
Fixed lease instalments, payable as follows:	
- 31 December 2021	Rs. 200,000
- 31 December 2022	Rs. 220,000
- 31 December 2023	Rs. 300,000

Plant has total useful life of 8 years and is being depreciated using straight line method.

Required: Prepare the journal entries in the books of Jay Limited from the start to end of lease term. Jay Limited year-end is 31 December.

► ANSWER:

Date	Particulars		Dr. Rs.	Cr. Rs.
01-Jan-21	Plant		30,000	
	Bank (initial direct costs)			30,000
31-Dec-21	Depreciation	W2	210,000	
	Accumulated depreciation			210,000
31-Dec-21	Bank		200,000	
	Lease rental receivable		40,000	
	Lease rental income (PL)	W1		240,000
31-Dec-22	Depreciation	W2	210,000	
	Accumulated depreciation			210,000
31-Dec-22	Bank		220,000	
	Lease rental receivable		20,000	
	Lease rental income (PL)	W1		240,000
31-Dec-23	Depreciation	W2	210,000	
	Accumulated depreciation			210,000
31-Dec-23	Bank		300,000	
	Lease rental receivable			60,000
	Lease rental income (PL)	W1		240,000

W1 - Annual lease income (straight line basis)		Rs.
First rental		200,000
Second rental		220,000
Third rental		300,000
		720,000
	Lease term	3 years
		240,000

W2 - Depreciation	Rs.
On initial direct costs capitalised [Rs. 30,000 / 3 years]	10,000
On cost of plant [Rs. 1,600,000 / 8 years]	200,000
	210,000

4.5 Disclosure [IFRS 16: 89 to 97]

4.5.1 Disclosure – Finance Lease

The following amounts are to be disclosed (preferably in tabular format):

- selling profit or loss;
- finance income on the net investment in the lease; and
- income relating to variable lease payments not included in the measurement of the net investment in the lease.

Changes in net investment in lease

A lessor shall provide a qualitative and quantitative explanation of the significant changes in the carrying amount of the net investment in finance leases.

Maturity analysis

A lessor shall disclose a maturity analysis of the lease payments receivable, showing the undiscounted lease payments to be received on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years.

Reconciliation

A lessor shall reconcile the undiscounted lease payments to the net investment in the lease. The reconciliation shall identify the unearned finance income relating to the lease payments receivable and any discounted unguaranteed residual value.

► Example 28:

On 1 Jan 2017, Oscar Bank Limited (OBL) gave a machine on finance lease to Pervez Limited (PL). Instalment of Rs. 5,714,000 at the end of each year is receivable for nine years. First payment was received on 30 December 2017. The interest rate implicit in the lease is 6%.

Required: Prepare maturity analysis and reconciliation disclosure for OBL as at 31 December 2017.

► ANSWER:

As at 31 December 2017	
Maturity analysis: Undiscounted lease payments	Rs. in 000
Less than one Year	5,714
One to two years	5,714
Two to three years	5,714
Three to four years	5,714
Four to five years	5,714
More than five years (5,714 x 3)	17,142
Total undiscounted lease receivable	45,712

Reconciliation	Rs. in 000
Total lease receivable	45,712
Add: Un-guaranteed Residual Value	0
Gross investment in lease	45,712
Less: Unearned finance income (balancing figure)	(10,229)
Net investment in lease [Rs. 5,714 x (1-1.06 ⁻⁸)/0.06]	35,483

4.5.2 Disclosure – Operating Lease

A lessor shall disclose:

- Lease income, separately disclosing income relating to variable lease payments that do not depend on an index or a rate.
- A lessor shall provide the disclosures required by IAS 16 for assets subject to an operating lease (by class of underlying asset) separately from owned assets held and used by the lessor.
- A lessor shall apply the disclosure requirements in IAS 36, IAS 38, IAS 40 and IAS 41 for assets subject to operating leases.

Maturity Analysis

A lessor shall disclose a maturity analysis of lease payments, showing the undiscounted lease payments to be received on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years.

► Example 29:

On 1 January 2017, Genuine Properties Limited (GPL) leased a building to Faheem Limited (FL) at Rs. 5,714,000 per annum. Lease term is for nine years and economic life of the building is thirty five years. First payment was received on 30 December 2017.

Required: Prepare maturity analysis for GPL as at 31 December 2017.

► ANSWER:

As at 31 December 2017	
Maturity analysis: Contractual undiscounted lease payments	Rs. in 000
Less than one Year	5,714
One to two years	5,714
Two to three years	5,714
Three to four years	5,714
Four to five years	5,714
More than five years (5,714 x 3)	17,142
Total undiscounted lease receivable	45,712

4.5.3 Disclosure – Additional Information

This additional information (qualitative & quantitative) includes, but is not limited to, information that helps users of financial statements to assess:

- the nature of the lessor's leasing activities; and
- how the lessor manages the risk associated with any rights it retains in underlying assets, in particular, its risk management strategy for its rights in underlying assets.

The above additional disclosure are applicable to both, finance lease and operating lease.

► **Example 30:**

Shalimar Industries (SI) is engaged in the manufacturing of tractors. The tractors are sold both on cash and finance lease basis. The cash selling price and cost of each tractor is Rs. 2.0 million and Rs. 1.6 million respectively.

On 1 January 2015, SI sold ten tractors to Caravan Transport (CT) on lease. The terms of the lease and related information are as follows:

- (i) The lease period is 4 years, whereas useful life of each tractor is 5 years.
- (ii) The total unguaranteed residual value at the end of lease term is Rs. 1 million.
- (iii) Lease rentals amounting to Rs. 6,375,454 per annum are payable in arrears.
- (iv) The rate implicit in the lease is 12%.

Required:

In accordance with the requirements of International Financial Reporting Standards, prepare:

- (a) Journal entries in the books of SI to record the transaction of the year ended 31 December 2015.
- (b) A note for inclusion in SI's financial statements for the year ended 31 December 2015.

► **ANSWER:****Part (a) Journal entries**

Date	Particulars	Debit Rs.	Credit Rs.
01-Jan-15	Net investment in lease (W1)	20,000,000	
	Cost of sales [(1.6m x 10) - 635,518]	15,364,482	
	Sales revenue		19,364,482
	Inventory [1.6m x 10]		16,000,000
31-Dec-15	Net Investment in lease	2,400,000	
	Finance income (PL)		2,400,000
31-Dec-15	Bank	6,375,454	
	Net Investment in lease		6,375,454

Part (b)**Notes to the financial statements****For the year ended 31 December 2015****Maturity Analysis**

	Rs.
Less than one Year	6,375,454
One to two years	6,375,454
Two to three years	6,375,454
Undiscounted lease payments	19,126,362

Reconciliation

	Rs.
Undiscounted lease payments	19,126,362
Add: Unguaranteed residual value	1,000,000
Gross investment in lease	20,126,362
Less: Unearned finance income (balancing figure)	(4,101,816)
Net investment in lease	16,024,546

The minimum lease payments have been discounted on interest rate of 12% per annum to arrive at their present value. Rentals are paid annually in arrears.

W1: Net investment in lease		Rs.
PV of lease payments (Revenue)	$[6,375,454 \times ((1 - 1.12^{-4}) / 0.12)]$	19,364,482
PV of Unguaranteed Residual Value	$[1,000,000 \times 1.12^{-4}]$	635,518
		20,000,000

W2: Lease schedule (Payment in arrears)				
Payment Date	Opening balance	Interest @ 12%	Payment	Closing Balance
	Rs.			
31-Dec-15	20,000,000	2,400,000	(6,375,454)	16,024,546
31-Dec-16	16,024,546	1,922,946	(6,375,454)	11,572,038
31-Dec-17	11,572,038	1,388,645	(6,375,454)	6,585,228
31-Dec-18	6,585,228	790,226	(6,375,454) (1,000,000)	0

► **Example 31:**

Galaxy Leasing Limited (GLL) has leased certain equipment to Dairy Products Limited on 1 July 2013. In this respect, the following information is available:

	Rs. in million
Cost of equipment	28.69
Amount received on 1 July 2013	3.00
Four annual instalments payable in arrears on 30 June, each year	7.80
Guaranteed residual value on expiry of the lease	5.00

Useful life of the equipment is estimated at 5 years. Rate of interest implicit in the lease is 14%.

Required:

- Prepare accounting entries for the year ended 30 June 2014 in the books of GLL to record the transactions related to the above lease arrangement in accordance with the requirements of International Financial Reporting Standards.
- Prepare a note for inclusion in GLL's financial statements for the year ended 30 June 2014, in accordance with the requirements of International Financial Reporting Standards.

► **ANSWER:**

Part (a)

Galaxy Leasing Limited			
Accounting entries for the year ended 30 June 2014			
Date	Particulars	Dr.	Cr.
		Rs. million	
01-Jul-13	Net Investment in lease	28.69	
	Equipment/Bank		28.69
01-Jul-13	Bank	3	
	Net Investment in lease		3
30-Jun-14	Net Investment in lease	3.6	
	Finance income		3.6
30-Jun-14	Bank	7.80	
	Net Investment in lease		7.80

Notes to the financial statements		
For the year ended 30 June 2014		
Maturity Analysis		Rs. million
Less than one Year		7.8
One to two years		7.8
Two to three years (including GRV)	[7.8 + 5]	12.8
Undiscounted lease payments		28.4

Reconciliation		Rs. million
Undiscounted lease payments		28.4
Less: Unearned finance income (balancing figure)		6.91
Net investment in lease		21.49

The minimum lease payments have been discounted on interest rate of 14% per annum to arrive at their present value. Rentals are paid annually in arrears.

W1 - Lease schedule (Payment in arrears)				
Payment Date	Opening balance	Interest @ 14%	Payment	Closing Balance
	Rs. million			
01-Jul-13	28.69		(3.00)	25.69
30-Jun-14	25.69	3.60	(7.80)	21.49
30-Jun-15	21.49	3.01	(7.80)	16.69
30-Jun-16	16.69	2.34	(7.80)	11.23
30-Jun-17	11.23	1.57	(7.80)	0
			(5.00)	

► **Example 32:**

Square Limited (SL) is a dealer of electronic items. SL acquires refrigerators of a particular model from a manufacturer at a discount of 15% on the retail price of Rs. 300,000 per unit.

On 1 January 2018, SL sold 12 refrigerators to Cube Hotel at retail price on lease.

The rate of interest implicit in the lease was 10% per annum. The payment is to be made in three equal annual instalments payable in advance. Residual value at the end of 3 years is nil.

The market rate of interest is 14% per annum.

Required:

Prepare journal entries in the books of SL in respect of above transaction for the year ended 31 December 2018.

► ANSWER:

Journal entries

Date	Particulars	Dr. Rs.	Cr. Rs.
01-Jan-18	Net investment in lease	3,483,079	
	Cost of sales [300,000 x 85% x 12 units]	3,060,000	
	Sales revenue		3,483,079
	Inventory		3,060,000
01-Jan-18	Bank	1,316,028	
	Net Investment in lease		1,316,028
31-Dec-18	Net Investment in lease	303,387	
	Finance income (PL)		303,387

W1: Calculation of rental

Retail price per unit = Rental per unit x Annuity (due) Factor @ 10%

Rs. 300,000 = Rental per unit x $(1 - 1.10^{-3+1}) / 0.10 + 1$

Rental per unit = Rs. 109,669

Rental of 12 units = Rs. 109,669 x 12 units = Rs. 1,316,028

Net investment in lease	[Rs. 1,316,028 x $(1 - 1.14^{-3+1}) / 0.14 + 1$]	Rs. 3,483,079

Revenue shall be measured at lower of fair value Rs. 3,600,000 (i.e. Rs. 300,000 x 12 units) and present value of lease payments Rs. 3,483,079.

Since market rate of interest is 14% and SL has quoted lower interest rate. The present value shall be calculated using market rate of interest.

W2: Lease schedule (Payment in advance)

Payment Date	Opening balance	Payment	Net Balance	Interest @ 14%	Closing Balance
	Rs.				
01-Jan-18	3,483,079	(1,316,028)	2,167,051	303,387	2,470,439
01-Jan-19	2,470,439	(1,316,028)	1,154,411	161,617	1,316,028
01-Jan-20	1,316,028	(1,316,028)	(0)		

5. COMPREHENSIVE EXAMPLES

► Example 33:

Guava Leasing Limited (GLL), had leased a machinery to Honeyberry Limited (HL) on 1 July 2017 on the following terms:

- (i) The non-cancellable lease period is 3.5 years. Each semi-annual lease instalment of Rs. 48 million is receivable in arrears.
- (ii) The lease contains an option to extend the lease term by 1.5 years. Each semi-annual lease instalment in the extended period will be of Rs. 15 million, receivable in arrears. It is reasonably certain that HL will exercise this option.
- (iii) The rate implicit in the lease is 10% per annum.
- (iv) The useful life of machinery is 6 years.
- (v) The unguaranteed residual value at the end of lease term is estimated at Rs. 20 million. GLL incurred a direct cost of Rs. 10 million and general overheads of Rs. 0.5 million to complete the transaction.

Required: Prepare note(s) for inclusion in GLL's financial statements, for the year ended 30 June 2018.

► ANSWER:

Guava Leasing Limited

Notes to the financial statements

For the year ended 30 June 2018

Maturity Analysis			Rs. million
Less than one Year	[48 + 48]		96
One to two years	[48 + 48]		96
Two to three years	[48 + 15]		63
Three to four years	[15 + 15]		30
Undiscounted lease payments			285

Reconciliation			Rs. million
Undiscounted lease payments			285
Add: Unguaranteed residual value			20
Gross investment in lease			305
Less: Unearned finance income	[Balancing figure]		(51.65)
Net investment in lease			253.35

Net Investment in lease			Rs. million
Non-Current Asset		W1	180.92
Current Asset	[Balancing figure]		72.43
Total			253.35

W1 - Lease schedule (Payment in arrears)				
Payment Date	Opening balance	Interest @ 5%	Payment	Closing Balance
	Rs. million			
31-Dec-17	319.05	15.95	(48.00)	287.00
30-Jun-18	287.00	14.35	(48.00)	253.35
31-Dec-18	253.35	12.67	(48.00)	218.02
30-Jun-19	218.02	10.90	(48.00)	180.92

Rentals & URV	Cash flow	PV / Annuity factor	Present value
	Rs. million		Rs. million
Rental 1 to 7	48	$(1 - 1.05^{-7}) / 0.05$	277.75
Rental 8 to 10	15	$(1 - 1.05^{-3}) / 0.05 \times (1.05^{-7})$	29.03
Unguaranteed RV	20	1.05^{-10}	12.28
			319.05

► **Example 34:**

On 1 January 2019, French Vanilla Leasing Limited (FVLL) purchased a machine costing Rs. 200 million having useful life of 8 years. Residual value of the machine at end of its useful life is estimated at Rs. 16 million.

On 1 February 2019, FVLL entered into a lease agreement for this machine with Cotton Candy Limited (CCL) for a non-cancellable period of 2.5 years with effect from 1 March 2019. Under the agreement, eight instalments of Rs. 12 million are to be paid quarterly in arrears commencing from the end of 3rd quarter i.e. 30 November 2019. FVLL has incorporated an implicit rate of 15% per annum which is not known to CCL. Incremental borrowing rate of CCL is 16% per annum.

On 1 April 2019, CCL completed installation of the machine at a cost of Rs. 4 million and put it into use.

Both companies follow straight line method for charging depreciation.

Required: Prepare journal entries for the year ended 31 December 2019 in the books of FVLL and CCL to record the above transactions.

► **ANSWER:**

Journal Entries (FVLL - Lessor - Operating Lease)

Date	Particulars	Dr. Rs. million	Cr. Rs. million
01-Jan-19	Machine (PPE)	200	
	Bank		200
30-Nov-19	Bank	12	
	Lease rental income		12
31-Dec-19	Depreciation $[(200 - 16 \text{ RV}) / 8 \text{ years}]$	23	
	Accumulated depreciation		23
31-Dec-19	Lease rental receivable	20	
	Lease rental income		20

W1: Rental income and receivables		Rs. million
Total Rentals to be received	[12m x 8]	96
Annual Rental income	[96m / 2.5 years]	38.4
Rental income of 10 months	[38.4 x 10/12]	32
Already received		(12)
Receivable		20

Journal Entries (CCL - Lessee)

Date	Particulars	Dr. Rs. million	Cr. Rs. million
01-Mar-19	Right of use asset	78.7	
	Bank (installation costs)		4
	Lease liability		74.7
31-May-19	Interest expense	2.99	
	Lease liability		2.99
31-Aug-19	Interest expense	3.11	
	Lease liability		3.11
30-Nov-19	Interest expense	3.23	
	Lease liability		3.23
30-Nov-19	Lease liability	12	
	Bank		12
31-Dec-19	Interest expense (Rs. 2.88 W2 x 1/3 months)	0.96	
	Lease liability		0.96
31-Dec-19	Depreciation [78.7 / 2.5 years x 10/12]	26.23	
	Accumulated depreciation		26.23

W1: Lease liability				Rs. million
PV of Lease payments		Rs. 12m x [(1 - 1.04 ⁻⁸) / 0.04 x 1.04 ⁻²]		74.70
Lease schedule (Payment in arrears)				
Payment Date	Opening balance	Interest @ 4%	Payment	Closing Balance
	Rs. million			
31-May-19	74.70	2.99		77.69
31-Aug-19	77.69	3.11		80.79
30-Nov-19	80.79	3.23	(12)	72.02
29-Feb-20	72.02	2.88		

► **Example 35:**

On 1 January 2020, Desk Limited (DL) acquired a machine on lease from Life Leasing Limited (LLL) for 3 years. The first annual instalment amounting to Rs. 35 million was paid on 1 January 2020 and all subsequent annual instalments are payable on 1 January subject to increase of 10% each year.

DL incurred initial direct cost of Rs. 5 million. As an incentive to DL for entering into the lease, LLL reimbursed Rs. 2 million.

LLL has incorporated an implicit rate of 11% per annum which is not known to DL.

The residual value of the machine at the end of 3 years is estimated at Rs. 30 million, out of which DL has guaranteed Rs. 20 million.

DL is also obliged to incur decommissioning cost of Rs. 4 million at the end of the lease term.

Discount rate of 12% may be assumed wherever required but not given.

Required:

- Prepare relevant extracts from DL's statement of profit or loss for the year ended 31 December 2020 and statement of financial position as on that date.
- Prepare note(s) for inclusion in the financial statements of Lifebuoy Leasing Limited (LLL) for the year ended 31 December 2020.

► **ANSWER:****Part (a)**

Desk Limited		
Statement of Comprehensive Income		
For the year ended 31 December 2020		Rs. million
Depreciation	W2	36.33
Interest exp. (Lease liability)	W1	8.18
Interest exp. (decommissioning)	[2.85 x 12%]	0.34

Desk Limited		
Statement of financial position		
As at 31 December 2020		Rs. million
Non-current assets		
Right of use asset	W2	72.66
Non-current liabilities		
Lease liability	W1	37.81
Decommissioning liability	[2.85 + 0.34]	3.19
Current liabilities		
Lease liability	W1	38.5

W1: PV of lease payments

Instalment number	Instalment date	Cash flow	PV Factor @ 12%	Present Value
		Rs. million		Rs. million
1	01-Jan-20	35.00	1.12 ⁰	35.00
2	01-Jan-21	38.50	1.12 ⁻¹	34.38
3	01-Jan-22	42.35	1.12 ⁻²	33.76
				103.14

Lease schedule (Payment in advance)

Payment Date	Opening balance	Payment	Net Balance	Interest @ 12%	Closing Balance
	Rs. million				
01-Jan-20	103.14	(35)	68.14	8.18	76.31
01-Jan-21	76.31	(38.5)	37.81		

W2: Right of Use asset

	Rs. million
Lease liability (including amount already paid)	103.14
Initial direct costs	5
Reimbursement from lessor	(2)
Decommissioning costs [4m x 1.12 ⁻³]	2.85
	108.98
Depreciation [108.98 / 3 years]	(36.33)
	72.66

Life Leasing Limited**Notes to the financial statements****For the year ended 31 December 2020****Maturity Analysis**

	Rs. million
Less than one Year	38.50
One to two years [42.35 + 20]	62.35
Undiscounted lease payments	100.85

Reconciliation

	Rs. million
Undiscounted lease payments	100.85
Add: Unguaranteed residual value	10
Gross investment in lease	110.85
Less: Unearned finance income [Balancing figure]	(9.85)
Net investment in lease	101.00

Net Investment in lease		Rs. million
Non-Current asset	W1	62.50
Current asset	W1	38.50
Total		101.00

W1: Net investment in lease				
Instalment number	Instalment date	Cash flow	PV Factor @ 11%	Present Value
		Rs. million		Rs. million
1	01-Jan-20	35.00	1.11 ⁰	35.00
2	01-Jan-21	38.50	1.11 ⁻¹	34.68
3	01-Jan-22	42.35	1.11 ⁻²	34.37
Guaranteed RV	31-Dec-22	20.00	1.11 ⁻³	14.62
Unguaranteed RV	31-Dec-22	10.00	1.11 ⁻³	7.31
				125.99

Lease schedule (Payment in advance)					
Payment Date	Opening balance	Payment	Net Balance	Interest @ 11%	Closing Balance
	Rs. million				
01-Jan-20	125.99	(35)	90.99	10.01	101.00
01-Jan-21	101.00	(38.5)	62.50		

► **Example 36:**

Sagahi Autos Limited (SAL) is a dealer of specialized vehicles. SAL acquires each unit of vehicle 'Alpha' from manufacturer at a cost of Rs. 26 million and sells it for Rs. 30 million. The estimated economic life of Alpha is five years.

Few prospective customers did not have adequate funds to purchase Alpha on cash. Therefore, SAL entered into the following arrangements during the year ended 31 December 2020:

- (i) On 1 January 2020, SAL leased Alpha to Haris for a non-cancellable period of four years. The rate of interest implicit in the lease is 10% per annum. The payment is to be made in four equal annual instalments payable on 31 December each year. The residual value at the end of four years is estimated at Rs. 5 million which is guaranteed by a third party related to SAL.
- (ii) On 1 April 2020, SAL leased Alpha to Yasir for a non-cancellable period of three years. The rate of interest implicit in the lease is 18% per annum. Annual instalment of Rs. 10 million is to be paid in advance. At the end of the lease term, Yasir has an option to purchase Alpha at Rs. 7.14 million. It is reasonably certain that Yasir will exercise this option.
- (iii) On 1 August 2020, SAL leased Alpha to Faisal for a non-cancellable period of one and a half years. Quarterly instalment of Rs. 3 million is to be paid in arrears. SAL will dispose this unit of Alpha at the end of two years at an estimated residual value of Rs. 11 million.

Direct cost of Rs. 1 million was incurred by SAL for each of the above arrangements. Market rate of interest is 15% per annum.

Required: Prepare journal entries for each of above lease transactions in the books of SAL for the year ended 31 December 2020.

► ANSWER:

Arrangement (i) Lease to Haris

Date	Particulars	Debit	Credit
		Rs. million	Rs. million
01-Jan-20	Net investment in lease	26.81	
	Cost of Sales [26m - 2.86m]	23.14	
	Revenue		23.95
	Inventory		26.00
01-Jan-20	Selling expense	1	
	Bank		1
31-Dec-20	Net investment in lease	4.02	
	Finance income [26.81 x 15%]		4.02
31-Dec-20	Bank	8.39	
	Net investment in lease		8.39

W1: Lease instalment (determined using implicit rate of interest)

		Rs. million
Fair value + initial direct costs	[30m + 0]	30
Less: PV of unguaranteed RV	[5m x 1.10 ⁻⁴]	3.42
PV of lease payments (rentals)		26.58
Annuity discount factor	(1 - 1.10 ⁻⁴) / 0.10	3.1699
Rental	[26.58 / 3.1699]	8.39

W2 - Revenue & Net investment in lease

		Rs. million
PV of lease payments (Revenue)	[8.39 x (1 - 1.15 ⁻⁴) / 0.15]	23.95
PV of unguaranteed residual value	[5 x 1.15 ⁻⁴]	2.86
Net investment in lease		26.81

Revenue is lower of fair value of Rs. 30m & PV of lease payments of Rs. 23.95m.

Arrangement (ii) Lease to Yasir

Date	Particulars	Debit	Credit
		Rs. million	Rs. million
01-Apr-20	Net investment in lease	30	
	Cost of Sales	26	
	Revenue (at fair value)		30
	Inventory		26
01-Apr-20	Selling expense	1	
	Bank		1
01-Apr-20	Bank	10	
	Net investment in lease		10
31-Dec-20	Net investment in lease	2.7	
	Finance income		2.7
	[(30 - 10) x 18% x 9/12]		

The present value of lease payments is Rs. 30.95 million $((Rs. 10m \times (1 - 1.15^{-2}) / 0.15) + (Rs. 7.14m \times 1.15^{-3}))$, therefore, the revenue shall be measured at fair value of Rs. 30 million, being the lower amount.

Arrangement (iii) Lease to Faisal

Date	Particulars	Debit	Credit
		Rs. million	Rs. million
01-Aug-20	PPE (Vehicle)	26	
	Inventory		26
01-Aug-20	PPE (Vehicle)	1	
	Bank (direct costs)		1
31-Oct-20	Bank	3	
	Rental income		3
31-Dec-20	Rent receivable	2	
	Rental income $[3 \times 2/3 \text{ months}]$		2
31-Dec-20	Depreciation $[(27 - 11) \times 5/24 \text{ months}]$	3.33	
	Accumulated depreciation		3.33

► Example 37:

Following information have been extracted from the financial statements of Fakhr Limited (FL) for the year ended 31 December 2019:

(i)	2019	2018	2017
	Draft	Audited	Audited
	----- Rs. in million -----		
Net profit	84	98	72
Revaluation surplus arising during the year*	25	(14)	-

***Transfer to retained earnings is made upon de-recognition of related asset.**

(ii)	Share capital and reserves as at 1 January:	2018	2017
		----- Rs. in million -----	
	Share capital (Rs. 10 each)	300	300
	Revaluation surplus	102	102
	Retained earnings	348	276
(iii)	On 1 March 2018, FL declared a final cash dividend of 10% for the year ended 31 December 2017. On 1 November 2018, FL issued 40% right shares to its ordinary shareholders at Rs. 24 per share. On 1 August 2019, an interim bonus of 15% was declared.		

Following matters need to be incorporated in the draft financial statements of FL:

- (i) To provide more relevant and reliable information about investment property, it has been decided to change the measurement basis for investment property from cost model to fair value model.

The only investment property of FL is a building purchased on 1 January 2016 at a cost of Rs. 150 million. 60% of the cost represents building component having estimated useful life of 20 years and residual value of Rs. 10 million. The depreciation is included in the above draft financial statements. The fair value of the investment property has increased by 6% in each year since acquisition.

- (ii) It was identified that annual payments in respect of machine acquired on lease have been recorded as rent expense.

FL entered into a lease agreement for a machine with Aaqil Limited (AL) for a non-cancellable period of 7 years on 1 January 2018. Instalment of Rs. 25 million is to be paid annually on 31 December each year. Implicit rate is 12% per annum.

Required: Prepare FL's statement of changes in equity (including comparative figures) for the year ended 31 December 2019. ('Total' column is not required)

► **ANSWER:**

Fakhr Limited		Share Capital	Share premium	Revaluation Surplus	Retained Earnings
Statement of changes in equity					
For the year ended 31 December 2019		Rs. million			
As at 31 December 2017 (reported)		300		102	348
Effect of change in policy	W1				26.54
As at 31 December 2017 (restated)		300	0	102	374.54
Final Cash Dividend Rs. 300m x 10%					(30)
Right Issue 30m shares x 40%		120	168		
Total comprehensive income	W1			(14)	107.12
As at 31 December 2018 (restated)		420	168	88	451.66
Interim Bonus issue Rs. 420m x 15%		63			(63)
Total comprehensive income	W1			25	95.09
Balance as at 31 December 2019		483	168	113	483.75

W1: Profit		2019	2018	2017	2016
		Rs. million			
As given		84.00	98.00		
Change in accounting policy					
Fair value gain	W2	10.72	10.11	9.54	9.00
Depreciation reversal $[(150 \times 60\% - 10) / 20 \text{ years}]$		4.00	4.00	4.00	4.00
		14.72	14.11	13.54	13.00
Correction of error					
Reversal of rental expense		25.00	25.00		
Depreciation on ROU asset	W3	(16.30)	(16.30)		
Interest on lease liability	W3	(12.33)	(13.69)		
		(3.63)	(4.99)		
At 31 December		95.09	107.12	26.54	

W2: Investment Property	2019	2018	2017	2016
	Rs. million			
At 1 January	178.65	168.54	159.00	150
Increase in FV @6%	10.72	10.11	9.54	9
At 31 December	189.37	178.65	168.54	159

W3: Lease Arrangement		Rs. m
PV of lease payments	$25 \times [(1 - 1.12^{-7}) / 0.12]$	114.09
Annual Depreciation	$[114.09 / 7 \text{ years}]$	16.30
Interest expense 2018	$[114.09 \times 12\%]$	13.69
Lease liability at 1 Jan 2019	$[114.09 + 13.69 - 25]$	102.78
Interest expense 2019	$[102.78 \times 12\%]$	12.33

► **Example 38:**

Optimism Limited (OL) entered into following arrangements:

- (i) On 1 January 2020, OL leased a machine from Fascinated Bank Limited (FBL). Details are as follows:
 - The lease period is agreed as six years. However, the lease contains an option for OL to terminate the lease at the end of four years upon payment of Rs. 1 million. OL is reasonably certain to exercise this option due to anticipated technological changes.
 - First annual instalment amounting to Rs. 12 million was paid on 1 January 2020 and all subsequent annual instalments are payable on 1 January subject to decrease of Rs. 2 million in each year.
 - Market rate for similar transaction is 12% per annum but as an incentive to OL for entering into the lease, FBL has incorporated an implicit rate of 11% per annum which is known to OL.
 - The fair value and useful life of the machine are Rs. 40 million and seven years respectively.
 - OL incurred initial direct cost of Rs. 3 million.
- (ii) On 1 May 2021, OL entered into an arrangement with Energetic Limited (EL) for the use of five photocopy machines for a non-cancellable period of three years. Semi-annual instalment of Rs. 2 million is to be paid in advance. As per agreement, EL has a substantive substitution right to replace the machines.

Required:

- (a) Prepare relevant extracts (including comparative figures) from OL's statement of financial position, statement of profit or loss and notes to the financial statements for the year ended 31 December 2021.
- (b) Compute the unguaranteed residual value estimated by FBL at the end of six years if FBL had incurred Rs. 2 million of initial direct cost. (Assume that FBL is reasonably certain that OL will not exercise termination option)

► Answer:

Part (a)**Optimism Limited****Statement of profit or loss for the year ended 31 December 2021**

	2021	2020
	Rs. m	Rs. m
Depreciation expense (note 1)	8.89	8.89
Interest expense W2	1.41	2.26
Photocopier rental expense $[2 + 2 = 4 \times 8/12]$	2.67	-

Statement of financial position as at 31 December 2021

	2021	2020
	Rs. m	Rs. m
Non-current assets		
Right of use asset (note 1)	17.77	26.66
Current assets		
Prepaid photocopier rent $[2 + 2 = 4 \times 4/12]$	1.33	-
Non-current liabilities		
Lease liability W2	6.22	12.81
Current liabilities		
Lease liability W2	8	10

Notes to the financial statements for the year ended 31 December 2021

	2021	2020
	Rs. m	Rs. m
Note 1: Right of use assets		
Cost		
1 January	35.55	-
Additions W1	-	35.55
31 December	35.55	35.55
Accumulated depreciation		
1 January	8.89	-
For the year	8.89	8.89
31 December	17.77	8.89
Carrying amount	17.77	26.66

	2021	2020
	Rs. m	Rs. m
Note 2: Maturity Analysis		
Not later than one year 8 ; 10	8	10
Later than one year but not later than five years 7; 8 + 7	7	15
	15	25

W1: Lease liability and right of use asset

Year	Particulars	Cash flows Rs. m	PV Factor @ 11%	Present value Rs. m
2020	Rental 1	12	1.11 ⁰	12.00
2021	Rental 2	10	1.11 ⁻¹	9.01
2022	Rental 3	8	1.11 ⁻²	6.49
2023	Rental 4	6	1.11 ⁻³	4.39
2024	Penalty	1	1.11 ⁻⁴	0.66
Present value of lease payments				32.55
Initial direct costs				3
Right of use asset				35.55

W2: Lease schedule (payment in advance)

Year	Opening balance	Payment	Net balance	Interest @11%	Closing balance
	Rs. m				
2020	32.55	(12)	20.55	2.26	22.81
2021	22.81	(10)	12.81	1.41	14.22
2022	14.22	(8)	6.22		

Part (b) Unguaranteed residual value (UGRV) estimated by FBL

		Rs. m
Fair value		40.00
Initial direct cost of lessor		2.00
Present value of lease payment	W3	(35.71)
Present value of UGRV		6.29
UGRV	6.29 / 1.11 ⁻⁶	11.76

W3: Lease liability and right of use asset

Year	Particulars	Cash flows Rs. m	PV Factor @ 11%	Present value Rs. m
2020	Rental 1	12	1.11 ⁰	12.00
2021	Rental 2	10	1.11 ⁻¹	9.01
2022	Rental 3	8	1.11 ⁻²	6.49
2023	Rental 4	6	1.11 ⁻³	4.39
2024	Rental 5	4	1.11 ⁻⁴	2.63
2025	Rental 6	2	1.11 ⁻⁵	1.19
Present value of lease payments				35.71

► *Example 39:*

On 1 July 2021, Nonagon Leasing (NL) leased a machine to Decagon Limited (DL). Details are as follows:

- (i) The non-cancellable lease term is five years during which annual instalment of Rs. 6 million is payable by DL in arrears.
- (ii) DL has an option to extend the lease term by one year by paying Rs. 4 million at start of sixth year. It is reasonably certain that DL will exercise this option.
- (iii) NL estimates the residual value of the machine at the end of lease term to be Rs. 10 million out of which DL has guaranteed Rs. 8 million. DL expects that the machine will have market value of Rs. 5 million at the end of lease term.
- (iv) NL incurred initial direct cost of Rs. 1 million.
- (v) The rate of interest implicit in the lease is 11% per annum.
- (vi) The useful life of the machine is eight years.

Required: Prepare note(s) for inclusion in the financial statements of NL for the year ended 30 June 2022.

► *Answer:***Nonagon Leasing****Notes to the financial statements****For the year ended 30 June 2022**

Maturity analysis - contractual undiscounted cash flows		Rs. in million
Less than one year		6.00
One to two year		6.00
Two to three years		6.00
Three to four years		6.00
Four to five years	4 + 8 GRV	12.00
		36.00
Reconciliation		
Undiscounted lease payments		36.00
Unguaranteed residual value		2.00
Gross investment in lease		38.00
Unearned finance income (bal.)		(10.82)
Net investment in lease	(W1)	27.18
Non-current asset	W1	24.17
Current asset (balancing)		3.01
Total		27.18

W1: Lease schedule (payment in arrears)

Payment date	Opening balance	Interest @11%	Payment	Closing balance
	Rs. m			
30-Jun-22	29.90 W2	3.29	(6)	27.18
30-Jun-23	27.18	2.99	(6)	24.17

W2: Present value of lease payments

Receipts	Cash flows Rs. m	PV / annuity factor	Present value Rs. m
Rental 1 to 5	6	$(1-1.11^{-5})/0.11$	22.18
Renewal option	4	1.11^{-5}	2.37
GRV	8	1.11^{-6}	4.28
UGRV	2	1.11^{-6}	1.07
TOTAL			29.90

► **Example 40:**

Gold Limited (GL) is a dealer of specialized engines. GL acquires each engine from a manufacturer at a cost of Rs. 58 million and sells it for Rs. 71 million on cash. The estimated economic life of an engine is five years.

On 1 January 2022, Lead Limited (LL) leased an engine from GL on four years lease term. The first annual instalment of Rs. 16 million was paid on 1 January 2022 and all subsequent annual instalments are payable on 1 January subject to increase of Rs. 2 million in each year. LL incurred initial direct cost of Rs. 4 million, out of which GL reimbursed Rs. 1.5 million. GL estimates the residual value of the engine at the end of lease term to be Rs. 5 million. However, LL has guaranteed an additional amount of Rs. 3 million at the end of lease term.

Market rate for similar transaction is 15% per annum. As an incentive to LL for entering into the lease, GL has incorporated an implicit rate of 10% per annum which is known to LL.

LL is also obliged to incur decommissioning cost of Rs. 9 million at the end of the lease term.

Discount rate of 12% per annum may be assumed wherever required but not given.

Required: In accordance with IFRSs:

- prepare journal entries in the books of GL for the year ended **31 December 2022**.
- prepare relevant extracts from LL's statement of profit or loss for the year ended **30 September 2022** and statement of financial position on that date.

► Answer:

Part (a)**Gold Limited****General Journal (for the year ended 31 December 2022)**

Date	Particulars	Debit Rs. m	Credit Rs. m
1 Jan 2022	Net Investment in lease	65.81	
	Revenue W1		65.81
1 Jan 22	Cost of sales	58	
	Inventory		58
1 Jan 22	Selling expense (PL)	1.5	
	Bank		1.5
1 Jan 22	Bank	16	
	Net investment in lease		16
31-Dec-22	Net investment in lease	7.47	
	Finance income $(65.81-16) \times 15\%$		7.47

W1: Net investment in lease

Instalment	Instalment date	Cash flows Rs. m	PV Factor @ 15%	Present value Rs. m
1	1-Jan-22	16	1.15	16
2	1-Jan-23	18	1.15^{-1}	15.65
3	1-Jan-24	20	1.15^{-2}	15.12
4	1-Jan-25	22	1.15^{-3}	14.47
GRV	31-Dec-25	8	1.15^{-4}	4.57
Present value of lease payments				65.81
Fair value (cash price)				71
Lower				65.81

Part (b)**Lead Limited****Statement of profit or loss for the year ended 30 September 2022**

		Rs. m
Depreciation	W2	14.19
Interest on lease liability	W1	3.86
Interest on provision for decommissioning	$[5.72 \times 12\% \times 9/12]$	0.51

Statement of financial position as at 30 September 2022

Non-current assets		Rs. m
Right of use asset	W2	61.5
Non-current liabilities		
Lease liability	W1	38.62
Provision for decommissioning	[5.72 + 0.51]	6.23
Current liabilities		
Lease liability	[55.33 – 38.62 NCL]	16.71

W1: Present value of lease payments

Instalment	Instalment date	Cash flows Rs. m	PV Factor @ 15%	Present value Rs. m
1	1-Jan-22	16	1.10	16
2	1-Jan-23	18	1.10 ⁻¹	16.36
3	1-Jan-24	20	1.10 ⁻²	16.53
4	1-Jan-25	22	1.10 ⁻³	16.53
GRV	31-Dec-25	3	1.10 ⁻⁴	2.05
Present value of lease payments				67.47

Lease schedule (payment in advance)

Payment date	Opening balance	Payment	Net balance	Interest @10%	Closing balance
	Rs. m				
1 Jan 22	67.47	(16)	51.47	3.86 [9/12]	55.33
				1.29 [3/12]	56.62
1 Jan 23	56.62	(18)	38.62		

W2: Right of use asset

		Rs. m
Lease liability (including amount paid)		67.47
Initial direct cost		4
Reimbursement by lessor		(1.5)
Decommissioning cost	[9 x 1.12 ⁻⁴]	5.72
		75.69
Depreciation	[75.69 / 4 years x 9/12]	(14.19)
		61.50

► *Example 41:*

Alluring Limited (AL) is considering to enter into an arrangement with Charming Limited (CL) for the use of a photocopy machine for a period of five years. The initial draft contract fulfils all conditions to be classified as a lease contract. However, the following additional terms are under consideration between the parties for inclusion in the contract:

- (i) Instead of fixed rentals, the lease rental would be based on the number of photocopies produced.
- (ii) The machine will be placed in a common area where neighbouring office can also utilize it, by paying charges to CL.
- (iii) AL will have the right to terminate the contract after three years.
- (iv) CL will have the right to replace the machine with another machine.

Required: For each additional term under consideration, evaluate whether its inclusion would affect the classification of the contract as a lease.

► *Answer:*

A contract is a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration.

In light of this lease definition, the evaluation of whether each of the additional terms would affect the classification of the contract as lease is as follows:

Term (i)

Inclusion of this term would not affect the classification of the contract as a lease as AL will be paying consideration for the use of asset though the consideration will be variable.

Term (ii)

Inclusion of this term would exclude the contract as lease as it would restrict the lessee's right to direct how and for what purpose the machine can be used as machine would also be used by others as well.

Term (iii)

Inclusion of this term would not affect the classification of contract as lease as the AL will have the right to use the asset for a period of time though variable.

Term (iv)

Inclusion of this term may exclude the contract as lease depending upon whether the substitution right of CL is substantial.

A supplier's right to substitute an asset is substantive only if both of the following conditions exist:

- Supplier has practical ability to substitute; and
- Supplier would benefit economically if it substituted the asset (i.e. benefits exceed expected costs).

► *Example 42:*

On 1 January 2022, Concatenate Limited (CL) acquired an equipment on lease from Gamma Limited (GL). Details are as follows:

- (i) An instalment of Rs. 5 million is to be paid annually in advance on 1 January.
- (ii) The lease is valid for 5 years with an option for CL to buy the equipment at the end of fifth year for Rs. 6 million.
- (iii) CL also has an option to return the equipment to GL at the end of third year and terminate the lease. For this, CL needs to pay an additional Rs. 2 million with the third instalment (i.e. at the start of the third year). It is reasonably certain that CL will exercise this option.

- (iv) On 1 January 2022, CL's incremental borrowing rate is 14% per annum. This rate is expected to increase by 1% every year.
- (v) On 1 January 2022, the fair value and useful life of the equipment were Rs. 25 million and seven years respectively.
- (vi) The equipment was delivered to CL on 1 January 2022 but was ready for use on 1 April 2022. A cost of Rs. 1 million was incurred by CL on installation of the equipment.

Required: Prepare journal entries in the books of CL for the years ended 31 December 2022 and 31 December 2023 to record the above transactions. (Narrations are not required).

► **Answer:**

Concatenate Limited

General Journal

Date	Particulars	Debit Rs. m	Credit Rs. m
1 Jan 22	Right of use asset W1	14.77	
	Lease liability W1		9.77
	Cash/Bank		5.00
1 Apr 22	Right of use asset	1.00	
	Cash		1.00
31 Dec 22	Interest expense [9.77 x 14%]	1.37	
	Lease liability		1.37
31 Dec 22	Depreciation expense [(14.77+1)/3 years]	5.26	
	Accumulated depreciation		5.26
1 Jan 23	Lease liability	5.00	
	Cash/Bank		5.00
31 Dec 23	Interest expense [(9.77 + 1.37 – 5) x 14%]	0.86	
	Lease liability		0.86
31 Dec 23	Depreciation expense [(14.77+1)/3 years]	5.26	
	Accumulated depreciation		5.26

W1: Lease liability and right of use asset

Payment date	Cash flows Rs. m	PV Factor @ 14%	Present value Rs. m
1 Jan 2022	5	(paid on inception)	5.00
1 Jan 2023	5	1.14 ⁻¹	4.38
1 Jan 2024	5+2	1.14 ⁻²	5.39
Lease liability			9.77
Right of use asset			14.77

6. OBJECTIVE BASED Q&A

- 01.** During the year ended 30 September 2014 an entity entered into two lease transactions.

On 1 October 2013, the entity made a payment of Rs. 900,000 being the first of five equal annual payments under a lease for an item of plant. The lease has an implicit interest rate of 10% and the present value of the total lease payments on 1 October 2013 was Rs. 3,752,879.

On 1 January 2014, the entity made a payment of Rs. 180,000 for a one-year lease of an item of equipment.

What amount in total would be charged to entity's statement of profit or loss for the year ended 30 September 2014 in respect of the above transactions?

- (a) Rs. 1,080,000
- (b) Rs. 1,110,864
- (c) Rs. 1,170,864
- (d) Rs. 1,155,000

- 02.** Zeta Limited entered into a five-year lease agreement on 1 November 2012, paying Rs. 109,750 per annum, commencing on 31 October 2013. The present value of the lease payments was Rs. 450,000 and the interest rate implicit in the lease was 7%.

What is the amount to be shown within non-current liabilities at 31 October 2013?

- (a) Rs. 262,072
- (b) Rs. 288,023
- (c) Rs. 371,750
- (d) Rs. 364,070

- 03.** IFRS 16 Leases permits certain assets to be exempt from the recognition treatment for right-of-use assets. Which of the following assets leased to an entity would be permitted to be exempt?

- (a) A used motor vehicle with an original cost of Rs. 1,500,000 and a current fair value of Rs. 70,000, leased for 24 months
- (b) A new motor vehicle with a cost of Rs. 1,500,000, leased for 24 months
- (c) A new motor vehicle with a cost of Rs. 1,500,000, leased for 24 months, to be rented to customers on a daily rental basis
- (d) A new motor vehicle with a cost of Rs. 1,500,000, leased for 12 months

- 04.** On 1 January 2013 Rita Limited acquires a new machine with an estimated useful life of 6 years under the following agreement:

An initial payment of Rs. 1,376,000 will be payable immediately and 5 further annual payments of Rs. 2,000,000 will be due, commencing 1 January 2013. The interest rate implicit in the lease is 8%.

The present value of the lease payments, excluding the initial payment, is Rs. 8,624,000

What will be recorded in financial statements at 31 December 2014 in respect of the lease liability?

- (a) Finance cost Rs. 412,314
Non-current liability Rs. 3,566,234
Current liability (including interest payable) Rs. 2,000,000

- (b) Finance cost Rs. 529,900
Non-current liability Rs. 5,153,900
Current liability (including interest payable) Rs. 2,000,000
- (c) Finance cost Rs. 531,200
Non-current liability Rs. 5,171,200
Current liability (including interest payable) Rs. 2,000,000
- (d) Finance cost Rs. 585,100
Non-current liability Rs. 4,370,900
Current liability (including interest payable) Rs. 1,528,100

05. On 1 April 2017 Pink Limited (PL) entered into a five-year lease agreement for a machine with an estimated life of 7 years. Which of the following condition would require the machine to be depreciated over 7 years?

- (a) PL has the option to extend the lease for two years at a market-rate rental
- (b) PL has the option to purchase the asset at market value at the end of the lease
- (c) Ownership of the asset passes to PL at the end of the lease period
- (d) PL's policy for purchased assets is to depreciate over 7 years

06. On 1 January 2014 Beta Limited (BL) entered into a lease agreement to lease an item of machinery for 4 years with rentals of Rs. 210,000 payable annually in arrears. The asset has a useful life of 5 years and at the end of the lease term legal ownership will pass to BL. The present value of the lease payments at the inception of the lease was Rs. 635,000 and the interest rate implicit in the lease is 12.2%.

For the year ended 31 December 2014 BL accounted for this lease by recording the payment of Rs. 210,000 as an operating expense. This treatment was discovered during 2015, after the financial statements for 2014 had been finalised.

In the statement of changes in equity for the year ended 31 December 2015 what adjustment will be necessary to retained earnings brought forward?

- (a) Rs. 5,530 credit
- (b) Rs. 132,530 credit
- (c) Rs. 210,000 debit
- (d) Rs. Nil

07. On 1 October 2013, Multan Limited acquired an item of plant under a five-year lease agreement.

The agreement had an implicit interest rate of 10% and required annual rentals of Rs. 6 million to be paid on 30 September each year for five years.

The present value of the annual rental payments was Rs. 23 million.

What would be the current liability for the leased plant in Multan Limited's statement of financial position as at 30 September 2014?

- (a) Rs. 19,300,000
- (b) Rs. 4,070,000
- (c) Rs. 5,000,000
- (d) Rs. 3,850,000

- 08.** Which of the following would not be included within the initial cost of a right-of-use asset?
- (a) Installation cost of the asset
 - (b) Estimated cost of dismantling the asset at the end of the lease period
 - (c) Payments made to the lessor before commencement of the lease
 - (d) Total lease rentals payable under the lease agreement
- 09.** IFRS 16 Leases permits certain assets to be exempt from the recognition treatment for right-of-use assets. Which of the following leases of assets leased to an entity would NOT be permitted to be exempt?
- (a) Vehicle with cost of Rs. 900,000 leased for 9 months
 - (b) Telephone system with cost of Rs. 45,000 leased for 24 months
 - (c) Vehicle with original cost of Rs. 900,000, current market value of Rs. 45,000 leased for 24 months
 - (d) An item of furniture of Rs. 30,000 leased for 24 months
- 10.** Noor Limited leases a car for office use. The present value of lease payments is Rs. 2,735,500 and the rate implicit in lease is 10%. The terms of the lease require three annual instalments of Rs. 1,000,000 each at the start of each year.
- At the end of first year of lease what amount will be shown for the lease liability in the company's statement of financial position under the heading of non-current liabilities?
- (a) Rs. 1,000,000
 - (b) Rs. 1,090,000
 - (c) Rs. 903,060
 - (d) Rs. 909,050
- 11.** Which TWO of the following are disclosure requirements relating to a lessor?
- (a) Selling profit or loss
 - (b) Income from subleasing right of use assets
 - (c) A reconciliation of undiscounted lease payments to the net investment in the lease
 - (d) The charge related to short term leases
- 12.** Jalal Leasing Limited (JLL) gave a plant under finance lease on 1 January 2011 to a customer. The lease term is 4 years. The fair value of the asset is Rs. 11,000 and JL incurred initial direct costs of Rs. 420. The interest rate implicit in lease is 15%. Rentals of Rs. 4,000 are receivable on 31 December (also financial year end) each year.
- What is amount of net investment in lease to be presented under current assets as at 31 December 2012?
- (a) Rs. 9,133
 - (b) Rs. 2,630
 - (c) Rs. 3,025
 - (d) Rs. 6,503

13. A company leases a computer server with legal title of the asset passing after four years. The company usually depreciate computers over six years.

The company also leases a machine for fourteen years, but legal title does not pass to the lessee at the end of the agreement. The company usually depreciate machinery over twenty years.

Over what period of time should the computer and machine be depreciated?

- (a) Computer (4 years) and Machine (14 years)
 - (b) Computer (4 years) and Machine (20 years)
 - (c) Computer (6 years) and Machine (14 years)
 - (d) Computer (6 years) and Machine (20 years)
14. Faheem Limited (FL) leased out its building on 1 January 2011 under an operating lease. The carrying value of building is Rs. 239,000 and its remaining useful life is 25 years with no residual value.

FL also incurred Rs. 11,000 as initial direct costs. According to agreement, Rs. 16,000 was paid by lessee as initial deposit and further rental of Rs. 10,000 per annum. shall be paid at the end of next two years and then Rs. 32,000 per annum. shall be paid for following two years.

The lease term is 4 years.

What amount of lease income should be recognised in profit or loss for the year ended 31 December 2011?

- (a) Rs. 10,000
 - (b) Rs. 26,000
 - (c) Rs. 25,000
 - (d) Rs. 16,000
15. Galaxy Leasing Limited (GLL) has leased certain equipment to Dairy Products Limited on 1 July 2013. In this respect, the following information is available:

	Rs. in million
Cost of equipment	28.69
Amount received on 1 July 2013	3.00
Four annual instalments payable in arrears (on 30 June, each year)	7.80
Guaranteed residual value on expiry of the lease	5.00

Useful life of the equipment is estimated at 5 years. Rate of interest implicit in the lease is 14%.

What amount will be presented in non-current assets for net investment in lease as at 30 June 2014?

- (a) Rs. 25.69 million
- (b) Rs. 24.48 million
- (c) Rs. 18.60 million
- (d) Rs. 16.69 million

16. Alpha Limited leases an asset with an estimated useful life of 6 years for an initial period of 5 years, and an optional secondary period of 2 years during which a nominal rental will be payable.

The present value of the initial period lease payments is Rs. 870,000.

What will be the carrying amount of the asset in Alpha Limited's statement of financial position at the end of the second year of the lease?

- (a) Rs. 580,000
- (b) Rs. 725,000
- (c) Rs. 870,000
- (d) Rs. 435,000

17. Kamil Limited (KL) is engaged in manufacturing of plants. The following data relates to an asset leased out by the company on January 01, 2011.

Cost	Rs. 200,000
Sales price (quoted)	Rs. 240,000
Instalment at the end of each year	Rs. 40,000
Lease term	7 years
Unguaranteed residual value	Rs. 2,000
Initial direct costs	Rs. 1,000
Rate of interest (quoted)	4%
(the low rate is quoted to attract customers)	
Market rate of interest	7%

What is the amount of net investment in lease as at January 01, 2011?

- (a) Rs. 215,572
- (b) Rs. 216,818
- (c) Rs. 214,326
- (d) Rs. 218,064

18. Kamil Limited (KL) is engaged in manufacturing of plants. The following data relates to an asset leased out by the company on January 01, 2011.

Cost	Rs. 200,000
Sales price (quoted)	Rs. 240,000
Instalment at the end of each year	Rs. 40,000
Lease term	7 years
Unguaranteed residual value	Rs. 2,000
Initial direct costs	Rs. 1,000
Rate of interest (quoted)	4%
(the low rate is quoted to attract customers)	
Market rate of interest	7%

What is the amount to be charged in cost of sales in respect of above transaction on January 01, 2011?

- (a) Rs. 198,754
- (b) Rs. 200,000
- (c) Rs. 201,246
- (d) Rs. 198,000

19. DJ Products deals in large office machines. It also offers such machines on lease. One such machine was leased to a customer on July 1, 2004. Its particulars are as follows:

Purchase cost of DJ Products	Rs. 150,000
Useful life	8 years
Lease period	6 years
Unguaranteed residual value	Rs. 10,000
Annual rental payable at beginning of each year	Rs. 36,500

The customer's incremental borrowing rate is 10% whereas the discounting rate implicit in the lease is 8%.

What is amount of net investment in lease that should be recognised on 1st July 2004?

- (a) Rs. 145,745
 - (b) Rs. 182,245
 - (c) Rs. 182,500
 - (d) Rs. 188,545
20. Guava Leasing Limited (GLL), had leased a machinery to Honeyberry Limited (HL) on 1 July 2017 on the following terms:
- (i) The non-cancellable lease period is 3.5 years. Each semi-annual lease instalment of Rs. 48 million is receivable in arrears.
 - (ii) The lease contains an option to extend the lease term by 1.5 years. Each semi-annual lease instalment in the extended period will be of Rs. 15 million, receivable in arrears. It is reasonably certain that HL will exercise this option.
 - (iii) The rate implicit in the lease is 10% per annum.
 - (iv) The useful life of machinery is 6 years.
 - (v) The unguaranteed residual value at the end of lease term is estimated at Rs. 20 million. GLL incurred a direct cost of Rs. 10 million and general overheads of Rs. 0.5 million to complete the transaction.
 - (vi) The net investment in lease at inception of lease has been calculated i.e. Rs. 319.06 million

What is the amount of interest income to be recognised in profit or loss for the year ended 30 June 2018?

- (a) Rs. 287.01 million
 - (b) Rs. 15.95 million
 - (c) Rs. 14.35 million
 - (d) Rs. 30.3 million
21. Which of the following should NOT be included in the initial cost of a right of use asset?
- (a) Amount of initial measurement of the lease liability
 - (b) Present value of estimated cost of dismantling the asset at the end of lease period
 - (c) Payments made to the lessor before commencement of the lease
 - (d) Gross lease rentals payable under the lease agreement

22. Wood Leasing Limited has leased certain equipment on 1 July 2018. In this respect, following information is available:

	Rs. in million
Fair value of equipment	67.00
Amount received on 1 July 2018	5.50
Four annual instalments payable in arrears	20.00
Guaranteed residual value on expiry of the lease	10.00

Useful life of the equipment is estimated at 5 years. Implicit rate in the lease is 16%.

What amount of net investment in lease will be presented in non-current assets as at 30 June 2019?

- (a) Rs. 57.72 million
 (b) Rs. 46.96 million
 (c) Rs. 51.34 million
 (d) Rs. 39.55 million
23. Zameer Ansari is a car dealer. Cars are sold both on cash and finance lease basis. He has been selling a car at the following terms:

Fair value	Rs. 5,000,000
Annual lease rental in arrears	Rs. 1,646,199
Market rate	12% per annum
Lease term	4 years

What would be the effect on sales revenue and finance income if annual lease rental is increased to Rs. 1.8 million and all other terms remain the same?

- (a) Increase in sales revenue and increase in finance income
 (b) Decrease in sales revenue and increase in finance income
 (c) No change in sales revenue and increase in finance income
 (d) Increase in sales revenue and no change in finance income
24. An entity acquires property on lease for a non-cancellable period of 3 years. The lease payments are payable semi-annually in arrears beginning from first year. What would be the impact of this transaction on lessee's current and gearing ratios upon commencement of lease?
- (a) Decrease in current ratio as well as gearing ratio
 (b) Decrease in current ratio and increase in gearing ratio
 (c) Increase in current ratio and decrease in gearing ratio
 (d) Increase in current ratio as well as gearing ratio
25. Which of the following is one of the conditions set out in IFRS 16 for an arrangement to be classified as a finance lease?
- (a) The lessee has the right to obtain substantially all of the economic benefits from use of the asset
 (b) The lease term covers substantially all of the economic life of the asset
 (c) The lessor has a substantive right of substitution
 (d) The lessor has the right to direct the use of the asset

26. Which of the following statements are correct in the context of IFRS 16?
- (I) When the supplier has a substantive right of substitution, then the contract does not constitute a lease.
 - (II) When consideration for use of an asset is paid in terms of goods and services (other than cash), then the contract does not constitute a lease.
- (a) Only (I) is correct
 - (b) Only (II) is correct
 - (c) Both are correct
 - (d) None is correct

27. Magnificent Motors (MM) is a car dealer. It sells cars for cash and also offers a certain model for sale by lease. MM sold a car on lease on 1 January 2023. The following information is relevant:

Price of the car in a cash sale	Rs. 3,500,000
Cost of the car to MM	Rs. 2,500,000
Annual rental (in arrears)	Rs. 1,012,339
Lease term	4 years
Interest rate implicit in the lease	8%
Market rate of interest	10%
Estimated residual value (unguaranteed)	Rs. 200,000

Which of the following amounts is to be recognized as revenue on 1 January 2023?

- (a) Rs. 3.50 million
 - (b) Rs. 3.21 million
 - (c) Rs. 3.35 million
 - (d) Rs. 2.36 million
28. IFRS 16 permits certain assets to be exempt from the recognition treatment for right-of-use assets. Which TWO of the following assets leased to an entity would be permitted to be exempt?
- (a) An equipment costing Rs. 45 million leased for 60 months
 - (b) An item of furniture costing Rs. 30,000 leased for 24 months
 - (c) A new motor vehicle with a cost of Rs. 1.5 million leased for 12 months
 - (d) A laptop costing Rs. 150,000 leased for 36 months, which is expected to be sub-leased for 24 months
29. Which TWO of the following are considered as lease payments for the lessee?
- (a) Variable lease payments that depend on an index or a rate
 - (b) Amounts expected to be payable by the lessee under residual value guarantees
 - (c) Residual value guarantees provided to the lessor by the lessee
 - (d) Residual value guarantees provided to the lessor by a party related to the lessee

ANSWERS

01.	(c)	Depreciation of leased plant Rs. 750,576 (Rs. 3,752,879/5 years) Finance cost Rs. 285,288 ((Rs. 3,752,879 – 900,000) × 10%) Rental of equipment (short term lease) Rs. 135,000 (180,000 × 9/12) Total Rs. 1,170,864					
02.	(b)	Time	Balance at beginning	Interest @ 7%	Rental	Principal Element	Balance at end
			Rupees				
		31.10.2013	450,000	31,500	109,750	(78,250)	371,750
		31.10.2014	371,750	26,023	109,750	(83,727)	288,023
03.	(d)	Assets permitted to be exempted from recognition are low-value assets and those with a lease term of 12 months or less. The use of the asset is irrelevant, and, although IFRS 16 Leases does not define low-value, it is the cost when new that is considered rather than current fair value.					
04.	(a)	Time	Opening	Payment	Subtotal	Interest 8%	Closing
			Rupees				
		2013	8,624,000	(2,000,000)	6,624,000	529,920	7,153,920
		2014	7,153,920	(2,000,000)	5,153,920	412,314	5,566,234
		2015	5,566,234	(2,000,000)	3,566,234		
05.	(c)	The transfer of ownership at the end of the lease indicates that PL will have use of the asset for its entire life, and therefore 7 years is the appropriate depreciation period. Potential transactions at market rate would be ignored as they do not confer any benefit on PL, and PL's depreciation policy for purchased assets is irrelevant.					
06.	(a)	Reverse incorrect treatment of rental: Dr Liability Rs. 210,000 Cr Retained Earnings Rs. 210,000 Charge asset depreciation (Rs. 635,000/5): Dr Retained earnings Rs. 127,000 Cr Property, plant and equipment Rs. 127,000 Charge finance cost (Rs. 635,000 × 12.2%): Dr Retained Earnings Rs. 77,470 Cr Liability Rs. 77,470 This gives a net adjustment of Rs. 5,530 to be credited to opening retained earnings.					
07.	(b)	Time	Balance at beginning	Interest @ 10%	Rental	Principal Element	Balance at end
		T	Rupees				
		30.09.14	23,000,000	2,300,000	6,000,000	(3,700,000)	19,300,000
		30.09.15	19,300,000	1,930,000	6,000,000	(4,070,000)	

08.	(d)	The value recognised in respect of the lease payments will be the present value of future lease payments rather than the total value.					
09.	(c)	Assets permitted to be exempted from recognition are low-value assets and those with a lease term of 12 months or less. Although IFRS 16 Leases does not define low-value but it lists examples which includes telephones and small items of furniture. Low value is based on original cost and not on current market value.					
10.	(d)	Time	Opening	Payment	Subtotal	Interest 10%	Closing
			Rupees				
		1	2,735,500	(1,000,000)	1,735,500	173,550	1,909,050
		2	1,909,050	(1,000,000)	909,050		
11.	(a) & (c)	(b) and (d) are relevant to lessee not lessor.					
12.	(c)	Receipt time	Receivable at beginning	Interest @ 15%	Rental	Principal Element	Receivable after receipt
		T	Rupees				
		31.12.2011	11,420	1,713	4,000	(2,287)	9,133
		31.12.2012	9,133	1,370	4,000	(2,630)	6,503
		31.12.2013	6,503	975	4,000	(3,025)	
13.	(c)	Assets are usually depreciated over lease term, however, if ownership is transferred these should be depreciated over useful life.					
14.	(c)	Total payments = Rs. 16,000 + (10,000 x2) + (32,000 x 20 = Rs. 100,000 On straight line basis over four years Rs. 100,000 / 4 = Rs. 25,000					
15.	(d)	Date	Opening balance	Interest @ 14%	payments	Principal repayments	Closing balance
		----- Rs. in million -----					
		01-Jul-2013	28.69		(3.00)	(3.00)	25.69
		30-Jun-2014	25.69	3.59	(7.80)	(4.21)	21.48
		30-Jun-2015	21.48	3.01	(7.80)	(4.79)	16.69
16.	(a)	The asset would initially be capitalised at Rs. 870,000. This is then depreciated over six years, being the shorter of the useful life and the lease term (including any secondary period). This would give a depreciation expense of Rs. 145,000 a year. After two years, accumulated depreciation would be Rs. 290,000 and therefore the carrying amount would be Rs. 580,000.					
17.	(b)	PV of MLP Rs. 40,000 x 5.3893 discount factor @7% = Rs. 215,572 PV of UGRV Rs. 2,000 x 0.6227 discount factor @7% = Rs. 1,246 Total Rs. 216,818					
18.	(a)	Cost of inventory transferred Rs. 200,000 less present value of unguaranteed residual value Rs. 1,246 = Rs. 198,754					

19.	(d)	Year	Particulars		Cash payment Rs.	Discount factor	Present value Rs.
		0	First rentals		36,500	1.000	36,500
		1-5	Other 5 rentals		36,500	3.993	145,745
			PV of Lease Payment				182,245
		6	URV		10,000	0.630	6,300
			PV of GI				188,545
20.	(d)	Date	Opening balance	Interest @ 10% $\times$ 6/12	payments	Principal repayments	Closing balance
		----- Rs. in million -----					
		31-Dec-17	319.06	15.95	(48)	(32.05)	287.01
		30-Jun-18	287.01	14.35	(48)	(33.66)	253.36
				30.3			
21.	(d)	Gross lease rentals payable under the lease agreement					
22.	(d)	Rs. 39.55 million					
23.	(c)	No change in sales revenue and increase in finance income					
24.	(b)	Decrease in current ratio and increase in gearing ratio					
25.	(a)	The lessee has the right to obtain substantially all of the economic benefits from use of the asset					
26.	(a)	Only (I) is correct					
27.	(b)	Lower of: • fair value of Rs. 3.5 million; and • present value of lease payment using market rate of interest Rs. 1,012,339 $\times$ [(1-1.10⁻⁴)/0.10] = Rs. 3.21 million					
28.	(b) and (c)	An item of furniture costing Rs. 30,000 leased for 24 months A new motor vehicle with a cost of Rs. 1,500,000 leased for 12 months					
29.	(a) and (b)	Variable lease payments that depend on an index or a rate Amounts expected to be payable by the lessee under residual value guarantees					

STICKY NOTES

Accounting by lessee

Initial recognition and measurement	Debit Right of use Credit Bank Credit Bank/accrual Credit Lease liability Credit Provision for dismantling
Depreciation over shorter of useful life or lease term (if ownership transfers, then over useful life)	Debit Depreciation Credit Accumulated dep. (right of use)
Increasing the carrying amount to reflect interest on the lease liability.	Debit Interest expense Credit Lease liability
Reducing the carrying amount to reflect the lease payments made.	Debit Lease liability Credit Bank
Variable lease payments when incurred.	Debit Expense (PL) Credit Bank / Accrual
Short term and low value item leases The lease payments associated with short term and low value item leases are charged as an expense on either a straight-line basis over the lease term or another systematic basis (only if more representative).	

Accounting by lessor

Initial recognition of finance lease by lessor	Debit Net investment in lease Credit Asset / Bank Credit Bank/accrual (initial direct costs)
Initial recognition of finance lease by manufacture and dealer lessor	Debit Net investment in lease Debit Cost of sales Credit Sales revenue Credit Inventory Debit Profit or loss (initial direct costs) Credit Bank / Accrual
Subsequent measurement (interest earned and cash received)	Debit Net investment in lease Credit Interest income Debit Bank Credit Net investment in lease
Operating lease Lease income from operating lease shall be recognized on a straight-line basis over the lease term unless another systematic basis is more representative of benefit derived from the leased asset.	

AT A GLANCE

SPOTLIGHT

STICKY NOTES

IAS 21 FOREIGN CURRENCY TRANSACTIONS

IN THIS CHAPTER:

AT A GLANCE

SPOTLIGHT

1. Introduction
2. Reporting foreign currency transactions
3. Comprehensive Examples
4. Objective Based Q&A

STICKY NOTES

AT A GLANCE

This chapter provides guidance as to how an entity shall report its foreign currency transactions in accordance with IAS 21 *The effects of changes in foreign exchange rates*.

The principal issues are which exchange rate(s) to use and how to report the effects of changes in exchange rates in the financial statements.

A foreign currency transaction shall be recorded, on initial recognition in the functional currency, by applying to the foreign currency amount the spot exchange rate between the functional currency and the foreign currency at the date of the transaction.

At the end of each reporting period:

- (a) foreign currency monetary items shall be translated using the closing rate;
- (b) non-monetary items that are measured in terms of historical cost in a foreign currency shall be translated using the exchange rate at the date of the transaction; and
- (c) non-monetary items that are measured at fair value in a foreign currency shall be translated using the exchange rates at the date when the fair value was determined.

Exchange differences arising on the settlement of monetary items or on translating monetary items at rates different from those at which they were translated on initial recognition during the period or in previous financial statements shall be recognised in profit or loss in the period in which they arise.

1. INTRODUCTION

1.1 Accounting issues [IAS 21: 1 & 2]

Many business often transact in a foreign currency and therefore it is common to have transactions and investments that are denominated in a foreign currency. These transactions need to be translated into the company's own currency, in order to record them in its ledger accounts.

For example:

- a Pakistani company may take out a loan from a French bank in Euros but will record the loan in its ledger accounts in Rupees; or
- a Pakistani company may sell goods to a Japanese company invoiced in Yen but will record the sale and the trade receivable in Rupees in its ledger accounts.

The two main accounting issues when accounting for foreign currency items are:

- What exchange rate(s) should be used for translation?
- How to account for the gains or losses that arise when exchange rates change?

1.2 Types of currencies [IAS 21: 8 to 10]

Type	Definition & Explanation
Presentation currency	Definition: The currency in which the financial statements of an entity are presented. Explanation: An entity is permitted to present its financial statements in any currency. This reporting currency is often the same as the functional currency but does not have to be. An entity may have more than one presentation currency.
Functional currency	Definition: The currency of the primary economic environment in which an entity operates. Explanation: A reporting entity records (journal entries, ledgers etc.) transactions in its functional currency. It will also, typically, prepare its financial statements in its functional currency but presentation currency may be different. The functional currency is not necessarily the currency of the country in which the entity operates or is based.
Foreign currency	Definition: A currency other than the functional currency of the entity.

► Example 01:

P is a Pakistan-registered mining company whose shares are traded on the Pakistan Stock Exchange. Its operating activities take place in the gold and diamond mines of South Africa. P bought specialised mining equipment from the US, invoiced in US dollars.

- What is the presentation currency of P?
- What is its functional currency?
- What type of currency is the US dollar, using the IAS 21 definitions?

► ANSWER:

- The presentation currency (reporting currency) is Pak Rupees (PKR). This is a requirement of the SECP, regulator of Companies in Pakistan to present financial statements using PKR currency.
- The functional currency is likely to be South African Rand, even though the company is based in Pakistan. This is because its operating activities take place in South Africa and so the company will be economically dependent on the Rand if the salaries of most of its employees, and most operating expenses and sales are in Rand.

- (c) US\$ is foreign currency in this case being any currency other than the functional currency.

IAS 21 provides detailed guidance on identifying the functional currency for an entity. An entity considers the following factors in determining its functional currency:

- The currency that mainly influences sales prices for goods and services (often the currency in which prices are denominated and settled) and the currency of the country whose competitive forces and regulations mainly determine the sales prices of its goods and services; and
- The currency that mainly influences labour, material and other costs of providing goods or services (often the currency in which prices are denominated and settled).

The following factors may also provide an evidence of an entity's functional currency;

- The currency in which funds are generated by issuing debt and equity
- The currency in which receipts from operating activities are usually retained.

1.3 Exchange rates [IAS 21: 8]

Term	Definition
Exchange rate	The rate of exchange between two currencies.
Spot rate	The exchange rate at the date of the transaction for immediate delivery.
Closing rate	The spot exchange rate at the end of the reporting period.
Exchange difference	A difference resulting from translating a given number of units of one currency into another currency at different exchange rates.

There are two ways in which exchange rates are quoted in markets, direct quote and indirect quote. The direct quote is often used in Pakistan in which variable units of PKR are quoted for one unit of foreign currency e.g. US\$ 1 = PKR 176. The indirect quote would quote variable units of foreign currency for one unit of PKR e.g. PKR 1 = US\$0.00568.

Based on these quotes, we can derive conversion formulas as follows:

Direct quote	$\text{PKR} = \text{Foreign currency units} \times \text{exchange rate}$ $\text{Foreign currency units} = \text{PKR} / \text{exchange rate}$
Indirect quote	$\text{PKR} = \text{Foreign currency units} / \text{exchange rate}$ $\text{Foreign currency units} = \text{PKR} \times \text{exchange rate}$

► Example 02:

Perform the following currency conversions:

- US\$ 500 into Pak rupees if US\$1 = PKR 174.52
- US\$ 500 into Pak rupees if PKR 1 = US\$ 0.00573
- Rs. 87,260 into US\$ if US\$1 = PKR 174.52
- Rs. 87,260 into US\$ if PKR 1 = US\$ 0.00573

► ANSWER:

- $\text{US\$ } 500 \times 174.52 = \text{PKR } 87,260$
- $\text{US\$ } 500 / 0.00573 = \text{PKR } 87,260$
- $\text{PKR } 87,260 / 174.52 = \text{US\$ } 500$
- $\text{PKR } 87,260 \times 0.00573 = \text{US\$ } 500$

1.4 Monetary vs. non-monetary items [IAS 21: 8 & 16]

In order to apply requirements of IAS 21 as discussed in next section of this chapter, it is important to distinguish monetary items from non-monetary items.

Monetary items are units of currency held and assets and liabilities to be received or paid (in cash), in a fixed number of currency units. Examples of monetary items include cash itself, loans, trade payables, trade receivables and interest payable.

Non-monetary items are not defined by IAS 21, but they are items that are not monetary items. They include tangible non-current assets, investments in other companies and investment properties.

In the following table, typical assets and liabilities have been summarised distinguishing them as either monetary or non-monetary.

Assets	
Monetary • Net investment in lease • Investments in debt securities • Trade receivables • Other receivables • Advances (to be received back in cash) • Cash and bank (including term deposits)	Non-monetary • Property, plant & equipment • Investment property • Biological assets • Intangible assets (including goodwill) • Right of use assets • Investments in equity shares • Inventories • Advances for goods/services • Prepayments for expenses • Deferred tax assets (IAS 12 Para 78)
Liabilities	
Monetary • Refund liability (to be settled in cash) • Provisions (to be settled in cash) • Provisions for employee benefits • Lease liability • Deferred tax liability • Current tax liability • Loans and borrowings • Trade payables • Accruals (to be paid in cash) • Cash dividend payable	Non-monetary • Advance from customer (contract liability) • Provisions (to be settled by delivery of non-monetary assets) • Deferred Government Grant
In practice, equity items (share capital and reserves) are usually treated as non-monetary items.	

2. REPORTING FOREIGN CURRENCY TRANSACTIONS

2.1 Initial recognition: translation of transactions [IAS 21: 20 to 22]

A foreign currency transaction is a transaction that is denominated or requires settlement in a foreign currency, including transactions arising when an entity:

- buys or sells goods or services whose price is denominated in a foreign currency;
- borrows or lends funds when the amounts payable or receivable are denominated in a foreign currency; or
- otherwise acquires or disposes of assets, or incurs or settles liabilities, denominated in a foreign currency; or
- receives dividends and other payments in another currency.

On initial recognition, a transaction in a foreign currency must be translated at the spot rate on the date of the transaction. If the company purchases goods on most days in the foreign currency, it may use an average rate for a time period, provided that the exchange rate does not fluctuate significantly over the period. For example, an entity might use an average exchange rate for a week or a month for translating all the foreign currency denominated transactions in that time period.

► Example 03:

A Pakistani company (with the rupee as its functional currency) has a financial year ending on 31 December.

It buys goods from an Australian supplier (with the Australian dollar as its functional currency) on 1 December 20X6 invoiced in A\$10,000. It also buys again from the same supplier on 10 December 20X6 invoiced in A\$7,000. The Australian supplier will eventually be paid in March 20X7.

Exchange rates:

- 1 December 20X6 Rs. 110/A\$1
- 10 December 20X6 Rs. 112 /A\$1

Required: Journal entries for the above transaction on above two dates.

► ANSWER:

Date	Particulars	Debit Rs.	Credit Rs.
1 Dec 20X6	Purchases (or inventory)	1,100,000	
	Trade payable		1,100,000
	(A\$10,000 x 110 = PKR 1,100,000)		
10 Dec 20X6	Purchases (or inventory)	784,000	
	Trade payable		784,000
	(A\$7,000 x 112 = PKR 784,000)		

Note that for practical purposes, if the entity buys items in A\$ frequently, it may be able to use an average spot rate for a period, for all transactions during that period.

For example, if the Pakistani company bought items from Australia on an ongoing basis it might adopt a policy of translating all purchases in a month at the average rate for that month.

2.2 Subsequent reporting: retranslation [IAS 21: 23, 28 & 30]

This table summarises the subsequent accounting for foreign currency transactions:

Asset or liability	Re-translate at	Exchange difference (gain or loss)
Monetary items (settled)	Exchange rate at the date of receipt or payment	Recognise in profit or loss
Monetary items (unsettled)	Closing rate	Recognise in profit or loss
Non-monetary items carried at cost	Not required	Not applicable
Non-monetary items carried at fair value	Exchange rate at the date fair value was measured	Recognised in the same section as the gain or loss from change in valuation is recognised. See note below.

Note:

Under IAS 16 and IAS 38, revaluation gain is recorded in other comprehensive income, therefore, exchange difference shall be recognised in other comprehensive income as well.

Under IAS 40, gain on fair value increase is recognised in profit or loss, therefore, exchange difference shall be recognised in profit or loss as well.

► Example 04:

A Pakistani company sells goods to a customer in Saudi Arabia for SR 72,000 on 12 September, when the exchange rate was Rs.42/SR (Saudi riyal).

It received payment on 19 November, when the exchange rate was Rs.44/SR.

The financial year-end is 31 December.

Required: Journal entries.

► ANSWER:

Date	Particulars	Debit Rs.	Credit Rs.
12 Sep	Receivable	3,024,000	
	Revenue		3,024,000
	<i>[SR 72,000 x 42 = Rs. 3,024,000]</i>		
19 Nov	Cash	3,168,000	
	Receivable		3,024,000
	Exchange gain (PL)		144,000
	<i>[SR 72,000 x 44 = Rs. 3,168,000]</i>		
	<i>[Rs. 3,168,000 – 3,024,000 = Rs. 144,000]</i>		

► **Example 05:**

A Pakistani company (with the rupee as its functional currency) has a financial year ending on 31 December.

It buys inventory from an Australian supplier (with the Australian dollar as its functional currency) on 1 December 20X6 invoiced in A\$10,000.

The Australian supplier will be eventually paid in March 20X7.

Exchange rates over the period were as follows:

- 1 December 20X6 Rs.110/A\$1
- 31 December 20X6 Rs.112/A\$1

Required: Journal entries for the year ended 31 December 20X6.

► **ANSWER:**

Date	Particulars	Debit Rs.	Credit Rs.
1 Dec	Purchases (or inventory)	1,100,000	
	Trade payable		1,100,000
	<i>[A\$ 10,000 x 110 = Rs. 1,100,000]</i>		
31 Dec	Exchange loss (PL)	20,000	
	Trade payable		20,000
	<i>[A\$ 10,000 x 112 = Rs. 1,120,000]</i>		
	<i>[Rs. 1,120,000 - 1,100,000 = Rs. 20,000]</i>		

Note: In the above example the Pakistani company had purchased inventory. Even if this were still held at the year-end it would not be retranslated as it is a non-monetary asset.

► **Example 06:**

A Pakistani company bought a machine from a German supplier for €200,000 on 1 March when the exchange rate was Rs. 120/€.

By 31 December, the end of the company's accounting year, the exchange rate was Rs. 110/€.

At 31 December, the Pakistani company had not yet paid the German supplier any of the money that it owed for the machine. The machinery is carried at cost less accumulated depreciation.

Required: Journal entries.

► **ANSWER:**

Date	Particulars	Debit Rs.	Credit Rs.
1 Mar	PPE (machinery)	24,000,000	
	Other payables		24,000,000
	<i>[€ 200,000 x 120 = Rs. 24,000,000]</i>		
31 Dec	Other payables	2,000,000	
	Exchange gain (PL)		2,000,000
	<i>[€ 200,000 x 110 = Rs. 22,000,000]</i>		
	<i>[Rs. 22,000,000 - 24,000,000 = Rs. 2,000,000]</i>		

Note: Machinery shall not be translated at closing rate being non-monetary item carried at cost.

► **Example 07:**

A Pakistani company (with the rupee as its functional currency) has a financial year ending on 31 December.

It bought a property (plot of land) to construct its factory in Bahrain on 1 August 20X6 for 100,000 Bahraini dinar (BD).

The property was revalued to BD 120,000 on 31 December 20X6 as permitted by IAS 16.

Exchange rates:

- 1 August 20X6 Rs.275/BD1
- 31 December 20X6 Rs. 290/BD1

Required: Journal entries for the year ended 31 December 20X6.

► **ANSWER:**

Date	Particulars	Debit Rs.	Credit Rs.
1 Aug	PPE (Land)	27,500,000	
	Bank		27,500,000
	<i>[BD 100,000 x 275 = Rs. 27,500,000]</i>		
31 Dec	PPE (Land)	7,300,000	
	Other comprehensive income		7,300,000
	<i>[BD 120,000 x 290 = Rs. 34,800,000]</i>		
	<i>[Rs. 34,800,000 - 27,500,000 = Rs. 7,300,000]</i>		

Note: The gain on revaluation and gain arising due to exchange differences can be calculated as follows:

	BD	Rate	Rs.
Property at initial recognition	100,000	275	27,500,000
Revaluation (year-end)	20,000	290	5,800,000
Exchange gain (balancing)			1,500,000
Property at year end	120,000	290	34,800,000

► **Example 08:**

A Pakistani company (with the rupee as its functional currency) has a financial year ending on 31 December.

It bought a property in Bahrain on 1 August 20X6 for 100,000 Bahraini dinar (BD). The property is held for capital appreciation and has been classified as investment property, the company uses fair value model.

The fair value of property increased to BD 120,000 on 31 December 20X6.

Exchange rates:

- 1 August 20X6 Rs.275/BD1
- 31 December 20X6 Rs. 290/BD1

Required: Journal entries for the year ended 31 December 20X6.

► **ANSWER:**

Date	Particulars	Debit Rs.	Credit Rs.
1 Aug	Investment property	27,500,000	
	Bank		27,500,000
	<i>[BD 100,000 x 275 = Rs. 27,500,000]</i>		
31 Dec	Investment property	7,300,000	
	Profit or loss		7,300,000
	<i>[BD 120,000 x 290 = Rs. 34,800,000]</i>		
	<i>[Rs. 34,800,000 - 27,500,000 = Rs. 7,300,000]</i>		

Note: The gain due to increase in fair value and gain arising due to exchange differences can be calculated as follows:

	BD	Rate	Rs.
Property at initial recognition	100,000	275	27,500,000
Increase in fair value (year-end)	20,000	290	5,800,000
Exchange gain (balancing)			1,500,000
Property at year end	120,000	290	34,800,000

2.3 Retranslation with frequent movement on the account

Sometimes there might be a movement on the carrying amount of a balance denominated in a foreign currency during a period. The exchange difference could be calculated by applying the above approach.

► **Example 09:**

A Pakistani company whose functional currency is the rupee paid \$90,000 into a dollar account on 30 June.

The company paid an additional \$10,000 into the account on 30 September, \$15,000 on 31 October and \$20,000 on 30 November.

There were no other movements on this account.

Exchange rates over the period were as follows:

30 June	30 Sep	31 Oct	30 Nov	31 Dec
Rs. 160/\$	Rs. 161/\$	Rs. 164/\$	Rs. 165/\$	Rs. 162/\$

Required: Calculate the exchange gain/loss on each deposit separately.

► **ANSWER:**

		Gain (loss)
Initial deposit 30 June	Rs.	Rs.
On 30 June \$90,000 x 160	14,400,000	
On 31 Dec \$90,000 x 162	14,580,000	180,000
Additional deposit 30 Sep		
On 30 Sep \$10,000 x 161	1,610,000	
On 31 Dec \$10,000 x 162	1,620,000	10,000
Additional deposit 31 Oct		
On 31 Oct \$15,000 x 164	2,460,000	
On 31 Dec \$15,000 x 162	2,430,000	(30,000)
Additional deposit 30 Nov		
On 30 Nov \$20,000 x 165	3,300,000	
On 31 Dec \$20,000 x 162	3,240,000	(60,000)
		100,000

However, this can be time consuming where there is a lot of movements. An easier approach is to find the exchange difference as a balancing figure.

► **Example 10:**

A Pakistani company whose functional currency is the rupee paid \$90,000 into a dollar account on 30 June.

The company paid an additional \$10,000 into the account on 30 September, \$15,000 on 31 October and \$20,000 on 30 November.

There were no other movements on this account.

Exchange rates over the period were as follows:

30 June	30 Sep	31 Oct	30 Nov	31 Dec
Rs. 160/\$	Rs. 161/\$	Rs. 164/\$	Rs. 165/\$	Rs. 162/\$

Required: Calculate the total exchange gain/loss on the deposit account.

► **ANSWER:**

	\$	Rate	Rs.
Initial deposit 30 June	90,000	160	14,400,000
Additional deposit 30 Sep	10,000	161	1,610,000
Additional deposit 31 Oct	15,000	164	2,460,000
Additional deposit 30 Nov	20,000	165	3,300,000
Exchange gain (balancing)			100,000
At year end 31 Decemebr	135,000	162	21,870,000

2.4 Retranslation of accrual of interest

There is no rule in IAS 21 as to what rate should be used for the accrual of interest. The accrual could be deemed to arise over the period in which case the average rate would be used or it could be treated as a year-end transaction in which case the closing rate would be used. The profit for the period is not affected by the choice of rate as there would be a compensating adjustment in the amount of the exchange difference.

► Example 11:

A Pakistani company whose functional currency is the rupee borrowed \$90,000 on 30 June.

The company recognised an interest accrual of \$10,000 at its year-end (31 December). There were no other movements on this account.

Exchange rates over the period were as follows:

- 30 June: Rs.160/\$.
- Average for the period Rs.161/\$.
- 31 December (year-end): Rs.162/\$.

Required: Calculate the amount of expense to be recognised in profit or loss using average rate approach.

► ANSWER:

Exchange difference (interest at average rate)	\$	Rate	Rs.
Balance at start (30 June)	90,000	160	14,400,000
Interest (PL)	10,000	161	1,610,000
Exchange loss (PL)			190,000
Balance at end (31 Dec.)	100,000	162	16,200,000

The total expense is Rs. 1,800,000 (i.e. Interest 1,610,000 + exchange loss 190,000).

► Example 12:

A Pakistani company whose functional currency is the rupee borrowed \$90,000 on 30 June.

The company recognised an interest accrual of \$10,000 at its year-end (31 December). There were no other movements on this account.

Exchange rates over the period were as follows:

- 30 June: Rs.160/\$.
- Average for the period Rs.161/\$.
- 31 December (year-end): Rs.162/\$.

Required: Calculate the amount of expense to be recognised in profit or loss using closing rate approach.

► ANSWER:

Exchange difference (interest at closing rate)	\$	Rate	Rs.
Balance at start (30 June)	90,000	160	14,400,000
Interest (PL)	10,000	162	1,620,000
Exchange loss (PL)			180,000
Balance at end (31 Dec.)	100,000	162	16,200,000

The total expense is Rs. 1,800,000 (i.e. Interest 1,620,000 + exchange loss 180,000).

3. COMPREHENSIVE EXAMPLES

► **Example 13:**

Tabrez Limited (TL), having operations in Lahore, purchases machinery from ABC Company for €200,000 on 31 May 2019 when the exchange rate was Rs.150 / Euro. TL also sells goods to a UK buyer for €150,000 on 30 September 2019, when the exchange rate was Rs.155 / Euro. At the TL's year end of 31 December 2019, both amounts are still outstanding and have not been paid. The closing exchange rate was Rs.160 to €1.

Required: Journal entries for the year ended 31 December 2019.

► **ANSWER:**

Date	Particulars	Debit Rs. m	Credit Rs. m
31 May 2019	PPE (machinery)	30	
	Other payables		30
	[€ 200,000 x 150 = Rs. 30m]		
30 Sep 2019	Trade receivable	23.25	
	Revenue		23.25
	[€ 150,000 x 155 = Rs. 23.25m]		
31 Dec 19	Exchange loss (PL)	2	
	Other payables		2
	[€ 200,000 x 160 = Rs. 32m]		
	[Rs. 32m – 30m = Rs. 2m]		
31 Dec 19	Trade receivable	0.75	
	Exchange gain (PL)		0.75
	[€ 150,000 x 160 = Rs. 24m]		
	[Rs. 24m – 23.25m = Rs. 0.75m]		

► **Example 14:**

On 1 January 2020 an American bank transfers USD 1 million to a local company in Pakistan, Bilal Limited in return for a promise to pay fixed interest of 8% per year for two years (due at the end of each year of the loan period, i.e. 31 December) and a payment of \$ 1 million at the end of the two-year period.

At the inception of the loan, 8% is the market rate for similar two-year fixed-interest \$ denominated loans. The BL's functional currency is PKR.

The effective interest rate is also 8%.

Exchange rates over the loan are:

- 1 January 2020: Rs. 150 = \$ 1
- Average exchange rate in 2020: Rs. 150.5 = \$ 1
- 31 December 2020: Rs. 151 = \$ 1
- Average exchange rate in 2021: Rs. 151.75 = \$ 1
- 31 December 2021: Rs. 152.5 = \$ 1

Required: Journal entries from 1 January 2020 to 31 December 2021.

► ANSWER:

Date	Particulars	Debit Rs. m	Credit Rs. m
1 Jan 2020	Bank	150	
	Loan (financial liability)		150
	<i>[US\$ 1m x 150 = Rs. 150m]</i>		
31 Dec 2020	Interest expense \$80,000 x 150.5	12.04	
	Exchange loss (PL) \$80,000 x 0.5	0.04	
	Bank \$80,000 x 151		12.08
	<i>[US\$ 1m x 8% = \$80,000]</i>		
31 Dec 2020	Exchange loss (PL)	1	
	Loan (financial liability)		1
	<i>[US\$ 1m x 151 = Rs. 151m]</i>		
	<i>[Rs. 151m - 150m = Rs. 1m]</i>		
31 Dec 2021	Interest expense \$80,000 x 151.75	12.14	
	Exchange loss (PL) \$80,000 x 0.75	0.06	
	Bank \$80,000 x 152.5		12.20
	<i>[US\$ 1m x 8% = \$80,000]</i>		
31 Dec 2021	Loan (financial liability)	151	
	Exchange loss (PL)	1.5	
	Bank		152.5
	<i>[US\$ 1m x 152.5 = Rs. 152.5m]</i>		
	<i>[Rs. 152.5m - 151m = Rs. 1.5m]</i>		

► Example 15:

DND Limited is a listed company, having its operations within Pakistan. During the year ended December 31, 20X6, the company contracted to purchase plants and machineries from a US Company. The terms and conditions thereof, are given below:

Total cost of contract = US\$ 100,000.

Payment to be made in accordance with the following schedule:

	Payment Dates	Amount Payable
On signing the contract	July 01, 20X6	US\$ 20,000
On shipment*	September 30, 20X6	US\$ 50,000
After installation and test run	January 31, 20X7	US\$ 30,000

*(risk and rewards of ownership are transferred on shipment)

The contract went through in accordance with the schedule and the company made all the payments on time. The following exchange rates are available:

Dates	Exchange Rates
July 1, 20X6	US\$ 1 = Rs. 160.50
September 30, 20X6	US\$ 1 = Rs. 161.00
December 31, 20X6	US\$ 1 = Rs. 161.20
January 31, 20X7	US\$ 1 = Rs. 161.50

Required: Prepare journals to show how the above contract should be accounted for under IAS 21.

► **ANSWER:**

Date	Particulars	Debit Rs.	Credit Rs.
1 Jul 20X6	Advance to supplier	3,210,000	
	Bank		3,210,000
	<i>[\$20,000 x 160.5 = Rs. 3,210,000]</i>		
30 Sep 20X6	PPE in transit (CWIP)	16,090,000	
	Advance to supplier		3,210,000
	Bank		8,050,000
	Payable to supplier		4,830,000
	<i>[paid \$50,000 x 161 = Rs. 8,050,000]</i> <i>[payable \$30,000 x 161 = Rs. 4,830,000]</i>		
31 Dec 20X6	Exchange loss (PL)	6,000	
	Payable to supplier		6,000
	<i>[\$30,000 x 161.2 = Rs. 4,836,000]</i> <i>[Rs. 4,836,000 - 4,830,000 = Rs. 6,000]</i>		
31 Jan 20X7	Property, plant and equipment	16,090,000	
	PPE in transit (CWIP)		16,090,000
31 Jan 20X7	Payable to supplier	4,836,000	
	Exchange loss (PL)	9,000	
	Bank		4,845,000
	<i>[\$30,000 x 161.5 = Rs. 4,845,000]</i> <i>[Rs. 4,845,000 - 4,836,000 = Rs. 9,000]</i>		

► **Example 16:**

Orlando is an entity whose functional currency is the PKR. It prepares its financial statements to 30 June each year. The following transactions take place on 21 May 20X4.

Goods were sold to Koln, a customer in Germany, for €96,000.

A specialised piece of machinery was bought from Frankfurt, a German supplier. The invoice for the machinery is for €1,000,000.

The company receives €96,000 from Koln on 12 June 20X4.

At 30 June 20X4 (year-end), it still owns the machinery purchased from Frankfurt. No depreciation has been charged on the asset for the current period to 30 June 20X4 as the machinery is not yet available for use.

The liability for the machine is settled on 31 July 20X4.

Relevant PKR/€ exchange rates are:

- 21 May 20X4 PKR 190 = €1
- 12 June 20X4 PKR 185 = €1
- 30 June 20X4 PKR 195 = €1
- 31 July 20X4 PKR 190 = €1

Required: Journal entries from 21 May 20X4 to 31 July 20X4 specifically identifying the effect on profit or loss.

► **ANSWER:**

Date	Particulars	Debit Rs. m	Credit Rs. m
21 May 20X4	Receivable	18.24	
	Revenue		18.24
	<i>[€ 96,000 x 190 = Rs. 18.24m]</i>		
21 May 20X4	PPE (machinery)	190	
	Payable		190
	<i>[€ 1m x 190 = Rs. 190m]</i>		
12 Jun 20X4	Bank	17.76	
	Exchange loss (PL)	0.48	
	Receivable		18.24
	<i>[€ 96,000 x 185 = Rs. 17.76m]</i>		
	<i>[Rs. 17.76m - 18.24m = Rs. 0.48m]</i>		
30 Jun 20X4	Exchange loss (PL)	5	
	Payable		5
	<i>[€ 1m x 195 = Rs. 195m]</i>		
	<i>[Rs. 195m - 190m = Rs. 5m]</i>		
31 Jul 20X4	Payable	195	
	Exchange gain (PL)		5
	Bank		190
	<i>[€ 1m x 190 = Rs. 190m]</i>		
	<i>[Rs. 190m - 195m = Rs. 5m]</i>		

► **Example 17:**

MZA Limited was involved in the following transactions in foreign currencies during the year ended December 31, 20X8.

- MZA Limited bought equipment for 130,000 Dinars on March 04, 20X8 and paid for on August 25, 20X8 in PKR.
- On February 27, 20X8 MZA Limited sold goods which had cost PKR 7,000,000 for PKR 8,500,000 to a company whose currency was Krams. The proceeds were received on May 25, 20X8 in Krams.
- On September 02, 20X8 MZA Limited sold goods which cost PKR 5,000,000 for PKR 7,499,980 to a company whose currency was Sarils. The amount was outstanding at December 31, 20X8 but the proceeds were received in Sarils on February 07, 20X9 when the exchange rate was Sarils 1 = PKR 27, the directors of MZA Limited approved the final accounts on March 28, 20X9.
- MZA Limited borrowed 426,000 Rolands on May 25, 20X8 and is repayable in two years' time.

Exchange rates (PKR to one unit of foreign currency) relevant to the above transactions are given below:

Date	Rolands	Dinars	Krams	Sarils
27-Feb-X8	-	-	20	-
4-Mar-X8	-	180	-	-
25-May-X8	40	-	19	-
25-Aug-X8	-	230	-	-
2-Sep-X8	-	-	-	29
31-Dec-X8	42	195	22	28

Required: Pass journal entries for MZA Limited for the above transactions, clearly stating the amount of exchange gain or loss. MZA Limited uses perpetual inventory method.

► **ANSWER:**

Date	Particulars	Debit Rs.	Credit Rs.
Transaction (a)			
4 Mar 20X8	Equipment	23,400,000	
	Payables		23,400,000
	[130,000 Dinars x 180 = Rs. 23.4m]		
25 Aug 20X8	Payables	23,400,000	
	Exchange loss (PL)	6,500,000	
	Bank		29,900,000
	[130,000 Dinars x 230 = Rs. 29.9m] [Rs. 29.9m – 23.4m = Rs. 6.5m]		
Transaction (b)			
27 Feb 20X8	Receivables	8,500,000	
	Sales		8,500,000
	[Rs. 8.5m / 20 = 425,000 Krams]		
27 Feb 20X8	Cost of sales	7,000,000	
	Inventory		7,000,000

Date	Particulars	Debit Rs.	Credit Rs.
25 May 20X8	Bank	8,075,000	
	Exchange loss (PL)	425,000	
	Receivables		8,500,000
	<i>[425,000 Krams x 19 = Rs. 8.075m]</i> <i>[Rs. 8.075m – 8.5m = Rs. 0.425m]</i>		
Transaction (c)			
2 Sep 20X8	Receivable	7,499,980	
	Sales		7,499,980
	<i>[Rs. 7,499,980 / 29 = 258,620 Sarils]</i>		
2 Sep 20X8	Cost of sales	5,000,000	
	Inventory		5,000,000
31 Dec 20X8	Exchange loss (PL)	258,620	
	Receivables		258,620
	<i>[258,620 Sarils x 28 = Rs. 7,241,360]</i> <i>[Rs. 7,241,360 – 7,499,980 = Rs. 258,620]</i>		
7 Feb 20X9	Bank	6,982,740	
	Exchange loss (PL)	258,620	
	Receivables		7,241,360
	<i>[258,620 Sarils x 27 = Rs. 6,982,740]</i> <i>[Rs. 6,982,740 – 7,241,360 = Rs. 258,620]</i>		
Transaction (d)			
25 May 20X8	Bank	17,040,000	
	Loan payable		17,040,000
	<i>[426,000 Rolands x 40 = Rs. 17.04m]</i>		
31 Dec 20X8	Exchange loss (PL)	852,000	
	Loan payable		852,000
	<i>[426,000 Rolands x 42 = Rs. 17.892m]</i> <i>[Rs. 17.892m – 17.04 = Rs. 0.852m]</i>		

► **Example 18:**

Copper Limited (CL) entered into following transactions during the year ended 30 June 20X9:

- On 1 October 20X8, CL imported a machine from China for USD 250,000 against 60% advance payment which was made on 1 July 20X8. The remaining payment was made on 1 April 20X9.
- On 1 January 20X9, CL sold goods to a Dubai based company for USD 40,000 on credit. CL received 25% amount on 1 April 20X9, however, the remaining amount is still outstanding.

Following exchange rates are available:

Date	1 Jul 20X8	1 Oct 20X8	1 Jan 20X9	1 Apr 20X9	30 Jun 20X9	Average
1 USD	Rs. 155	Rs. 158	Rs. 160	Rs. 162	Rs. 163	Rs. 159

Required: Prepare journal entries in CL's books to record the above transactions for the year ended 30 June 20X9.

► ANSWER:

Date	Particulars	Debit Rs.	Credit Rs.
1 Jul 20X8	Advance payment (machine)	23,250,000	
	Bank		23,250,000
	$[\$250,000 \times 60\% \times 155 = \text{Rs. } 23,250,000]$		
1 Oct 20X8	Machine	39,050,000	
	Advance payment		23,250,000
	Payable		15,800,000
	$[\$250,000 \times 40\% \times 158 = \text{Rs. } 15,800,000]$		
1 Jan 20X9	Receivable	6,400,000	
	Sales		6,400,000
	$[\$40,000 \times 160 = \text{Rs. } 6,400,000]$		
1 Apr 20X9	Bank	1,620,000	
	Exchange gain (PL)		20,000
	Receivables		1,600,000
	$[\$40,000 \times 25\% \times 162 = \text{Rs. } 1,620,000]$		
	$[\text{Rs. } 1,620,000 - (6.4\text{m} \times 25\%) = \text{Rs. } 20,000]$		
1 Apr 20X9	Payable	15,800,000	
	Exchange loss (PL)	400,000	
	Bank		16,200,000
	$[\$250,000 \times 40\% \times 162 = \text{Rs. } 16,200,000]$		
	$[\text{Rs. } 16.2\text{m} - 15.8\text{m} = \text{Rs. } 400,000]$		
30 Jun 20X9	Receivable	90,000	
	Exchange gain (PL)		90,000
	$[\$40,000 \times 75\% \times 163 = \text{Rs. } 4,890,000]$		
	$[\text{Rs. } 4,890,000 - (6.4\text{m} \times 75\%) = \text{Rs. } 90,000]$		

► Example 19:

Rocky Road Limited (RRL) had a stock of 2,000 cows on 1 January 2019.

On 1 May 2019, RRL purchased 750 cows at fair value of Rs. 56,000 per cow. Further Rs. 2 million were incurred to transport the cows to the farm.

On 1 August 2019, RRL imported cattle feed of USD 150,000 against 70% payment. RRL also paid 5% custom duty on import. The feed is specially designed to provide vital nutrients to cows that keep them healthy and improve the quality of their produce. At year-end, 30% of the amount is payable whereas 40% of the feed is unused.

Following average fair values per cow are available:

1-Jan-19	1-May-19	31-Dec-19	Average for the year
Rs. 50,000	Rs. 56,000	Rs. 61,000	Rs. 57,000

Auctioneers charge a 2% commission on fair value from seller. Further, there is a government levy of 3% at the time of purchase and 4% at the time of sale on fair value.

Following exchange rates are available:

Date	1-Aug-19	31-Dec-19	Average Aug-Dec	Average for the year
1 USD	Rs. 164	Rs. 152	Rs. 157	Rs. 159

Required: Prepare journal entries in RRL's books to record the above information for the year ended 31 December 2019.

► **ANSWER:**

Date	Description	Debit	Credit
		Rs. in '000	
1-May-19	Biological Assets [750 cows × Rs. 56,000×94%]	39,480	
	Loss on initial recognition (PL)	3,780	
	Bank [750 cows × Rs. 56,000× 103%]		43,260
1-May-19	Carriage expense	2,000	
	Cash / Bank		2,000
1-Aug-19	Cattle feed expense [Rs. 24.6m × 105%]	25,830	
	Payable [24.6m × 30%]		7,380
	Cash/Bank (Bal.)		18,450
	<i>[\$150,000 × 164 = Rs. 24.6m]</i>		
31-Dec-19	Biological Assets (W1)	24,205	
	P & L / Gain on re-measurement		24,205
31-Dec-19	Payables	540	
	Exchange gain (PL)		540
	<i>[\$150,000 × 30% × 152 = Rs. 6.84m]</i> <i>[Rs. 6.84m – 7.38m = Rs. 0.54m]</i>		
31-Dec-19	Cattle feed inventory [Rs. 25.83m × 40%]	10,332	
	Cattle feed expense		10,332

W1: Gain on re-measurement of Biological assets		Rs. in '000
Closing carrying value	[2,750 cows × Rs. 61,000 × 94%]	157,685
Opening	[2,000 cows × Rs. 50,000 × 94%]	94,000
Purchase on 1-May-2019		39,480
		(133,480)
		24,205

► *Example 20:*

For the purpose of this question, assume that the date today is 31 August 2022. Financial statements of Cone Motors Limited (CML) for the year ended 31 July 2022 are under preparation. Following matter is under consideration:

CML is concerned with the impact of rupee devaluation as its significant cost of production is incurred in USD. Between 15 June 2022 to 31 July 2022, rupee devalued from Rs. 200 to Rs. 240 per USD. At year-end, CML has following foreign currency balances appearing in its books:

- Trade payables to foreign suppliers amounting to Rs. 638 million (representing USD 3.1 million) which would be settled within next two months.
- Advances to other foreign suppliers amounting to Rs. 654 million (representing USD 3 million) against which the raw materials would be delivered within next three months.

CML's management is of the view that above balances do not need retranslation at year-end as loss of one will net off with gain of other. Further, rupee has started appreciating since 15 August 2022 and is trading at Rs. 208 per USD on 31 August 2022.

Required: Comment on the CML's management view about the impact of above matters in the financial statements for the year ended 31 July 2022, in accordance with the IFRSs.

► *Answer:*

CML's management view is incorrect as per IAS 21. Foreign currency trade payables are monetary item, which need to be retranslated at closing rate of Rs. 240 per USD i.e. Rs. 744 million which should result in an exchange loss of Rs. 106 million to be taken to profit or loss. However, advance to other foreign suppliers being a non-monetary item should not be retranslated at the closing rate. The decline in exchange rate on 31 August 2022 should be a non-adjusting event as no condition existed on 31 July 2022.

4. OBJECTIVE BASED Q&A

- 01.** On 19 December 2019 Star Limited bought goods from Morgan plc for 80,000 British Pounds. At the date of the transactions, the exchange rates were: £1 = PKR 186
On 31 December 2019, Star Limited's financial year end, the equivalent rates were: £1 = PKR 182
The average rate for the year ended 31 December 2019 was £1 = PKR 185
Star Limited paid this creditor on 3 February 2020 when the exchange rates were: £1 = PKR 188
Star Limited should recognise purchases on 19 December 2019 at:
- (a) Rs. 14,880,000
 - (b) Rs. 14,560,000
 - (c) Rs. 14,800,000
 - (d) Rs. 15,040,000
- 02.** On 19 December 2019 Star Limited bought goods from Morgan plc for 80,000 British Pounds. At the date of the transactions, the exchange rates were: £1 = PKR 186
On 31 December 2019, Star Limited's financial year end, the equivalent rates were: £1 = PKR 182
The average rate for the year ended 31 December 2019 was £1 = PKR 185
Star Limited paid this creditor on 3 February 2020 when the exchange rates were: £1 = PKR 188
The carrying amount of trade payables in respect of above on 31 December 2019 shall be:
- (a) Rs. 14,880,000
 - (b) Rs. 14,560,000
 - (c) Rs. 14,800,000
 - (d) Rs. 15,040,000
- 03.** On 19 December 2019 Star Limited bought goods from Morgan plc for 80,000 British Pounds. At the date of the transactions, the exchange rates were: £1 = PKR 186
On 31 December 2019, Star Limited's financial year end, the equivalent rates were: £1 = PKR 182
The average rate for the year ended 31 December 2019 was £1 = PKR 185
Star Limited paid this creditor on 3 February 2020 when the exchange rates were: £1 = PKR 188
The amount of exchange gain or loss for the year ended 31 December 2019 shall be:
- (a) Rs. 320,000 gain
 - (b) Rs. 320,000 loss
 - (c) Rs. 480,000 gain
 - (d) Rs. 480,000 loss
- 04.** On 19 December 2019 Star Limited bought goods from Morgan plc for 80,000 British Pounds. At the date of the transactions, the exchange rates were: £1 = PKR 186
On 31 December 2019, Star Limited's financial year end, the equivalent rates were: £1 = PKR 182
The average rate for the year ended 31 December 2019 was £1 = PKR 185
Star Limited paid this creditor on 3 February 2020 when the exchange rates were: £1 = PKR 188
The amount of exchange gain or loss to be recognised on 03 February 2020 shall be:
- (a) Rs. 320,000 gain
 - (b) Rs. 320,000 loss
 - (c) Rs. 480,000 gain
 - (d) Rs. 480,000 loss

05. Which of the following statements are correct?
- (i) An entity can have only one presentation currency
 - (ii) Functional currency is the currency of primary economic environment in which an entity operates
 - (iii) Any currency other than functional currency of the entity is foreign currency.
- (a) (i) and (ii)
 - (b) (i) and (iii)
 - (c) (ii) and (iii)
 - (d) (i), (ii) and (iii)
06. Which of the following is NOT a primary indicator for determining functional currency of an entity?
- (a) The currency that mainly influences sales prices for goods and services
 - (b) The currency of the country whose competitive forces and regulations mainly determine the sales prices of its goods and services
 - (c) The currency in which funds from financing activities (raising loans and issuing equity) are generated
 - (d) The currency that mainly influences labour, material and other costs
07. Which of the following is NOT a monetary item?
- (a) Cash at bank (Fixed deposit in Pakistani Rupees)
 - (b) Investment equity instruments of other companies
 - (c) Trade receivables
 - (d) Loan payable
08. On 19 December 2019 Star Limited sold goods to Clinton Inc for US\$ 20,000. At the date of the transactions, the exchange rates were \$1 = PKR 148
On 31 December 2019, Star Limited's financial year end, the equivalent rates were \$1 = PKR 149
Star Limited received the amount due on 3 February 2020 when the exchange rates were \$1 = PKR 146
Star Limited should record revenue on 19 December 2019 at:
- (a) Rs. 2,960,000
 - (b) Rs. 2,980,000
 - (c) Rs. 2,920,000
 - (d) None of above
09. On 19 December 2019 Star Limited sold goods to Clinton Inc for US\$ 20,000. At the date of the transactions, the exchange rates were \$1 = PKR 148
On 31 December 2019, Star Limited's financial year end, the equivalent rates were \$1 = PKR 149
Star Limited received the amount due on 3 February 2020 when the exchange rates were \$1 = PKR 146
The receivables on 31 December 2019 shall be presented at:
- (a) Rs. 2,960,000
 - (b) Rs. 2,980,000
 - (c) Rs. 2,920,000
 - (d) None of above

- 10.** On 19 December 2019 Star Limited sold goods to Clinton Inc for US\$ 20,000. At the date of the transactions, the exchange rates were \$1 = PKR 148
On 31 December 2019, Star Limited's financial year end, the equivalent rates were \$1 = PKR 149
Star Limited received the amount due on 3 February 2020 when the exchange rates were \$1 = PKR 146
The amount of exchange gain or loss for the year ended 31 December 2019 in respect of above transaction is:
- Rs. 20,000 gain
 - Rs. 20,000 loss
 - Rs. 40,000 gain
 - Rs. 60,000 gain
- 11.** On 19 December 2019 Star Limited sold goods to Clinton Inc for US\$ 20,000. At the date of the transactions, the exchange rates were \$1 = PKR 148
On 31 December 2019, Star Limited's financial year end, the equivalent rates were \$1 = PKR 149
Star Limited received the amount due on 3 February 2020 when the exchange rates were \$1 = PKR 146
The amount of exchange gain or loss on receipt of cash on 03 February 2020 is:
- Rs. Nil
 - Rs. 60,000 gain
 - Rs. 40,000 loss
 - Rs. 60,000 loss
- 12.** Moon Limited functional currency is Pak Rupees. It bought a property in New York for \$5 million on 2 July 2019. The 25% amount was paid immediately and remaining is to be paid on 31 October 2019.
Moon Limited financial year ends on 30 September each year.
Relevant exchange rates are:
- | | |
|-------------------|---------------|
| 02 July 2019 | \$1 = PKR 164 |
| 30 September 2019 | \$1 = PKR 158 |
| 31 October 2019 | \$1 = PKR 156 |
- The fair value of property is \$5.1 million on 30 September 2019.
The property is being used for administrative purposes and has a useful life of 50 years. Moon Limited uses revaluation model.
At which amount the above property shall be presented in statement of financial position on 30 September 2019?
- Rs. 820.0 million
 - Rs. 815.9 million
 - Rs. 805.8 million
 - Rs. 790.0 million
- 13.** Moon Limited functional currency is Pak Rupees. It bought a property in New York for \$5 million on 2 July 2019. The 25% amount was paid immediately and remaining is to be paid on 31 October 2019.
Moon Limited financial year ends on 30 September each year.

Relevant exchange rates are:

02 July 2019	\$1 = PKR 164
30 September 2019	\$1 = PKR 168
31 October 2019	\$1 = PKR 166

The fair value of property is \$5.1 million on 30 September 2019.

The property is being used for administrative purposes and has a useful life of 50 years. Moon Limited uses revaluation model.

What is the total charge/credit (net) in profit or loss in respect of the above for the year ended 30 September 2019?

- (a) Rs. 4.1 million expense
- (b) Rs. 19.1 million expense
- (c) Rs. 15 million expense
- (d) Rs. 5 million credit

14. Earth Limited has overseas freehold land which it bought for \$2 million on 1 March 2019. It uses revaluation model under IAS 16 for this property. The fair value of land is \$2.5 million on 31 December 2019 (year-end).

Relevant exchange rates are:

01 March 2019	\$1 = PKR 144
31 December 2019	\$1 = PKR 165

Which of the following is correct for its financial statements for the year ended 31 December 2019?

- (a) PPE Rs.412.5 million, Revaluation surplus Rs. 82 million, Profit or loss Rs. 42.5 million
- (b) PPE Rs. 288 million, Revaluation surplus Rs. 82 million, Profit or loss Rs. 42.5 million
- (c) PPE Rs. 412.5 million, Revaluation surplus Rs. 124.5 million, Profit or loss Rs. Nil
- (d) PPE Rs.288 million, Revaluation surplus Rs. 124.5 million, Profit or loss Rs. Nil

15. Which TWO of the following are secondary indicator for determining functional currency of an entity?

- (a) The currency in which funds from financing activities (raising loans and issuing equity) are generated
- (b) The currency of the country in which the entity is registered
- (c) The currency in which receipts from operating activities are usually retained
- (d) The currency that mainly influences labour, material and other costs

16. Moon Limited functional currency is Pak Rupees. It bought a property in New York for \$5 million on 2 July 2019. The 25% amount was paid immediately and remaining is to be paid on 31 October 2019.

Moon Limited financial year ends on 30 September each year.

Relevant exchange rates are:

02 July 2019	\$1 = PKR 164
30 September 2019	\$1 = PKR 158
31 October 2019	\$1 = PKR 156

The fair value of property is \$5.1 million on 30 September 2019.

The property is being used for administrative purposes and has a useful life of 50 years. Moon Limited uses cost model.

At which amount the above property shall be presented in statement of financial position on 30 September 2019?

- (a) Rs. 820.00 million
- (b) Rs. 815.90 million
- (c) Rs. 786.05 million
- (d) Rs. 776.10 million

17. Moon Limited functional currency is Pak Rupees. It bought a property in New York for \$5 million on 2 July 2019. The 25% amount was paid immediately and remaining is to be paid on 31 October 2019.

Moon Limited financial year ends on 30 September each year.

Relevant exchange rates are:

02 July 2019	\$1 = PKR 164
30 September 2019	\$1 = PKR 158
31 October 2019	\$1 = PKR 156

The fair value of property is \$5.1 million on 30 September 2019.

The property is being used for administrative purposes and has a useful life of 50 years. Moon Limited uses cost model.

At which amount the payables for property shall be presented in statement of financial position on 30 September 2019?

- (a) Rs. 585.00 million
- (b) Rs. 592.50 million
- (c) Rs. 615.00 million
- (d) Rs. 790.00 million

18. Moon Limited functional currency is Pak Rupees. It bought a property in New York for \$5 million on 2 July 2019. The 25% amount was paid immediately and remaining is to be paid on 31 October 2019.

Moon Limited financial year ends on 30 September each year.

Relevant exchange rates are:

02 July 2019	\$1 = PKR 164
30 September 2019	\$1 = PKR 158
31 October 2019	\$1 = PKR 156

The fair value of property is \$5.1 million on 30 September 2019.

The property is being used for administrative purposes and has a useful life of 50 years. Moon Limited uses cost model.

What is the total charge/credit (net) in statement of profit or loss in respect of the above for the year ended 30 September 2019?

- (a) Rs. 4.1 million charge
- (b) Rs. 22.5 million credit
- (c) Rs. 26.6 million charge
- (d) Rs. 18.4 million credit

19. Moon Limited functional currency is Pak Rupees. It bought a property in New York for \$5 million on 2 July 2019. The 25% amount was paid immediately and remaining is to be paid on 31 October 2019.

Moon Limited financial year ends on 30 September each year.

Relevant exchange rates are:

02 July 2019	\$1 = PKR 164
30 September 2019	\$1 = PKR 158
31 October 2019	\$1 = PKR 156

The fair value of property is \$5.1 million on 30 September 2019.

The property being vacant is held for capital appreciation and has a useful life of 50 years. Moon Limited uses fair value, where permitted under relevant IFRSs.

At which amount the above property shall be presented in statement of financial position on 30 September 2019?

- (a) Rs. 795.60 million
- (b) Rs. 801.77 million
- (c) Rs. 805.80 million
- (d) Rs. 836.40 million

20. Moon Limited functional currency is Pak Rupees. It bought a property in New York for \$5 million on 2 July 2019. The 25% amount was paid immediately and remaining is to be paid on 31 October 2019.

Moon Limited financial year ends on 30 September each year.

Relevant exchange rates are:

02 July 2019	\$1 = PKR 164
30 September 2019	\$1 = PKR 158
31 October 2019	\$1 = PKR 156

The fair value of property is \$5.1 million on 30 September 2019.

The property being vacant is held for capital appreciation and has a useful life of 50 years. Moon Limited uses fair value, where permitted under relevant IFRSs.

What is the total charge/credit (net) in statement of profit or loss in respect of the above for the year ended 30 September 2019?

- (a) Rs. 14.2 million charge
- (b) Rs. 22.5 million credit
- (c) Rs. 8.3 million charge
- (d) Rs. 8.3 million credit

21. Which TWO of the following is a monetary item?

- (a) Deferred tax liability
- (b) Advance paid
- (c) Income tax payable
- (d) Inventories

22. In relation to IAS 21, which of the following statements is correct?
- (a) Exchange gains and losses arising on the retranslation of monetary items are recognised in other comprehensive income for the period
 - (b) Non-monetary items carried at fair value in a foreign currency are retranslated at the date when the fair value was measured
 - (c) An intangible asset is a monetary item
 - (d) Non-monetary items carried at cost in a foreign currency are retranslated at the reporting date
23. Which of the following is correct in accordance with IAS 21?
- (a) Functional currency and presentation currency of an entity must be same
 - (b) Functional currency and presentation currency of an entity must be different
 - (c) Functional currency of an entity is identified by reference to environment of the business
 - (d) Functional currency of an entity is identified by reference to the functional currency of its parent entity
24. Which two of the following are the non-monetary items?
- (a) Foreign currency trade payables
 - (b) Right of use assets
 - (c) Advance to suppliers
 - (d) Lease liabilities
25. As per IAS 21, non-monetary items carried at fair value are retranslated at the exchange rate prevailing:
- (a) at year-end
 - (b) during the year i.e. average rate
 - (c) at the date when fair value was determined
 - (d) at acquisition date
26. Which of the following statements is/are correct under IAS 21?
- (I) Exchange differences on retranslation of all items are taken to profit or loss.
 - (II) Dividend received on foreign investments are recognized at average exchange rate for the year.
- (a) Only (I) is correct
 - (b) Only (II) is correct
 - (c) Both are correct
 - (d) None is correct
27. Which of the following statements is/are correct under IAS 21?
- (I) An entity can have only one presentation currency.
 - (II) Any currency other than functional currency of the entity is foreign currency.
- (a) Only (I) is correct
 - (b) Only (II) is correct
 - (c) Both are correct
 - (d) None is correct

28. A Pakistan based company purchased a piece of land in Saudi Arabia for SAR 10 million on 1 August 2022. Details of payments on various dates are as follows:

Date	Amount	Exchange rate
1 May 2022	SAR 3 million	1 SAR = Rs. 65
1 August 2022	SAR 5 million	1 SAR = Rs. 74
1 October 2022	SAR 2 million	1 SAR = Rs. 78

At what amount, should this piece of land be recognised?

- (a) Rs. 713 million
 (b) Rs. 721 million
 (c) Rs. 740 million
 (d) Rs. 780 million
29. Which of the following statements is correct in the light of IAS 21?
- (a) 'Investment in debt securities' is a monetary item while 'Refund liability' is a non-monetary item
 (b) 'Advance from customers' is a monetary item while 'Biological assets' is a non-monetary item
 (c) 'Deferred government grant' is a monetary item while 'Deferred tax asset' is a non-monetary item
 (d) 'Lease liability' is a monetary item while 'Right-of-use asset' is a non-monetary item
30. Which TWO of the following are primary indicators for determining functional currency of an entity?
- (a) The currency that mainly influences sales prices for goods and of the country whose competitive forces and regulations mainly determine the sales prices of its goods
 (b) The currency in which receipts from operating activities are usually retained
 (c) The currency in which funds from financing activities are generated
 (d) The currency that mainly influences labour, material and other costs

ANSWERS

01.	(a)	$£80,000 \times 186 = \text{Rs. } 14,880,000$ The exchange rate at the date of transaction is applied.
02.	(b)	$£80,000 \times 182 = \text{Rs. } 14,560,000$ The closing exchange rate is applied for monetary items.
03.	(a)	Initially recorded at $£80,000 \times 186 = \text{Rs. } 14,880,000$ Retranslated at $£80,000 \times 182 = \text{Rs. } 14,560,000$ Difference (decrease in liability is gain) $= \text{Rs. } 320,000$
04.	(d)	On 31 December 2019 $£80,000 \times 182 = \text{Rs. } 14,560,000$ Payment $£80,000 \times 188 = \text{Rs. } 15,040,000$ Difference (more payment means loss) $= \text{Rs. } 480,000$
05.	(c)	Statement (i) is incorrect, an entity may have more than one presentation currencies, in which they present their financial statements.
06.	(c)	This is one of the secondary indicators.
07.	(b)	Investment in other companies is non-monetary item as it may not be realised in fixed number of currency units.
08.	(a)	$\$20,000 \times 148 = \text{Rs. } 2,960,000$ The exchange rate at the date of transaction is applied.
09.	(b)	$\$20,000 \times 149 = \text{Rs. } 2,980,000$ The closing exchange rate is applied for monetary items.
10.	(a)	Initially recorded at $\$20,000 \times 148 = \text{Rs. } 2,960,000$ Retranslated at $\$20,000 \times 149 = \text{Rs. } 2,980,000$ Difference (increase in asset is gain) $= \text{Rs. } 20,000$
11.	(d)	On 31 December 2019 $\$20,000 \times 149 = \text{Rs. } 2,980,000$ Received $\$20,000 \times 146 = \text{Rs. } 2,920,000$ Difference (less received means loss) $= \text{Rs. } 60,000$
12.	(c)	$\$5.1 \text{ million} \times 158 = \text{Rs. } 805.8 \text{ million}$ Revalued at year end.
13.	(b)	Depreciation $\text{Rs. } 820 \text{ million} / 50 \text{ years} \times 3/12 = \text{Rs. } 4.1 \text{ million}$ The exchange gain shall be recognised in other comprehensive income as revaluation gain is also recognised in other comprehensive income. Exchange loss on payables $\$5 \text{ million} \times 75\% \times \text{Rs. } (164-168) = \text{Rs. } 15 \text{ million}$ Net $\text{Rs. } 19.1 \text{ million}$
14.	(c)	PPE $\$2.5 \text{ million} \times 165 = \text{Rs. } 412.5 \text{ million}$ Gain on revaluation (including exchange gain) $= \$412.5 \text{ million} - (\$2 \text{ million} \times 144) = \text{Rs. } 124.5 \text{ million}$ Profit or loss Rs. Nil (because no depreciation on land and exchange gain is to be recognised in other comprehensive income)

15.	(a) and (c)	(b) is not an indicator (d) is primary indicator
16.	(b)	\$5 million x 164 = Rs. 820 million Depreciation Rs. 820 million / 50 years x 3/12 = Rs. 4.1 million Carrying amount Rs. 815.9 million
17.	(b)	\$5 million x 75% x Rs. 158 = Rs. 592.5 million Using closing rate
18.	(d)	Depreciation Rs. 820 million / 50 years x 3/12 = Rs. 4.1 million Exchange gain \$5 million x 75% x Rs. (164-158) = Rs. 22.5 million Net Rs. 18.4 million
19.	(c)	\$5.1 million x 158 = Rs. 805.8 million Investment property under fair value model (no depreciation is charged).
20.	(d)	Initial recognition \$5 million x 164 = Rs. 820 million At year end \$5.1 million x 158 = Rs. 805.8 million Decrease in value Rs. 14.2 million Investment property under fair value model (no depreciation is charged). Exchange gain on payables \$5 million x 75% x Rs. (164-158) = Rs. 22.5 million Net Rs. 8.3 million
21.	(a) and (c)	Deferred tax liability and Income tax payable
22.	(b)	Non-monetary items carried at fair value in a foreign currency are retranslated at the date when the fair value was measured
23.	(c)	Functional currency of an entity is identified by reference to environment of the business
24.	(b)	Currency in which funds from financing activities are generated
25.	(b) and (c)	Right of use assets and Advance to suppliers are non-monetary items.
26.	(c)	at the date when fair value was determined
27.	(d)	None is correct
28.	(b)	Only (II) is correct
29.	(a)	SAR 3m x Rs. 65 + SAR 7m x Rs. 74 = Rs. 713 million
30.	(d)	'Lease liability' is a monetary item while 'Right-of-use asset' is a non-monetary item
31.	(a) and (d)	The currency that mainly influences sales prices for goods and of the country whose competitive forces and regulations mainly determine the sales prices of its goods The currency that mainly influences labour, material and other costs

STICKY NOTES

Key definitions

Presentation currency	The currency in which the financial statements of an entity are presented.
Functional currency	The currency of the primary economic environment in which an entity operates.
Foreign currency	A currency other than the functional currency of the entity.
Exchange rate	The rate of exchange between two currencies.
Spot rate	The exchange rate at the date of the transaction for immediate delivery.
Closing rate	The spot exchange rate at the end of the reporting period.
Exchange difference	A difference resulting from translating a given number of units of one currency into another currency at different exchange rates.
Monetary items	Monetary items are units of currency held and assets and liabilities to be received or paid (in cash), in a fixed number of currency units.

Summary of accounting treatment

Initial recognition	At spot rate at the date of transaction. Average rate may be used provided that the exchange rate does not fluctuate significantly over the period.	
Subsequent reporting		
Asset or liability	Re-translate at	Exchange difference (gain or loss)
Monetary items (settled)	Exchange rate at the date of receipt or payment	Recognise in profit or loss
Monetary items (unsettled)	Closing rate	Recognise in profit or loss
Non-monetary items carried at cost	Not required	Not applicable
Non-monetary items carried at fair value	Exchange rate at the date fair value was measured	Recognised in the same section as the gain or loss from change in valuation is recognised. See note below.
Note: Under IAS 16 and IAS 38, revaluation gain is recorded in other comprehensive income, therefore, exchange difference shall be recognised in other comprehensive income as well. Under IAS 40, gain on fair value increase is recognised in profit or loss, therefore, exchange difference shall be recognised in profit or loss as well.		

AT A GLANCE

SPOTLIGHT

STICKY NOTES

IFRS 15 REVENUE FROM CONTRACTS WITH CUSTOMERS

IN THIS CHAPTER:

AT A GLANCE

SPOTLIGHT

1. Introduction
2. Determining the transaction price
3. Allocating the transaction price
4. Recognition
5. Other aspects
6. Comprehensive Examples
7. Objective Based Q&A

STICKY NOTES

AT A GLANCE

Applying IFRS 15, an entity recognises revenue to depict the transfer of promised goods or services to the customer in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.

To recognise revenue under IFRS 15, an entity applies the following five steps:

- (a) Identify the contract(s) with a customer.
- (b) Identify the performance obligations in the contract. Performance obligations are promises in a contract to transfer to a customer goods or services that are distinct.
- (c) Determine the transaction price. The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer. If the consideration promised in a contract includes a variable amount, an entity must estimate the amount of consideration to which it expects to be entitled in exchange for transferring the promised goods or services to a customer.
- (d) Allocate the transaction price to each performance obligation on the basis of the relative stand-alone selling prices of each distinct good or service promised in the contract.
- (e) Recognise revenue when a performance obligation is satisfied. by transferring a promised good or service to a customer (which is when the customer obtains control of that good or service). A performance obligation may be satisfied at a point in time (typically for promises to transfer goods to a customer) or over time (typically for promises to transfer services to a customer). For a performance obligation satisfied over time, an entity would select an appropriate measure of progress to determine how much revenue should be recognised as the performance obligation is satisfied.

1. INTRODUCTION

1.1 Core principle and the five step model [IFRS 15: 1, 2 & Appendix A]

The objective of IFRS 15 is to establish the principles that an entity shall apply to report useful information to users of financial statements about the nature, amount, timing and uncertainty of revenue and cash flows arising from a contract with a customer.

The following definitions are relevant:

Income	Increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in an increase in equity, other than those relating to contributions from equity participants.
Revenue	Revenue is income arising in the course of an entity's ordinary activities.
Customer	A customer is a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities.

IFRS 15 is based on a core principle that requires an entity to recognise revenue:

- in a manner that depicts the transfer of goods or services to customers
- in an amount that reflects the consideration the entity expects to be entitled to in exchange for those goods or services.

Applying this core principle involves following a five step model as follows:

Step 1: Identify the contract(s) with the customer

Step 2: Identify the separate performance obligations

Step 3: Determine the transaction price

Step 4: Allocate the transaction price

Step 5: Recognise revenue when or as an entity satisfies performance obligations

► **Example 01:**

On 1 November 20X7, Shahid receives an order from a customer for 30 computers as well as 12 months of technical support for computers. Shahid delivers the computers (and transfers its legal title) to the customer on the same day. The customer paid Rs. 25,000 upfront. The computer sells for Rs. 20,000 and the annual technical support sells for Rs. 5,000.

Required: Apply the five-step model on above arrangement for the year ended 31 December 20X7.

► **ANSWER:**

Step 1 - Identify the contract

There is a contract between Shahid and its customer for the provision of goods (computers) and services (technical support services).

Step 2 - Identify the separate performance obligations within a contract

There are two performance obligations (promises) within the contract:

1. The supply of a computer
2. The provision of technical support services over a year

Step 3 – Determine the transaction price

The total transaction price is Rs. 25,000 per computer and Rs. 750,000 in total for 30 computers.

Step 4 – Allocate the transaction price to the performance obligations in the contract

Allocation is simple as there is no discount:

There are two performance obligations (promises) within the contract:

1. The supply of the computers (Rs. 20,000 x 30 computers = Rs. 600,000)
2. The provision of technical support (Rs. 5,000 x 30 computers = Rs. 150,000)

Step 5 – Recognise revenue when (or as) a performance obligation is satisfied.**Computer (Point in time)**

Control over the computer has been passed to the customer so the full revenue of Rs. 20,000 for 30 computers (i.e. Rs. 600,000) should be recognized immediately.

Technical support services (Over time)

The technical support is provided over time (12 months), so revenue from this should be recognized evenly over time. For the year ended 31 December 20X7, revenue of Rs. 25,000 (Rs. 150,000 x 2/12) should be recognised from the provision of technical support services.

1.2 Identifying the contract**1.2.1 Criteria [IFRS 15: 9 & 10]**

A “**contract**” is an agreement between two or more parties that creates enforceable rights and obligations.

Enforceability of the rights and obligations in a contract is a matter of law. The contract may be written, oral, or implied by entity’s customary business practices. A contract does not exist if each party has an enforceable right to terminate a wholly unperformed contract without compensating the other party.

An entity shall account for a contract with a customer under IFRS 15 only when all of the following criteria are met:

- a) the parties to the contract have approved the contract (in writing, orally or as per customary business practices) and are committed to perform their respective obligations;
- b) the entity can identify each party’s rights regarding the goods or services to be transferred;
- c) the entity can identify the payment terms for the goods or services to be transferred;
- d) the contract has commercial substance (i.e. the risk, timing or amount of the entity’s future cash flows is expected to change as a result of the contract); and
- e) it is probable that the entity will collect the consideration considering only the customer’s ability and intention to pay that amount of consideration when it is due.

► **Example 02:**

A shopkeeper agreed to deliver 10 computers to Waqas Enterprises within 3 months. As per the agreement shopkeeper can cancel the contract any time before delivering the computers. In case of cancellation, shopkeeper is not required to pay any penalty to Waqas Enterprises.

Required: Does the contract exist?

► **ANSWER:**

A contract does not exist if each party (either buyer or seller) has an enforceable right to terminate a wholly unperformed contract without compensating the other party. As shopkeeper can cancel contract without compensating Waqas Enterprises so contract does not exist.

1.2.2 Consideration received in advance [IFRS 15: 15 & 16]

When a contract does not meet the criteria and an entity receives consideration from the customer, the entity shall recognise it as revenue only when either of the following events has occurred:

- the entity has no remaining obligations to transfer goods or services to the customer and all, or substantially all, of the consideration promised by the customer has been received by the entity and is non-refundable; or
- the contract has been terminated and the consideration received from the customer is non-refundable.

An entity shall recognise the consideration received from a customer as a liability until one of the above events occurs or until the criteria are subsequently met. In either case, the liability shall be measured at the amount of consideration received from the customer.

► *Example 03:*

Mr. Owais agreed on March 1, 20X7 to sell 5 cutting machines to Axiom Enterprises. Due to some deficiency in drafting the agreement each party's rights cannot be identified. On March 31, 20X7 Mr. Owais delivered the goods and these were accepted by Axiom Enterprises. After 10 days of delivery i.e. April 10, 20X7 Axiom Enterprises made the full payment and the payment is non-refundable.

Required: When should Owais record the revenue?

► *ANSWER:*

Mr. Owais cannot identify each party's rights so revenue recognition should be delayed until the entity's (Owais) performance is complete and substantially all of the consideration (cash) in the arrangement has been collected and is non-refundable.

Therefore, Mr. Owais should record the revenue on April 10, 20X7, as it is the date on which performance is complete and non-refundable payment is received.

1.2.3 Combination of contracts [IFRS 15: 17]

An entity shall combine two or more contracts entered into at or near the same time with the same customer (or related parties of the customer) and account for the contracts as a single contract if one or more of the following criteria are met:

- the contracts are negotiated as a package with a single commercial objective;
- the amount of consideration to be paid in one contract depends on the price or performance of the other contract; or
- the goods or services promised in the contracts (or some goods or services promised in each of the contracts) are a single performance obligation in accordance with IFRS 15.

► *Example 04:*

Adil Limited enters into 2 separate agreements with customer X.

Agreement 1: Deliver 10,000 bricks for Rs. 100,000

Agreement 2: Build a boundary wall for Rs. 20,000

Required: Should the above agreements be combined?

► *ANSWER:*

The two agreements should be combined and considered as a one agreement because contracts are negotiated with a single commercial objective of building a wall. The price of two agreements is interdependent. Adil Limited is probably charging high price for bricks to compensate for the discounted price for building the wall.

1.3 Identifying performance obligations

1.3.1 Separate performance obligations [IFRS 15: 22 & 26]

Performance obligations are normally specified in the contract but could also include promises implied by an entity's customary business practices, published policies or specific statements that create a valid customer expectation that goods or services will be transferred under the contract.

Depending on the contract, promised goods or services may include, but are not limited to, the following:

- Goods produced by an entity for sale (e.g. inventory of a manufacturer)
- Resale of goods purchased by an entity (e.g. merchandise of a retailer)
- Performing a contractually agreed-upon task for a customer
- Standing ready to provide goods or services (e.g. unspecified updates to software that are provided on a when-and-if-available basis)
- Granting rights to goods or services to be provided in the future that a customer can resell (e.g. an entity selling a product to a retailer promises to transfer an additional good or service to an individual who purchases the product from the retailer)
- Constructing, manufacturing or developing an asset on behalf of a customer (e.g. construction contract)

At the inception of a contract the entity must assess the goods or services promised in a contract with a customer and must identify as a performance obligation each promise to transfer to the customer either:

- a good or service (or a bundle of goods or services) that is distinct; or
- a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

1.3.2 Distinct goods or services [IFRS 15: 27 & 28]

A good or service is **distinct** if both of the following criteria are met:

- the customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer; and
- The entity's promise to transfer the good or service is separately identifiable from other promises in the contract.

A customer can benefit from a good or service if the good or service could be used, consumed, sold for an amount that is greater than scrap value or otherwise held in a way that generates economic benefits. If a good or service is regularly sold separately, this would indicate that customers generally can benefit from the good/service on its own or in conjunction with other available resources.

► Example 05:

Pico Ltd. (PL) sells 10 washing machines for Rs. 20,000 each to a Retailer Co. (RC). PL also provides the following free of cost:

- Free service and maintenance for 3 years
- 10 kg of washing powder every month for the next 18 months
- A discount voucher for a 50% discount if next purchase is made in the next 6 months

Required: Identify separate performance obligations.

► ANSWER:

There are 4 separate performance obligations as all of the goods and services are distinct because RC can benefit from the good and service on its own and the PL's promise to transfer the good or service is separately identifiable from other promises in the contract.

Following are the separate performance obligations:

- Delivery of washing machines (point in time)
- Service and maintenance over 3 years (over time)
- 10 kg washing powder over the next 18 months (over time)
- Discount voucher (point in time)

1.3.3 Not distinct goods or services [IFRS 15: 29 & 30]

Factors that indicate that two or more promises to transfer goods or services to a customer are not separately identifiable include, but are not limited to, the following:

- the entity provides a significant service of integrating the goods or services with other goods or services promised in the contract into a bundle of goods or services that represent the combined output.
- one or more of the goods or services significantly modifies or customises, one or more of the other goods or services promised in the contract.
- the goods or services are highly interdependent or highly interrelated.

If a promised good or service is not distinct, an entity must combine that good or service with other promised goods or services until it identifies a bundle of goods or services that is distinct. In some cases, this would result in the entity accounting for all the goods or services promised in a contract as a single performance obligation.

► Example 06:

[Based on IFRS 15 Illustrative Example 11]

An entity, a software developer, enters into a contract with a customer to transfer a software licence, perform an installation service and provide unspecified software updates and technical support (online and telephone) for a two-year period.

The contract specifies that, as part of the installation service, the software is to be substantially customised to add significant new functionality to enable the software to interface with other customised software applications used by the customer.

The entity sells the licence, installation service and technical support separately. The customised installation service can be provided by other entities. The software remains functional without the updates and the technical support.

Required: Identify performance obligations.

► ANSWER:

The software licence and the customised installation service are not distinct. The entity identifies three performance obligations in the contract for the following goods or services:

- customised installation service (that includes the software licence);
- software updates; and
- technical support.

► Example 07:

Consider the following two contracts:

- ECL has entered into a contract with Kashif Builders for construction of a residential project, including supply of construction material, architectural services, engineering and site clearance. ECL and its competitors provide such services separately also.
- eSolutions Limited, a software developer, entered into a two-year contract with a customer to provide software license including future software updates and post implementation support services. The software license would remain functional even if the updates and post implementation support services are discontinued.

Required: In view of the requirements of IFRS 15 'Revenue from Contracts with Customers', discuss whether goods and services provided in each of the above contracts represent a single performance obligation.

► **ANSWER:**

Part (i) ECL

The different services (construction material, architectural services, engineering and site clearance) being performed under the contract are separately identifiable but the customer cannot benefit from services separately from the other.

Based on this, ECL should account for services in the contract as a single performance obligation.

Part (ii) eSolutions

Transfer of software license, software updates and support services are distinct. The software license is delivered before the other services and remains functional without updates and technical support.

Further, the customer can benefit from each of the services either on their own or together with other services that are readily available. Thus, the entity's promise to transfer the good or service is separately identifiable from other promises in the contract.

Based on the above, the contract should not be accounted for as a single performance obligation.

2. DETERMINING THE TRANSACTION PRICE

2.1 The concept of transaction price [IFRS 15: 47 & 48]

The “**transaction price**” is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (for example, some sales taxes).

The consideration promised in a contract with a customer may include fixed amounts, variable amounts, or both. An entity shall consider the terms of the contract and its customary business practices to determine the transaction price. The nature, timing and amount of consideration promised by a customer affect the estimate of the Transaction Price (TP).

When determining the TP, an entity must consider the effects of all of the following:

- variable consideration;
- constraining estimates of variable consideration;
- the existence of a significant financing component in the contract;
- non-cash consideration; and
- consideration payable to a customer (e.g. reduction in TP due to coupon or vouchers).

2.2 Variable consideration [IFRS 15: 50, 51 & 53]

If the consideration promised in a contract includes a variable amount (e.g. discounts, refunds, price concession, performance bonus or penalty etc.), an entity shall estimate the amount of consideration to which the entity will be entitled in exchange for transferring the promised goods or services to a customer.

The promised consideration can also vary if an entity’s entitlement to the consideration is contingent on the occurrence or non-occurrence of a future event.

For example, a product was sold with a right of return or a fixed amount is promised as a performance bonus on achievement of a specified milestone.

An entity shall estimate an amount of variable consideration by using either expected value method or most likely amount method, depending on which method the entity expects to better predict the amount of consideration to which it will be entitled.

► Example 08:

Tayyab Co. enters into a contract to build an oil rig for Rs. 100 million. If the oil rig is not completed on time, there will be a Rs. 20 million penalty.

Tayyab Co. has built similar oil rigs before and there is 90% chance that the oil rig will be completed on time.

Required: Briefly discuss how Tayyab Co. should measure transaction price.

► ANSWER:

There are two possible outcomes, Rs. 100 million if completed on time or Rs. 80 million if not completed on time.

The “most likely amount” method better predicts the amount of consideration due to significant 90% chance that the oil rig will be completed on time. The transaction price should be Rs. 100 million.

► Example 09:

[Based on IFRS 15 Illustrative Example 20]

An entity enters into a contract with a customer to build an asset for Rs.1 million. In addition, the terms of the contract include a penalty of Rs. 100,000 if the construction is not completed within three months of a date specified in the contract.

Required: Using the expected value approach, determine the transaction price if there is 40% chance of completing the contract on time and 60% chance that there would be delay of 3 to 5 days.

► **ANSWER:**

The consideration promised in the contract includes:

- a fixed amount of Rs. 900,000 and
- a variable amount of Rs.100,000 (arising from the penalty).

Transaction Price = Rs. 900,000 + (100,000 x 40%) = Rs. 940,000

Alternative calculation: (Rs. 1,000,000 x 40%) + (Rs. 900,000 x 60%) = Rs. 940,000

► **Example 10:**

[Based on IFRS 15 Illustrative Example 22]

An entity enters into 100 contracts on 31 December 20X7 with customers. Each contract includes the sale of one product for Rs.100 (100 total products x Rs. 100 = Rs. 10,000 total consideration).

Cash is received when control of a product transfers. The entity's customary business practice is to allow a customer to return any unused product within 30 days and receive a full refund. The entity's cost of each product is Rs. 60.

Using the expected value method, the entity estimates that 97 products will not be returned.

The entity estimates that the costs of recovering the products will be immaterial and expects that the returned products can be resold at a profit.

Required: Journal entries (entity uses perpetual inventory system) if:

- 3 products are returned on January 30, 20X8
- 2 products are returned on January 30, 20X8
- 4 products are returned on January 30, 20X8

► **ANSWER:**

The journal entries on 31 December 20X7 shall be same in all scenarios based on entity's expectation of 97 products not to be returned:

Date	Particulars	Debit Rs.	Credit Rs.
31-Dec-X7	Bank (100 x Rs. 100)	10,000	
	Revenue (97 x Rs. 100)		9,700
	Refund liability (3 x Rs. 100)		300
	Cost of Sales (97 x Rs. 60)	5,820	
	Asset - Right to product (3 x Rs. 60)	180	
	Inventory (100 x Rs. 60)		6,000

On 30th January 20X8, the adjustment shall be made when actual returns are confirmed:

Date	Particulars	Debit Rs.	Credit Rs.
Part (a) if 3 products are returned			
30-Jan-X8	Refund liability (3 x Rs.100)	300	
	Bank		300
	Inventory	180	
	Asset - Right to product		180

Date	Particulars	Debit Rs.	Credit Rs.
Part (b) if 2 products are returned			
30-Jan-X8	Refund liability (3 x Rs.100)	300	
	Cash (2 x Rs.100)		200
	Revenue (1 x Rs.100)		100
	Inventory	120	
	COS	60	
	Asset - Right to product		180
Part (c) if 4 products are returned			
30-Jan-X8	Refund liability (3 x Rs.100)	300	
	Revenue	100	
	Cash (4 x Rs.100)		400
	Inventory	240	
	COS		60
	Asset - Right to product		180

2.3 Constraining estimates of variable consideration [IFRS 15: 56]

An entity shall include in the transaction price some or all of an amount of variable consideration estimated by applying the expected value or most likely method only to the extent that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur when the uncertainty associated with the variable consideration is subsequently resolved.

► **Example 11:**

[Based on IFRS 15 Illustrative Example 24]

An entity enters into a contract with a customer on 1 January 20X8 to sell Product A for Rs. 100 per unit. If the customer purchases more than 1,000 units of Product A in a calendar year, the contract specifies that the price per unit is retrospectively reduced to Rs. 90 per unit.

For the first quarter ended 31 March 20X8, the entity sells 75 units of Product A to the customer. The entity estimates that the customer's purchases will not exceed the 1,000-unit threshold required for the volume discount in the calendar year.

In May 20X8, the entity's customer purchases an additional 500 units of Product A from the entity. In the light of the new fact, the entity estimates that the customer's purchases will exceed the 1,000-unit threshold. All transactions are on cash basis and refund or adjustment shall be made only when the customer purchases exceed 1,000 units.

Required: Prepare the journal entries from 1 January 20X8 to 30 June 20X8 relating to above.

► ANSWER:

Date	Particulars	Debit Rs.	Credit Rs.
31 Mar 20X8	Cash	7,500	
	Revenue		7,500
	<i>[75 units x Rs. 100]</i>		
30 Jun 20X8	Cash [500 x Rs. 100]	50,000	
	Revenue		44,250
	Refund liability [(500+75)x Rs. 10]		5,750
	<i>Revenue Rs. 44,250 (i.e. 500 units x Rs. 90) – (75 units x Rs. 10)</i>		

2.3.1 Settlement discounts

The variable consideration is only included in the transaction price if, and to the extent that, it is highly probable that its inclusion will not result in a significant revenue reversal in the future when the uncertainty has been subsequently resolved.

When an entity makes a sale, it does not know whether the customer will take advantage of the settlement discount or not, therefore, this is dealt in following ways:

- a) Record the revenue for the full amount if the customer is not expected to pay early:
 - (i) If customer does not pay early as expected, the full amount is due as recorded already.
 - (ii) If customer pays early and is entitled to discount, recognise the reduction in revenue by the amount of discount. Reduction in revenue may be recorded by debiting the 'revenue' account directly or by debiting 'discount allowed' account which is eventually deducted from sales revenue (similar to sales returns).
- b) Record the revenue for reduced (net of discount) amount if the customer is expected to pay early:
 - (i) If customer pays early as expected, the net amount is due as recorded already.
 - (ii) If customer does not pay early as expected, treat the additional amount received as revenue from original sales transaction.

► Example 12:

Maria Limited (ML) sold goods of Rs. 10,000 to Zahra Traders (ZT) on 8th August 20Y1 to be paid on 31st August 20Y1. However, if ZT pays within 10 days, it will be entitled to 4% cash discount and will have to pay only Rs. 9,600.

Required: How the above transactions alongwith following independent scenarios will be treated in the books of ML on 8th August and on the date of payment:

- (a) ML expected that ZT will not pay within 10 days and ZT actually paid on 31st August.
- (b) ML expected that ZT will not pay within 10 days but ZT actually paid on 17th August.
- (c) ML expected that ZT will pay within 10 days and ZT actually paid on 17th August.
- (d) ML expected that ZT will pay within 10 days but ZT actually paid on 31st August.

► ANSWER:

Date	Particulars	Debit Rs.	Credit Rs.
Part (a)			
8 th August	ZT: Receivables	10,000	
	Revenue		10,000
31 st August	Cash/Bank	10,000	
	ZT: Receivables		10,000
Part (b)			
8 th August	ZT: Receivables	10,000	
	Revenue		10,000
17 th August	Cash/Bank	9,600	
	Revenue	400	
	ZT: Receivables		10,000
Part (c)			
8 th August	ZT: Receivables	9,600	
	Revenue		9,600
17 th August	Cash/Bank	9,600	
	ZT: Receivables		9,600
Part (d)			
8 th August	ZT: Receivables	9,600	
	Revenue		9,600
31 st August	Cash/Bank	10,000	
	ZT: Receivables		9,600
	Revenue		400

As the above example highlights, applying IFRS 15 has a significant impact on the reported revenue. Offering settlement discounts will result in lower revenue being recognised, when the discount is accepted. This will result in lower gross profit margins and net profit margins. Before IFRS 15, entities used to report discount allowed in operating expenses which did not affect gross profit margins.

2.4 Significant financing component [IFRS 15: 60, 61, 63 & 65]

In determining the transaction price, an entity shall adjust the promised amount of consideration for the effects of the time value of money if the timing of payments agreed to by the parties to the contract (either explicitly or implicitly) provides the customer or the entity with a significant benefit of financing the transfer of goods or services to the customer.

The objective when adjusting the promised amount of consideration for a significant financing component is for an entity to recognise revenue at an amount that reflects the price that a customer would have paid for the promised goods or services if the customer had paid cash for those goods or services when (or as) they transfer to the customer (i.e. the cash selling price).

An entity shall consider all relevant facts and circumstances in assessing whether a contract contains a financing component and whether that financing component is significant to the contract, including both of the following:

- (a) the difference between the amount of promised consideration and the cash selling price of the promised goods or services;
- (b) the combined effect of both of the following:
 - (i) the expected length of time between when the entity transfers the promised goods or services to the customer and when the customer pays for those goods or services; and
 - (ii) the prevailing interest rates in the relevant market.

As a practical expedient, an entity need not adjust the promised amount of consideration for the effects of a significant financing component if the entity expects, at contract inception, that the period between when the entity transfers a promised good or service to a customer and when the customer pays for that good or service will be one year or less.

An entity shall present the effects of financing (interest revenue or interest expense) separately from revenue from contracts with customers in the statement of comprehensive income. Interest revenue or interest expense is recognised only to the extent that a contract asset (or receivable) or a contract liability is recognised in accounting for a contract with a customer.

► **Example 13:**

[Based on IFRS 15 Illustrative Example 26]

An entity sells a product to a customer for Rs. 121 on 3 October 20X7 that is payable 24 months after lapse of return period of 90 days. The product is new and the entity has no relevant historical evidence of product returns or other available market evidence. Therefore, the entity concludes that risk and rewards (and control) will transfer to customer on expiry of return period.

The cash selling price of the product is Rs. 100 and the cost of inventory is Rs. 80. The entity has year-end of December 31. The contract includes an implicit interest of 10%.

Required: Comment on when to recognise revenue and prepare the journal entries for the contract.

► **ANSWER:**

The entity does not recognise revenue when control of the product transfers to the customer. This is because the existence of the right of return and the lack of relevant historical evidence means that the entity cannot conclude that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur.

Date	Particulars	Debit Rs.	Credit Rs.
3 Oct 20X7	Asset - Right to product	80	
	Inventory		80
1 Jan 20X8	Receivable	100	
	Revenue		100
1 Jan 20X8	Cost of sales	80	
	Asset - Right to product		80
31 Dec 20X8	Receivable	10	
	Interest income [Rs. 100 x 10%]		10
31 Dec 20X9	Receivable	11	
	Interest income [Rs. 110 x 10%]		11
31 Dec 20X9	Bank	121	
	Receivable		121

► **Example 14:**

[Based on IFRS 15 Illustrative Example 29]

An entity enters into a contract with a customer to sell an asset. Control of the asset will transfer to the customer in two years (i.e. the performance obligation will be satisfied at a point in time). The contract includes two alternative payment options: payment of Rs. 5,000 in two years when the customer obtains control of the asset or payment of Rs. 4,000 when the contract is signed. The customer elects to pay Rs. 4,000 when the contract is signed on 1 January 20X8.

The entity concludes that the contract contains a significant financing component because of the length of time between when the customer pays for the asset and when the entity transfers the asset to the customer, as well as the prevailing interest rates in the market.

The interest rate implicit in the transaction is 11.8%, which is the interest rate necessary to make the two alternative payment options economically equivalent. However, the entity determines that, the rate that should be used in adjusting the promised consideration is 6%, which is the entity's incremental borrowing rate.

Required: Discuss when the revenue will be recognised and prepare the journal entries for the above contract.

► **ANSWER:**

The contract contains a significant financing component because of the length of time between when the customer pays for the asset and when the entity transfers the asset to the customer, as well as the prevailing interest rates in the market.

Date	Particulars	Debit Rs.	Credit Rs.
01-Jan-X8	Cash	4,000	
	Contract liability		4,000
31-Dec-X8	Interest expense [4,000 x 6%]	240	
	Contract liability		240
31-Dec-X9	Interest expense [(4,000+240) x 6%]	254	
	Contract liability		254
31-Dec-X9	Contract liability [4,000 + 240 + 254]	4,494	
	Revenue		4,494

► **Example 15:**

Car World sells new cars on deferred payment basis whereby 40% deposit is received on sale and the balance payment is received at the end of two years. The appropriate discount rate is 10%.

On 1 July 20X4 a car was sold to a customer for Rs. 2,000,000.

Required: Prepare necessary journal entries to record the above transaction in the books of Car World for the years ended 30 June 20X5 and 20X6.

► **ANSWER:**

Date	Particulars	Debit Rs.	Credit Rs.
1 Jul 20X4	Bank [Rs. 2m x 40%]	800,000	
	Receivable [Rs. 2m x 60% x 1.10 ⁻²]	991,735	
	Revenue (car sales)		1,791,735
30 Jun 20X5	Receivable [Rs. 991,735 x 10%]	99,174	
	Interest income		99,174
30 Jun 20X6	Receivable [Rs. 1,090,909 x 10%]	109,091	
	Interest income		109,091
30 Jun 20X6	Bank	1,200,000	
	Receivable		1,200,000

► **Example 16:**

Jupiter Limited (JL) entered into a two year contract on 1 January 20X7, with a customer for the maintenance of computer network. JL has offered the following payment options:

Option 1: Immediate payment of Rs. 200,000.

Option 2: Payment of Rs. 110,000 at the end of each year.

The applicable discount rate is 6.596%.

Required: Prepare journal entries to be recorded in the books of JL under each option over the period of contract.

► **ANSWER:****Option 1: Lump sum Payment**

Date	Particulars	Debit Rs.	Credit Rs.
1 Jan 20X7	Cash	200,000	
	Contract liability		200,000
31 Dec 20X7	Interest expense [Rs. 200,000 x 6.596%]	13,193	
	Contract liability		13,193
31 Dec 20X7	Contract liability	110,000	
	Revenue		110,000
31 Dec 20X8	Interest expense	6,807	
	Contract liability		6,807
	[(Rs. 200,000 + 13,193 - 110,000) x 6.596%]		
31 Dec 20X8	Contract liability	110,000	
	Revenue		110,000

Option 2: Normal payment terms

Date	Particulars	Debit Rs.	Credit Rs.
31 Dec 20X7	Cash	110,000	
	Revenue		110,000
31 Dec 20X8	Cash	110,000	
	Revenue		110,000

2.5 Non-cash consideration [IFRS 15: 66 & 69]

To determine the transaction price for contracts in which a customer promises consideration in a form other than cash, an entity shall measure the non-cash consideration at fair value.

If a customer contributes goods (for example, materials, equipment or labour) to facilitate an entity's fulfilment of the contract, the entity shall assess whether it obtains control of those contributed goods. If so, the entity shall account for the contributed goods or services as non-cash consideration received from the customer.

► **Example 17:**

[Based on IFRS 15 Illustrative Example 31]

An entity enters into a contract with a customer to provide a monthly service for one year. The contract is signed on 1 January 20Y1 and work begins immediately.

The entity concludes that the service is a single performance obligation performed over time and also measured on time basis.

In exchange for the service, the customer promises 100 shares of its ordinary shares per month of service (a total of 1,200 shares for the contract). The terms in the contract require that the shares must be paid upon the successful completion of each month of service.

On 31st January 20Y1, when entity received 100 shares as agreed, the fair value of one share in customer's company is Rs. 25.

Required: Journal entry on 31st January 20Y1.

► **ANSWER:**

Date	Particulars	Debit Rs.	Credit Rs.
31 Jan 20Y1	Financial asset (investment in shares)	2,500	
	Revenue (of services)		2,500
	<i>[100 shares x Rs. 25 = Rs. 2,500]</i>		

The entity does not reflect any subsequent changes in the fair value of the shares received (or receivable) in revenue.

2.6 Consideration payable to customer [IFRS 15: 70 & 72]

Consideration payable to a customer includes cash amounts that an entity pays, or expects to pay, to the customer. Consideration payable to a customer also includes credit items (for example, a coupon or voucher) that can be applied against amounts owed to the entity. An entity shall account for consideration payable to a customer as a reduction of the transaction price and, therefore, of revenue.

An entity shall recognise the reduction of revenue when (or as) the later of either of the following events occurs:

- (a) the entity recognises revenue for the transfer of the related goods or services to the customer; and
- (b) the entity pays or promises to pay the consideration (even if the payment is conditional on a future event). That promise might be implied by the entity's customary business practices.

► **Example 18:**

[Based on IFRS 15 Illustrative Example 32]

An entity enters into a one-year contract to sell goods to a customer that is a large global chain of retail stores. The customer commits to buy at least Rs. 15 million of products during the year.

The contract also requires the entity to make a non-refundable payment of Rs. 1.5 million to the customer at the inception of the contract (1 Jan 20X8) for the changes it needs to make to its shelving to accommodate the entity's products.

By 30th June 20X8, Rs. 6 million goods were invoiced.

By 31st December 20X8, remaining Rs. 9 million goods were invoiced.

Required: Journal entries.

► **ANSWER:**

Consideration paid to customer is 10% of total invoice value (i.e. Rs. 1.5m / 15m).

Date	Particulars	Debit Rs.	Credit Rs.
1 Jan 20X8	Consideration paid to customer	1,500,000	
	Bank		1,500,000
30 Jun 20X8	Bank/Receivable	6,000,000	
	Revenue 90%		5,400,000
	Consideration paid to customer 10%		600,000
31 Dec 20X8	Bank/Receivable	9,000,000	
	Revenue 90%		8,100,000
	Consideration paid to customer 10%		900,000

3. ALLOCATING THE TRANSACTION PRICE

3.1 Basis of allocation [IFRS 15: 73,74 & 84]

IFRS requires to allocate the transaction price to each performance obligation in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer.

The general approach to allocation is on a relative stand-alone selling price basis with following exceptions:

- Allocation of discounts (discussed later)
- Allocation of variable consideration (variable consideration that is promised in a contract may be attributable to the entire contract or a specific part of the contract. An entity should allocate transaction price accordingly).

3.2 Allocation based on stand-alone selling prices [IFRS 15: 77 to 80]

The “**stand-alone selling price**” is the price at which an entity would sell a promised good or service separately to a customer.

The best evidence of a stand-alone selling price is the observable price of a good or service when the entity sells that good or service separately in similar circumstances and to similar customers. A contractually stated price or a list price for a good or service may be (but shall not be presumed to be) the stand-alone selling price of that good or service.

If a stand-alone selling price is not directly observable, an entity shall estimate the stand-alone selling price. Suitable methods for estimating the stand-alone selling price of a good or service include, but are not limited to, the following:

- adjusted market assessment approach - an entity could evaluate the market in which it sells goods or services and estimate the price that a customer in that market would be willing to pay for those goods or services. That approach might also include referring to prices from the entity's competitors for similar goods or services and adjusting those prices as necessary to reflect the entity's costs and margins.
- expected cost plus margin approach - an entity could forecast its expected costs of satisfying a performance obligation and then add an appropriate margin for that good or service.
- Residual approach - an entity may estimate the stand-alone selling price by reference to the total transaction price less the sum of the observable stand-alone selling prices of other goods or services promised in the contract.

A combination of methods may need to be used to estimate the stand-alone selling prices of the goods or services promised in the contract if two or more of those goods or services have highly variable or uncertain stand-alone selling prices.

► Example 19:

[Based on IFRS 15 Illustrative Example 33]

An entity enters into a contract with a customer to sell Products A, B and C in exchange for Rs. 100. The entity will satisfy the performance obligations for each of the products at different points in time. The entity regularly sells Product A separately and therefore the stand-alone selling price is directly observable.

To estimate the stand-alone selling prices, the entity uses the adjusted market assessment approach for Product B and the expected cost plus a margin approach for Product C.

Product	Stand-alone selling price*	Method
Product A	Rs. 50	Directly observable
Product B	Rs. 25	Adjusted market assessment approach
Product C	Rs. 75	Expected cost (Rs. 60) plus a margin (Rs. 15) approach
Total	Rs. 150	

Required: Allocate the transaction price of Rs. 100 to Product A, B and C.

► **ANSWER:**

Product	Allocated price Rs.	Calculation
Product A	33	$50 / 150 \times \text{Rs. } 100$
Product B	17	$25 / 150 \times \text{Rs. } 100$
Product C	50	$75 / 150 \times \text{Rs. } 100$
Total	100	

► **Example 21:**

[Based on IFRS 15 Illustrative Example 34A]

An entity regularly sells Products A, B and C individually, thereby establishing the following stand-alone selling prices:

Product	Stand-alone Selling prices
Product A	Rs. 40
Product B	Rs. 55
Product C	Rs. 45

In addition, the entity regularly sells Products B and C together for Rs. 60.

The entity enters into a contract with a customer to sell Products A, B and C in exchange for Rs. 100.

Required: Comment on the basis and Allocate the transaction price of Rs. 100 to Product A, B and C.

► **ANSWER:**

Since the entity regularly sells Products B and C together for Rs.60 and Product A for Rs.40, it has evidence that the entire discount should be allocated to the promises to transfer Products B and C only.

Product	Stand-alone	Allocation of Rs. 60 to Product B & C		Allocation of Rs. 100 to Product A, B & C	
	Rs.	Rs.	Rs.	Rs.	Rs.
A	40		40	$40/100 \times 100$	40
B	55	$55/100 \times 60$	33	$33/100 \times 100$	33
C	45	$45/100 \times 60$	27	$27/100 \times 100$	27
	100		60		
Total	140		100		100

► **Example 22:**

[Based on IFRS 15 Illustrative Example 34B]

An entity regularly sells Products A, B, C and D individually, thereby establishing the following stand-alone selling prices:

Product	Stand-alone Selling prices
Product A	Rs. 40
Product B	Rs. 55
Product C	Rs. 45
Product D	Rs. 15 to 45

In addition, the entity regularly sells Products B and C together for Rs. 60 and Products A, B and C together for Rs. 100. The entity enters into a contract with a customer to sell Products A, B, C and D in exchange for Rs. 130.

Required: Allocate the transaction price of Rs. 130 to Product A, B and C and D, and discuss whether residual approach for Product D is appropriate.

► **ANSWER:**

Product	Stand-alone	Allocation of Rs. 60 to Product B & C		Allocation of Rs. 100 to Product A, B & C	
	Rs.	Rs.	Rs.	Rs.	Rs.
A	40		40	$40/100 \times 100$	40
B	55	$55/100 \times 60$	33	$33/100 \times 100$	33
C	45	$45/100 \times 60$	27	$27/100 \times 100$	27
	100		60		
Total	140		100		100

Product	Allocated price Rs.	Basis of allocation
Product A	40	As above
Product B	33	As above
Product C	27	As above
Product D	30	Residual approach
Total	130	

Residual approach seems appropriate for Product D as Rs. 30 falls within the range of Rs. 15 to 45 at which Product D is sold separately.

► **Example 23:**

[Based on IFRS 15 Illustrative Example 34C]

An entity regularly sells Products A, B, C and D individually, thereby establishing the following stand-alone selling prices:

Product	Stand-alone Selling prices
Product A	Rs. 40
Product B	Rs. 55
Product C	Rs. 45
Product D	Rs. 15 to 45

In addition, the entity regularly sells Products B and C together for Rs. 60 and Products A, B and C together for Rs. 100. The entity enters into a contract with a customer to sell Products A, B, C and D in exchange for Rs. 105.

Required: Allocate the transaction price of Rs. 105 to Product A, B and C and D, and discuss whether residual approach for Product D is appropriate.

► **ANSWER:**

Product	Stand-alone	Allocation of Rs. 60 to Product B & C		Allocation of Rs. 100 to Product A, B & C	
	Rs.	Rs.	Rs.	Rs.	Rs.
A	40		40	$40/100 \times 100$	40
B	55	$55/100 \times 60$	33	$33/100 \times 100$	33
C	45	$45/100 \times 60$	27	$27/100 \times 100$	27
	100		60		
Total	140		100		100

Product	Allocated price Rs.	Basis of allocation
Product A	40	As above
Product B	33	As above
Product C	27	As above
Product D	5	Residual approach
Total	105	

Residual approach seems inappropriate for Product D as Rs. 5 falls significantly below the lowest end of range that is Rs. 15. Consequently, the entity should review its observable data, including sales and margin reports, to estimate the stand-alone selling price of product D. Then, the entity should allocate Rs. 105 to Product A, B, C and D using the relative stand-alone selling prices of the products.

As an alternative discount working could also be done taking product D price rupees 10.

► **Example 24:**

Pluto Limited (PL) sells industrial chemicals at following standalone prices:

Products	Rupees (per carton)
C-1	100,000
C-2	90,000
C-3	110,000

PL regularly sells a carton each of C-2 and C-3 together for Rs. 170,000.

Required: Calculate the selling price to be allocated to each product, in case PL offers to sell one carton of each product for a total price of Rs. 260,000.

► **ANSWER:**

Chemical	Stand-alone	Allocation of Rs. 170,000 to C2 & C3		Allocation of Rs. 260,000 to C1, C2 & C3	
	Rs.	Rs. 000	Rs.	Rs. 000	Rs.
C1	100,000		100,000	$100/270 \times 260$	96,296
C2	90,000	$90/200 \times 170$	76,500	$76.5/270 \times 260$	73,667
C3	110,000	$110/200 \times 170$	93,500	$93.5/270 \times 260$	90,037
	200,000		170,000		
Total	300,000		270,000		260,000

► **Example 25:**

Stupa Limited (SL) sells electrical products at following standalone prices:

Products	Rupees
E-1	30,000
E-2	30,000
E-3	50,000

Required: Calculate transaction price to be allocated to each product under each of the following independent situations:

- SL offered to sell one unit of each of the above products for Rs. 90,000. SL regularly sells one unit each of E-2 and E-3 together for Rs. 70,000.
- SL offered to sell one unit of E-1 and two units of E-3 for Rs. 104,000.

► **ANSWER:****Part (i)**

Product	Stand-alone	Allocation of Rs. 70,000 to E2 & E3		Allocation of Rs. 90,000 to E1, E2 & E3	
	Rs.	Rs. 000	Rs.	Rs. 000	Rs.
E1	30,000		30,000	$30/100 \times 90$	27,000
E2	30,000	$30/80 \times 70$	26,250	$26.25/100 \times 90$	23,625
E3	50,000	$50/80 \times 70$	43,750	$43.75/100 \times 90$	39,375
	80,000		70,000		
Total	110,000		100,000		90,000

Part (ii)

Product	Stand-alone	Allocation of Rs. 104,000	
	Rs.	Rs.000	Rs.
E1	30,000	30/130 x 104	24,000
E3 (Rs. 50,000 x 2 units)	100,000	100/130 x 104	80,000
Total	130,000		104,000

► **Example 20:**

Brilliant Limited (BL) manufactures and sells plastic card printing machines with laminators. A machine-specific card printing software is provided as a must part of the printing machine. BL also sells plastic cards imported from Thailand.

BL agreed to supply the following to, Proud Learners (PL), a country-wide school network:

- 15 Card printing machines – Available in ready stock
- 8 Laminators – Would require 30 days to deliver
- 100,000 Plastic cards – Available in ready stock

A lump sum price of Rs.9.2 million for the total contract has been agreed between BL and school network.

Cost and list prices of the goods (per unit) are:

Item	Price (Rs.)	Cost (Rs.)
Card printing machines	800,000	400,000
Laminators		200,000
Plastic cards	12	5

BL does not sell printing machine without laminator. However, in order to get this order BL went against its policy. There is another supplier of imported card printing machine of almost similar specification. This supplier sells the machine at Rs. 750,000.

In most recent customers' surveys printing machine of BL has been given 7 out of 10 points as against 9 out of 10 given to competitors' imported machine. There is no supplier of laminator in the market.

Required:

Identify the performance obligations and allocate the transaction price to the identified performance obligations.

► **ANSWER:****Identification of performance obligations**

There are three performance obligations:

- Transfer of 15 Plastic card printing machines and its software
- Transfer of 8 Laminators
- Transfer of 100,000 plastic cards

Although the software is distinct from printing machine, but both are highly dependable to each other and inter-related. In the context of this contract, these are providing a combined output to PL. Therefore, software is not a separate performance obligation. The total transaction price as per the contract is Rs.9.2 million. On the basis of available information the stand-alone prices of each item will be estimated using the following approaches:

Plastic card printing machines and its software:

In the absence of observable stand-alone price, we may use 'adjusted market assessment' approach. The competitor's machine is sold at Rs.750,000 which is similar (not identical) to BL's machine. As per given information, we may use customers' rating for adjustment of competitors' price that worked out as follows:

	Rupees
Competitors' price	750,000
Adjusted price of BL machine ($7 / 9 \times 750,000$)	583,000
Total price (15 units x Rs. 583,000)	8,745,000

Laminators:

There is neither observable stand-alone price nor any comparable competitors' product available in the market in which BL operates. In this case, we may use 'expected cost plus a margin approach'. The estimated stand-alone price is worked out as follows:

	Rupees
Expected cost to BL	200,000
Markup estimated $(800,000 - 600,000) / 600,000 = 33\%$	66,000
	266,000
Total price (8 units x Rs. 266,000)	2,128,000

Plastic cards:

Observable stand-alone price is available.

	Rupees
Total price (100,000 units x Rs. 12)	1,200,000

Allocation	Stand alone	Calculation	Allocated
	Rs.		Rs.
Printing machine and software	8,745,000	$(8,745 / 12,073 \times 9,200)$	6,663,961
Laminators	2,128,000	$(2,128 / 12,073 \times 9,200)$	1,621,602
Plastic Cards	1,200,000	$(1,200 / 12,073 \times 9,200)$	914,437
Total	12,073,000		9,200,000

3.3 Allocation of a discount [IFRS 15: 81 & 83]

A customer receives a discount for purchasing a bundle of goods or services if the sum of the stand-alone selling prices of those promised goods or services in the contract exceeds the promised consideration in a contract. The entity shall allocate a discount proportionately to all performance obligations in the contract on the basis of the relative stand-alone selling prices of the underlying distinct goods or services.

An entity shall not allocate a discount proportionately when there is observable evidence that entire discount relates to one or more specific performance obligations and not the others.

Allocation of discount must be done before applying residual approach.

4. RECOGNITION

4.1 Satisfaction of performance obligations [IFRS 15: 31 to 34]

An entity shall recognise revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service (i.e. an asset) to a customer. Goods and services are assets, even if only momentarily, when they are received and used (as in the case of many services).

An asset is transferred when (or as) the customer obtains control of that asset. Control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset.

For each performance obligation identified, an entity shall determine at contract inception whether it:

- satisfies the performance obligation over time; or
- satisfies the performance obligation at a point in time.

► Example 26:

On 1 October 20X7, Galaxy Telecommunications (GT) entered into a contract with a bank for supplying 20 smart phones to the bank staff with unlimited use of mobile network for one year. The contract price per smart phone is Rs. 34,650 and the price is payable in full within 10 days from the date of contract. At the end of the contract, the phones will not be returned to GT. The entire amount received as per contract was credited by GT to advance from customers account. The smart phones were delivered on 1 November 20X7.

If sold separately, GT charges Rs. 18,000 for a smart phone and a monthly fee of Rs. 1,800 for unlimited use of mobile network.

Required: Prepare adjusting entry for the year ended 31 December 20X7 in accordance with IFRS 15 'Revenue from Contracts with Customers'.

► ANSWER:

Adjusting entry

Date	Particulars	Debit Rs.	Credit Rs.
31 Dec 20X7	Advance from customers	378,000	
	Revenue (smart phones)		315,000
	Revenue (network usage)		63,000

Working	Stand alone	Allocated	
	Rs.	Rs.	
Smart Phone	18,000	15,750	$18,000 / 39,600 \times 34,650$
Network use [Rs. 1,800 x 12 months]	21,600	18,900	$21,600 / 39,600 \times 34,650$
Total	39,600	34,650	
Revenue: Smart Phone	315,000	Rs. 15,750 x 20 units	
Revenue: Network usage	63,000	Rs. 18,900 x 20 units x 2/12 months	
Total to be recognised	378,000		
Total received	(693,000)	Rs. 34,650 x 20 units	
Advance from customer balance	(315,000)	Rs. 18,900 x 20 units x 10/12 months	

4.2 Performance obligations satisfied over time [IFRS 15: 35]

An entity transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognises revenue over time, if one of the following criteria is met:

Criteria	Example
the customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs;	Routine or recurring services such as a cleaning service or software debugging services or teaching/training services.
the entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced; or	providing interior designing and painting services at a customer's premises.
the entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date.	a customized machinery is being developed for a customer and contract specifically prevents the entity to direct/transfer this machinery to another customer. Also, the customer has no right to terminate the contract unless the entity fails to perform its obligations.

► Example 27:

[Based on IFRS 15 Illustrative Example 13]

An entity enters into a contract to provide monthly payroll processing services to a customer for one year. The promised payroll processing services are accounted for as a single performance obligation.

Required: Whether the revenue shall be recognised over time or at a point in time?

► ANSWER:

The performance obligation is satisfied over time because the customer simultaneously receives and consumes the benefits of the entity's performance in processing each payroll transaction as and when each transaction is processed.

The fact that another entity would not need to re-perform payroll processing services for the service that the entity has provided to date also demonstrates that the customer simultaneously receives and consumes the benefits of the entity's performance as the entity performs.

4.3 Measuring progress towards complete satisfaction over time [IFRS 15: 39 to 45 & B14]

For each performance obligation satisfied over time, an entity shall:

- recognise revenue over time by measuring the progress towards complete satisfaction of that performance obligation.
- apply a single method of measuring progress for each performance obligation satisfied over time.
- apply that method consistently to similar performance obligations and in similar circumstances.
- remeasure its progress towards complete satisfaction of a performance obligation satisfied over time at the end of each reporting period.

An entity shall recognise revenue for a performance obligation satisfied over time only if the entity can reasonably measure its progress towards complete satisfaction of the performance obligation. In some circumstances (for example, in the early stages of a contract), an entity may not be able to reasonably measure the outcome of a performance obligation, but the entity expects to recover the costs incurred in satisfying the performance obligation. In those circumstances, the entity shall recognise revenue only to the extent of the costs incurred until such time that it can reasonably measure the outcome of the performance obligation.

Appropriate methods of measuring progress include:

- Output methods, for example, units produced, units delivered, contract milestones, survey of work performed.
- Input methods, for example, costs incurred, labour hours expended, machine hours worked.

► **Example 28:**

[Based on IFRS 15 Illustrative Example 18]

An entity, an owner and manager of health clubs, enters into a contract with a customer for one year of access to any of its health clubs. The customer has unlimited use of the health clubs and promises to pay Rs. 15,000 per month. (Annual Rs. 180,000)

Required: How the revenue related to this single performance obligation should be recognised?

► **ANSWER:**

The customer simultaneously receives and consumes the benefits of the entity's performance as it performs by making the health clubs available. Consequently, the entity's performance obligation is satisfied over time.

The customer benefits from the entity's service of making the health clubs available evenly throughout the year. (That is, the customer benefits from having the health clubs available, regardless of whether the customer uses it or not.)

Consequently, the best measure of progress towards complete satisfaction of the performance obligation over time is a time-based measure and it recognises revenue on a straight-line basis throughout the year at Rs. 15,000 per month.

4.4 Performance obligations satisfied at a point in time [IFRS 15: 38]

If a performance obligation is not satisfied over time, an entity satisfies the performance obligation at a point in time.

To determine the point in time at which a customer obtains control of a promised asset and the entity satisfies a performance obligation, the entity shall consider the requirements for control as discussed earlier. In addition, an entity shall consider indicators of the transfer of control, which include, but are not limited to, the following:

- a) The entity has a present right to payment for the asset.
- b) The customer has legal title to the asset.
- c) The entity has transferred physical possession of the asset.
- d) The customer has the significant risks and rewards of ownership of the asset.
- e) The customer has accepted the asset.

► **Example 29:**

On 31 March Parvez Limited's (PL) car manufacturing division consigned several vehicles to independent dealers for sale to third parties. The sales price to the dealer is PL's list price at the date of sale to third parties. If a vehicle is unsold after six months, the dealer has a right to return the vehicle to PL within next fifteen days.

Required: Discuss how the above transactions should be accounted for in the books of accounts of PL.

► **ANSWER:**

There is a contract for sale of cars between Parvez Limited (PL) and dealer containing confirmation of respective right and obligation, payment term, commercial substance and probability of collection of price.

There is only one performance obligation, namely, the transfer of cars to the dealer.

As per contract, the transaction price would be list price on the date of sale to third parties during the six-month period. Thereafter, though not specifically mentioned, after the lapse of fifteen days the list price applicable on sixteenth day would be the transaction price of the unsold cars not returned.

Since there is only one performance obligation, the question of allocation of transaction price does not arise till the time of sale to third parties.

PL will recognize revenue upon satisfaction of performance obligation. Performance obligation would be satisfied once the dealer has sold any cars to third parties during the six-month period. Thereafter, if the dealer does not return the unsold cars within fifteen days, the performance obligation would be considered as satisfied on sixteenth day.

On 31 March 20X7, the vehicles should remain in inventories in PL books of accounts.

► **Example 30:**

[Based on IFRS 15 Illustrative Example 17A]

An entity is developing a multi-unit residential complex. A customer enters into a binding sales contract with the entity for a specified unit that is under construction. Each unit has a similar floor plan and is of a similar size, but other attributes of the units are different (for example, the location of the unit within the complex).

The contract inception is 1 January 20X8. The price of one unit is Rs. 3,000,000. The expected date of completion and possession transfer is 31 December 20X9. The entity year end is December 31. The construction is 60% complete by 31 December 20X8.

- The customer pays a 10% deposit on 1 January 20X8, refundable only if the entity fails to complete the construction.
- The remainder of the contract price is payable on completion of the contract when the customer obtains physical possession of the unit.
- If the customer defaults on the contract before completion of the unit, the entity only has the right to retain the deposit.

Note: Ignore financing component & ignore accounting for contract costs.

Required: Journal entries for all of the following independent situations:

- The unit is completed and possession is transferred on due date.
- The entity allocated the unit to another customer on 1 March 20X8.
- The entity completes the unit but customer defaults (the entity plans to sell unit to another customer).

► **ANSWER:**

The entity does not have an enforceable right to payment for performance completed to date because, until construction of the unit is complete, the entity only has a right to the deposit paid by the customer.

Because the entity does not have a right to payment for work completed to date, the entity's performance obligation is not a performance obligation satisfied over time.

The entity shall recognise revenue at a point in time when the control is transferred on 31 December 20X9.

Date	Particulars	Debit Rs.	Credit Rs.
Journal Entry in case of (i), (ii) & (iii)			
01-Jan-X8	Bank	300,000	
	Contract liability		300,000
Part (i)			
31-Dec-X9	Bank	2,700,000	
	Contract liability	300,000	
	Revenue		3,000,000

Date	Particulars	Debit Rs.	Credit Rs.
Part (ii)			
01-Mar-X8	Contract liability	300,000	
	Bank		300,000
Part (iii)			
31-Dec-X9	Contract liability	300,000	
	Revenue		300,000

► **Example 31:**

[Based on IFRS 15 Illustrative Example 17B]

An entity is developing a multi-unit residential complex. A customer enters into a binding sales contract with the entity for a specified unit that is under construction. Each unit has a similar floor plan and is of a similar size, but other attributes of the units are different (for example, the location of the unit within the complex).

The contract inception is 1 January 20X8. The price of one unit is Rs. 3,000,000. The expected date of completion and possession transfer is 31 December 20X9. The entity year end is December 31. The construction is 60% complete by 31 December 20X8.

- The customer pays a 10% non-refundable deposit on 1 January 20X8.
- The customer will make progress payments of Rs. 1,350,000 (45%) on 31 December 20X8 and 20X9 each.
- The contract has substantive terms that preclude the entity from being able to direct the unit to another customer. In addition, the customer does not have the right to terminate the contract unless the entity fails to perform as promised.

Note: Ignore financing component & ignore accounting for contract costs.

Required: Journal entries as the unit is completed and possession is transferred on due date in each of the following situations.

- If the customer defaults on its obligations by failing to make the promised progress payments as and when they are due, the entity would have a right to all of the consideration promised in the contract if it completes the construction of the unit. The courts have previously upheld similar rights that entitle developers to require the customer to perform, subject to the entity meeting its obligations under the contract.
- In the event of a default by the customer, either the entity can require the customer to perform as required under the contract or the entity can cancel the contract in exchange for the asset under construction and an entitlement to a penalty of a proportion of the contract price.

► **ANSWER:**

Situation (i)

The asset (unit) created by the entity's performance does not have an alternative use to the entity because the contract precludes the entity from transferring the specified unit to another customer.

The entity also has a right to payment for performance completed to date. This is because if the customer were to default on its obligations, the entity would have an enforceable right to all of the consideration promised under the contract if it continues to perform as promised.

Therefore, the entity has a performance obligation that it satisfies over time.

Situation (ii)

Notwithstanding that the entity could cancel the contract; the entity has a right to payment for performance completed to date because the entity could also choose to enforce its rights to full payment under the contract. Therefore, the entity has a performance obligation that it satisfies over time.

Therefore, same accounting treatment follows in both of above situations.

Date	Particulars	Debit Rs.	Credit Rs.
01-Jan-X8	Bank	300,000	
	Contract liability		300,000
31-Dec-X8	Contract liability	300,000	
	Bank (3,000,000 x 45%)	1,350,000	
	Contract asset (Balancing)	150,000	
	Revenue (3,000,000 x 60%)		1,800,000
31-Dec-X9	Bank	1,350,000	
	Contract asset		150,000
	Revenue		1,200,000

► **Example 32:**

[Based on IFRS 15 Illustrative Example 49]

An entity enters into a contract for the sale of Product A for Rs. 100 on 1 January 20X9. As part of the contract, the entity gives the customer a 40% discount voucher for any future purchases up to Rs. 100 in the next 30 days.

The entity intends to offer a 10% discount on all sales during the next 30 days as part of a seasonal promotion. The 10% discount cannot be used in addition to the 40% discount voucher.

The entity estimates an 80% likelihood that a customer will redeem the voucher and that a customer will, on average, purchase Rs. 50 of additional products.

Required: Allocate the transaction price of Rs. 100 for above contract and state when each performance obligation should be recognised.

► **ANSWER:**

Additional discount due to voucher $40\% - 10\% = 30\%$

Estimated selling price of discount voucher = Rs. 50 x 30% discount x 80% likelihood = Rs. 12

Performance obligations	Stand-alone price	Allocated price	Working
	Rs.	Rs.	Rs.
Product A	100	89	$100/112 \times \text{Rs. } 100$
Discount voucher	12	11	$12/112 \times \text{Rs. } 100$
Total	112	100	

Product A revenue shall be recognised on 1 January 20X9 on transfer of control. The revenue allocated to discount voucher shall be recognised on redemption or expiry.

► **Example 33:**

[Based on IFRS 15 Illustrative Example 52]

An entity has a customer loyalty programme that rewards a customer with one customer loyalty point for every Rs.10 of purchases. Each point is redeemable for a Rs. 1 discount on any future purchases of the entity's products.

During 20X7, customers purchase products for Rs.100,000 and earn 10,000 points that are redeemable for future purchases. The consideration is fixed and the stand-alone selling price of the purchased products is Rs.100,000. The entity expects 9,500 points to be redeemed.

At the end of 20X7, 4,500 points have been redeemed and the entity continues to expect 9,500 points to be redeemed in total.

At the end of 20X8, 8,500 points have been redeemed cumulatively (i.e. 4,000 point in 20X8). The entity updates its estimate of the points that will be redeemed and now expects that 9,700 points will be redeemed.

At the end of 20X9, 9,600 points have been redeemed cumulatively (i.e. 1,100 points in 20X9). The entity estimates that no further points shall be redeemed.

Required: Allocation of transaction price along with journal entries assuming that all transaction is made on cash basis.

► **ANSWER:**

Estimated selling price of points = $\text{Rs. } 1 \times 9,500 / 10,000 = \text{Rs. } 0.95$ per point

(on the basis of likelihood of redemption)

Performance Obligations	Stand-alone price	Allocated price	Working
	Rs.	Rs.	Rs.
Product	100,000	91,324	$[100,000 / 109,500 \times \text{Rs. } 100,000]$
Points	9,500	8,676	$[9,500 / 109,500 \times \text{Rs. } 100,000]$
Total	109,500	100,000	

Date	Particulars	Debit Rs.	Credit Rs.
20X7	Cash	100,000	
	Revenue – Product		91,324
	Revenue – Points		4,110
	Contract liability – Points (balancing)		4,566
20X8	Contract liability – Points	3,492	
	Revenue – Points		3,492
20X9	Contract liability – Points	1,074	
	Revenue – Points		1,074

Working: Revenue to be recognised		Rs.
20X7	Rs. 8,676 x 4500/9500 points	4,110
20X8	Rs. 8,676 x 8500/9700 points – Rs. 4,110	3,492
20X9	Rs. 8,676 x 9600/9600 points – Rs. 4,110 – Rs. 3,492	1,074
	Total	8,676

► **Example 34:**

On 1 October 20X8, Kushan Construction Limited (KCL) entered into a contract to construct a commercial building for a customer for Rs. 50 million and a bonus of Rs. 10 million if the building is completed on or before 31 December 20X9.

Till 30 June 20X9, KCL expected that the building will be completed within time at a total cost of Rs. 40 million. However, due to bad weather and time involved in regulatory approvals, the building was completed on 28 February 20Y0 at a total cost of Rs. 42 million of which Rs. 26 million was incurred till 30 June 20X9.

Required: Compute profit to be recognized for the years ended 30 June 20X9 and 20Y0, if:

- performance obligation under the contract is satisfied over time.
- performance obligation under the contract is satisfied at a point in time.

► **ANSWER:**

Part (i) Profit computation: Performance obligation satisfied over time

		20X9		20Y0
		Rs.		Rs.
Revenue	50 + 10 = 60 x 65%	39	50 – 39 last year	11
Costs		(26)	42 – 26 last year	(16)
Profit (loss)		13		(5)
Completion %	26/40	65%	42 /42	100%

Part (ii) Profit computation: Performance obligation satisfied at a point in time

		20X9		20Y0
		Rs.		Rs.
Revenue		-		50
Costs		-		(42)
Profit (loss)		-		8

5. OTHER ASPECTS

5.1 Incremental costs of obtaining a contract [IFRS 15: 91 to 94]

An entity shall recognise as an asset the incremental costs of obtaining a contract with a customer if the entity expects to recover those costs. The incremental costs of obtaining a contract are those costs that an entity incurs to obtain a contract with a customer that it would not have incurred if the contract had not been obtained (for example, a sales commission).

Costs to obtain a contract that would have been incurred regardless of whether the contract was obtained shall be recognised as an expense when incurred, unless those costs are explicitly chargeable to the customer regardless of whether the contract is obtained.

As a practical expedient, an entity may recognise the incremental costs of obtaining a contract as an expense when incurred if the amortisation period of the asset that the entity otherwise would have recognised is one year or less.

► **Example 35:**

[Based on IFRS 15 Illustrative Example 36]

An entity, a provider of consulting services, wins a competitive bid to provide consulting services to a new customer. The entity incurred the following costs to obtain the contract:

	Rs.
External legal fees for due diligence	15,000
Travel costs to deliver proposal	25,000
Commissions to sales employees	10,000
Total costs incurred	50,000

The entity also paid discretionary annual bonuses of Rs. 100,000 to sales supervisors based on annual sales targets, overall profitability of the entity and individual performance evaluations.

Required: Discuss which of the above costs may be recognised as an asset in accordance with IFRS 15 with reasoning.

► **ANSWER:**

The external legal fees and travel costs would have been incurred regardless of whether the contract was obtained. Therefore, these costs are recognised as expenses when incurred, unless they are within the scope of another Standard, in which case, the relevant provisions of that Standard apply.

The commissions to sales employees are incremental costs of obtaining the contract and shall be recognised as an asset for Rs. 10,000 because the entity expects to recover those costs through future fees for the consulting services.

The bonuses paid to sales supervisors are not incremental to obtaining a contract. The bonuses are not directly attributable to identifiable contracts and shall be charged as an expense.

5.2 Presentation [IFRS 15: 105 to 109]

When either party to a contract has performed an entity shall present the contract in the statement of financial position as a:

Contract liability	If a customer pays consideration, or an entity has a right to an amount of consideration that is unconditional (i.e. a receivable), before the entity transfers a good or service to the customer, the entity shall present the contract as a contract liability when the payment is made or the payment is due (whichever is earlier).

Contract asset	If an entity performs by transferring goods or services to a customer before the customer pays consideration or before payment is due, the entity shall present the contract as a contract asset, excluding any amounts presented as a receivable.
Receivable	A receivable is an entity's right to consideration that is unconditional. A right to consideration is unconditional if only the passage of time is required before payment of that consideration is due.
A contract asset is reclassified as a receivable when the supplier's right to consideration becomes unconditional.	

IFRS 15 allows that alternative descriptions may be used instead of 'contract asset' or 'contract liability'. For example, contract liability may be presented as "Advance from customer" or "unearned revenue".

► **Example 36:**

[Based on IFRS 15 Illustrative Example 39]

On 1 January 20X8, X Limited enters into a contract to transfer Products A and B to Y Limited in exchange for Rs. 1,000. Product A & Product B are to be delivered on 28 February & 31 March respectively. Control transfers with the delivery.

The promises to transfer Products A and B are identified as separate performance obligations. Rs.400 is allocated to Product A and Rs.600 to Product B.

Situation 1: X Limited has unconditional right to payment on delivery of each product separately.

Situation 2: Payment for the delivery of Product A is conditional on the delivery of Product B.

Required: Journal entries to record revenue.

► **ANSWER:**

Situation 1: Journal entries

Date	Particulars	Debit Rs.	Credit Rs.
28 Feb 20X8	Receivables	400	
	Revenue		400
31 Mar 20X8	Receivables	600	
	Revenue		600

Situation 2: Journal entries

Date	Particulars	Debit Rs.	Credit Rs.
28 Feb 20X8	Contract asset	400	
	Revenue		400
31 Mar 20X8	Receivables	1,000	
	Revenue		600
	Contract asset		400

► **Example 37:**

[Based on IFRS 15 Illustrative Example 38]

On 1 January 20X9, an entity enters into a contract to transfer a product to a customer on 31 March 20X9.

The contract requires the customer to pay consideration of Rs. 1,000 in advance on 31 January 20X9 but the customer pays the consideration on 1 March 20X9.

The entity transfers the product on 31 March 20X9.

Situation 1: Contract is cancellable.

Situation 2: Contract is non-cancellable.

Required: Journal entries for the above contract.

► **ANSWER:****Situation 1: Journal entries**

Date	Particulars	Debit Rs.	Credit Rs.
01 Mar 20X9	Cash	1,000	
	Contract liability		1,000
31 Mar 20X9	Contract liability	1,000	
	Revenue		1,000

Situation 2: Journal entries

Date	Particulars	Debit Rs.	Credit Rs.
31 Jan 20X9	Receivable	1,000	
	Contract liability		1,000
01 Mar 20X9	Cash	1,000	
	Receivable		1,000
31 Mar 20X9	Contract liability	1,000	
	Revenue		1,000

► **Example 38:**

[Based on IFRS 15 Illustrative Example 40]

An entity enters into a contract with a customer on 1 January 20X9 to transfer products to the customer for Rs. 150 per product.

If the customer purchases more than 1 million products in a calendar year, the contract indicates that the price per unit is retrospectively reduced to Rs. 125 per product.

Consideration is due when control of the products transfer to the customer.

In determining the transaction price, the entity concludes at contract inception that the customer will meet the 1 million products threshold.

Required: Journal entry on shipment of first 100 products on 4 January 20X9.

► **ANSWER:**

Date	Particulars	Debit Rs.	Credit Rs.
4 Jan 20X9	Receivable [100 units x Rs. 150]	15,000	
	Revenue [100 units x Rs. 125]		12,500
	Refund liability		2,500

5.3 Contract modifications [IFRS 15: 18, 20 & 21]

A contract modification is a change in the scope or price (or both) of a contract that is approved by the parties to the contract.

The following table provides guidance on accounting for such contract modifications:

Separate contract	If both of the following conditions are present: (a) the scope of the contract increases because of the addition of distinct promised goods or services; and (b) the price of the contract increases by an amount of consideration that reflects the entity's stand-alone selling prices of the additional promised goods or services and any appropriate adjustments. The entity should account for contract modification as a separate contract.
Adjustment to revenue of the existing contract	If additional goods or services are NOT distinct: • Account for the contract modification as if it were a part of the existing contract and forms part of a single performance obligation that is partially satisfied at the date of modification. • The effect that the contract modification has on the transaction price, and on the entity's measure of progress towards complete satisfaction of the performance obligation, is recognised as an adjustment to revenue (either as an increase in or a reduction of revenue) at the date of the contract modification.
Termination of existing contract and creation of new contract	If the additional goods or services are distinct, but price increase does not reflect stand-alone selling price of those additional goods: • Account for the contract modification as if it were a termination of the existing contract and the creation of a new contract. • The amount of consideration to be allocated to the remaining performance relating to goods or services is equal to unearned revenue under previous arrangement plus additional revenue from modification.

► **Example 39:**

[Based on IFRS 15 Illustrative Example 5]

On 1 January 20Y1, SL promises to sell 120 products to CL for Rs. 12,000 (Rs. 100 per product). The products are to be transferred equally on January 31 and February 28. CL paid Rs. 12,000 on inception of contract.

On February 15, the contract is modified to require the delivery of an additional 30 products to CL on March 10 at Rs. 80 per product (Total Rs. 2,400). CL paid additional amount on modification date i.e. February 15, 20Y1.

The additional 30 products are distinct and reflect the stand-alone selling price of the additional products.

All products were delivered as agreed.

Required: Pass Journal entries for the above contract.

► **ANSWER:**

Date	Particulars	Debit Rs.	Credit Rs.
01-Jan-Y1	Bank	12,000	
	Contract liability		12,000
	[120 units x Rs. 100]		
31-Jan-Y1	Contract liability	6,000	
	Revenue		6,000
	[60 units x Rs. 100]		
15-Feb-Y1	Bank	2,400	
	Contract liability		2,400
	[30 units x Rs. 80]		
28-Feb-Y1	Contract liability	6,000	
	Revenue		6,000
	[60 units x Rs. 100]		
10-Mar-Y1	Contract liability	2,400	
	Revenue		2,400
	[30 units x Rs. 80]		

► **Example 40:**

[Based on IFRS 15 Illustrative Example 5]

On 1 January 20Y1, SL promises to sell 120 products to CL for Rs. 12,000 (Rs. 100 per product). The products are to be transferred equally on January 31 and February 28. CL paid Rs. 12,000 on inception of contract.

On February 15, the contract is modified to require the delivery of an additional 30 products to CL on March 10 at Rs. 80 per product (Total Rs. 2,400). CL paid additional amount on modification date i.e. February 15, 20Y1.

The additional 30 products are distinct but do not reflect the stand-alone selling price of the additional products. All products were delivered as agreed.

Required: Pass Journal entries for the above contract.

► **ANSWER:**

Date	Particulars	Debit Rs.	Credit Rs.
01-Jan-Y1	Bank	12,000	
	Contract liability		12,000
	[120 units x Rs. 100]		
31-Jan-Y1	Contract liability	6,000	
	Revenue		6,000
	[60 units x Rs. 100]		
15-Feb-Y1	Bank	2,400	
	Contract liability		2,400
	[30 units x Rs. 80]		

Date	Particulars	Debit Rs.	Credit Rs.
28-Feb-Y1	Contract liability	5,600	
	Revenue		5,600
	$[(6,000 + 2,400) / 90 \text{ units} \times 60 \text{ units}]$		
10-Mar-Y1	Contract liability	2,800	
	Revenue		2,800
	$[(6,000 + 2,400) / 90 \text{ units} \times 30 \text{ units}]$		

► **Example 41:**

[Based on IFRS 15 Illustrative Example 5]

On 1 January 20Y1, SL promises to sell 120 products to CL for Rs. 12,000 (Rs. 100 per product). The products are to be transferred equally on January 31 and February 28. CL paid Rs. 12,000 on inception of contract.

On February 15, the contract is modified to require the delivery of an additional 30 products to CL on March 10 at Rs. 80 per product (Total Rs. 2,400). CL paid additional amount on modification date i.e. February 15, 20Y1.

The additional 30 products are distinct but do not reflect the stand-alone selling price of the additional products.

It was discovered that 60 products already supplied had minor defects. SL agreed to give Rs. 900 credit to CL for this i.e. (Rs. 15 per product $\times$ 60 products).

All products were delivered as agreed.

Required: Pass Journal entries for the above contract.

► **ANSWER:**

Date	Particulars	Debit Rs.	Credit Rs.
01-Jan-Y1	Bank	12,000	
	Contract liability		12,000
	$[120 \text{ units} \times \text{Rs. } 100]$		
31-Jan-Y1	Contract liability	6,000	
	Revenue		6,000
	$[60 \text{ units} \times \text{Rs. } 100]$		
15-Feb-Y1	Bank	1,500	
	Revenue (credit for minor defects)	900	
	Contract liability		2,400
	$[30 \text{ units} \times \text{Rs. } 80]$		
28-Feb-Y1	Contract liability	5,600	
	Revenue		5,600
	$[(6,000 + 2,400) / 90 \text{ units} \times 60 \text{ units}]$		
10-Mar-Y1	Contract liability	2,800	
	Revenue		2,800
	$[(6,000 + 2,400) / 90 \text{ units} \times 30 \text{ units}]$		

► **Example 42:**

[Based on IFRS 15 Illustrative Example 5]

On 1 January 20Y1, SL promises to sell 120 products to CL for Rs. 12,000 (Rs. 100 per product). The products are to be transferred equally on January 31 and February 28. CL paid Rs. 12,000 on inception of contract.

On February 15, the contract is modified to require the delivery of an additional 30 products to CL on March 10 at Rs. 80 per product (Total Rs. 2,400). CL paid additional amount on modification date i.e. February 15, 20Y1.

The additional 30 products are neither distinct nor reflect the stand-alone selling price of the additional products.

All products were delivered as agreed.

Required: Pass Journal entries for the above contract.

► **ANSWER:**

Date	Particulars	Debit Rs.	Credit Rs.
01-Jan-Y1	Bank	12,000	
	Contract liability		12,000
	[120 units x Rs. 100]		
31-Jan-Y1	Contract liability	6,000	
	Revenue		6,000
	[60 units x Rs. 100]		
15-Feb-Y1	Bank	2,400	
	Revenue	240	
	Contract liability [2,400 + 240]		2,640
	[(Rs. 12,000 + 2,400) / 150 units = Rs. 96 per unit]		
	Adjustment = Rs. 96 x 60 = Rs. 5,760 - 6,000 = Rs. 240		
28-Feb-Y1	Contract liability	5,760	
	Revenue		5,760
	[60 units x Rs. 96]		
10-Mar-Y1	Contract liability	2,880	
	Revenue		2,880
	[30 units x Rs. 96]		

6. COMPREHENSIVE EXAMPLES

► Example 43:

Thursday Enterprise (TE) is a supplier of product Zee and has provided you the following information:

Part (a)

On 1 August 20X8, TE entered into a six months contract with customer Alpha for sale of Zee for Rs. 250 per unit, under the following terms and conditions:

- if Alpha purchases more than 5,000 units during the contract period, the price per unit would be retrospectively reduced to Rs. 215 per unit.
- TE's unconditional right to receive consideration would be established upon:
 - completion of quality control procedures by Alpha for the first order. The procedure would take a week after receiving the goods.
 - placement of order by Alpha for subsequent orders.

At the inception of the contract, TE concludes that Alpha's purchases will not exceed the 5,000 units threshold for the discount.

Alpha placed the following orders:

Order date	Units	Delivery date (Transfer of control)	Payment date
10 August 20X8	3,000	28 August 20X8	12 September 20X8
25 December 20X8	4,000	15 January 20X9	10 January 20X9

Part (b)

On 1 February 20X9, TE entered into a six months contract with another customer Beta for sale of Zee for Rs. 250 per unit, under the following terms and conditions:

- if the Beta purchases more than 15,000 units during the contract period, the price per unit would be retrospectively reduced to Rs. 215 per unit.
- TE's unconditional right to receive consideration would be established upon delivery of goods to Beta.

At the inception of the contract, TE concludes that Beta will meet 15,000 units threshold for the discount.

Beta placed the following orders:

Order date	Units	Delivery date (Transfer of control)	Payment date
14 February 20X9	10,000	28 February 20X9	20 March 20X9
1 June 20X9	8,000	15 July 20X9	18 July 20X9

Required: In respect of the above contracts, prepare journal entries to be recorded in the books of TE for the years ended 31 December 20X8 and 20X9. (Entries without date will not be awarded any marks).

► **ANSWER:****Part (a)**

Date	Particulars	Debit Rs.	Credit Rs.
28-08-X8	Contract asset – Alpha	750,000	
	Revenue		750,000
	[3,000 units x Rs. 250]		
05-09-X8	Receivable – Alpha	750,000	
	Contract asset – Alpha		750,000
12-09-X8	Bank	750,000	
	Receivable – Alpha		750,000
25-12-X8	Revenue [3,000 units x Rs. 35]	105,000	
	Contract liability – Alpha		105,000
25-12-X8	Receivable – Alpha	755,000	
	Contract liability – Alpha		755,000
	[(4,000 x Rs. 215) – 105,000]		
10-01-X9	Bank	755,000	
	Receivable – Alpha		755,000
15-01-X9	Contract liability – Alpha	860,000	
	Revenue [755,000 + 105,000]		860,000

Part (b)

28-02-X9	Receivable – Beta [10,000 x Rs. 250]	2,500,000	
	Revenue [10,000 x Rs. 215]		2,150,000
	Contract liability – Beta [10,000 x Rs. 35]		350,000
20-03-X9	Bank	2,500,000	
	Receivable – Beta		2,500,000
15-07-X9	Receivable – Beta [(8,000 x Rs. 215) – 350,000]	1,370,000	
	Contract liability – Beta	350,000	
	Revenue [8,000 x Rs. 215]		1,720,000
18-07-X9	Bank	1,370,000	
	Receivable – Beta		1,370,000

► **Example 47:**

Financial statements of Trich Mir Limited (TML) for the year ended 31 December 20X9 are under preparation. While reviewing revenues from contract with customers, following matters have been identified:

- On 1 October 20X9, TML sold Machine C to Chan Limited for Rs. 25 million. As per the contract, payment would be made after 2 years. The accountant recognised sales revenue of Rs. 25 million upon delivery on 1 October 20X9. Further, commission paid to sales employees for winning the contract of Rs. 1.6 million was capitalised and is being amortised over 2 years period. Applicable discount rate is 10% per annum.
- TML entered into a contract to manufacture a specialised machine for Dhan Limited at a price of Rs. 30 million. The contract meets the criteria of recognition of revenue over time. At the year end, the machine was 60% complete and it was estimated that a further cost of Rs. 10 million would be incurred. Cost of Rs. 15 million incurred till year end has been included in closing inventory and receipts of Rs. 11 million have been credited to revenues.

- (iii) TML entered into a contract to sell one unit of Machine A and Machine B for a total price of Rs. 16 million. Machine A was delivered in December 20X9 to the customer while Machine B was delivered in January 20Y0. The consideration of Rs. 16 million is due only after TML transfers both the machines to the customer. TML sells machines A and B at standalone prices of Rs. 12 million and Rs. 8 million respectively. The accountant recognised receivable and revenue of Rs. 12 million upon delivery of Machine A.

Required: Prepare correcting entries for the year ended 31 December 20X9 in accordance with IFRS 15 'Revenue from Contracts with Customers'.

► **ANSWER:**

Trich Mir Limited – Correcting entries for the year ended 31 December 20X9

Sr. #	Particulars	Debit Rs. m	Credit Rs. m
(i)	Revenue $[25 \times 1.10^{-2} = 20.66 - 25]$	4.34	
	Receivables		4.34
	Receivable $[20.66 \times 10\% \times 3/12]$	0.52	
	Interest income		0.52
	Commission expense	1.6	
	Amortisation $[1.6 / 2 \text{ years} \times 3/12]$		0.2
	Contract costs		1.4
(ii)	Receivable $[30 \times 60\% = 18 - 11 \text{ received}]$	7	
	Revenue		7
	Cost of sales	15	
	Inventory		15
(iii)	Revenue $[12 - 9.6]$	2.4	
	Contract asset $[12 / (12+8) \times 16]$	9.6	
	Receivable		12

► **Example 48:**

On 1 June 20X8 Ravi Limited (RL) delivered 500 units of one of its products to Bravo Limited (BL) at Rs. 200 per unit. BL immediately paid the amount and obtained control upon delivery. BL is allowed to return unused units within 30 days and receive a full refund. RL's cost of the product is Rs. 150 per unit and it uses perpetual system for recording inventory transactions.

On 30 June 20X8, BL returned 20 units.

Required: Prepare necessary journal entries in the books of RL on 1 June 20X8 and 30 June 20X8 under each of the following independent situations:

- Based upon historical data, RL estimates that 5% units will be returned on expiry of 30 days.
- The product is new and RL has no relevant historical evidence of product returns or other available market evidence.

► **ANSWER:****Part (i)**

Date	Particulars	Debit	Credit
		Rs.	Rs.
01-Jun-X8	Bank [500 units x Rs. 200]	100,000	
	Refund liability 5% [25 units x 200]		5,000
	Revenue 95% [475 units x 200]		95,000
	Cost of Sales 95% [475 units x 150]	71,250	
	Right to recover product 5% [25 units x 150]	3,750	
	Inventory [500 units x Rs. 150]		75,000
30-Jun-X8	Refund liability	5,000	
	Revenue [5 units x Rs. 200]		1,000
	Bank [20 units x Rs. 200]		4,000
	Cost of Sales [5 units x Rs. 150]	750	
	Inventory [20 units x Rs. 150]	3,000	
	Right to recover product		3,750

Part (ii)

01-Jun-X8	Bank	100,000	
	Contract liability [500 units x 200]		100,000
	Right to recover product	75,000	
	Inventory [500 units x Rs. 150]		75,000
30-Jun-X8	Contract liability	100,000	
	Revenue [480 units x Rs. 200]		96,000
	Bank [20 units x Rs. 200]		4,000
	Cost of Sales [480 units x Rs. 150]	72,000	
	Inventory [20 units x Rs. 150]	3,000	
	Right to recover product		75,000

► **Example 49:**

Guitar World (GW) normally sells Machine A13 for Rs. 1.7 million. Maintenance services for such type of machines are provided separately at Rs. 25,000 per month. Details of two contracts for sale of Machine A13 are as follows:

- (i) On 1 July 20X8, GW signed a contract with Energene Limited to sell Machine A13 with one year free maintenance services at a lumpsum payment of Rs. 1.8 million. The amount was received upon delivery of machine on 1 August 20X8.
- (ii) On 1 October 20X8, GW sold Machine A13 to Vitalene Limited for Rs. 1.95 million. As per the contract, payment would be made after 2 years. Maintenance services would also be provided for Rs. 25,000 per month for two years which would be paid at the end of each month.

Required: With reference to IFRS-15 'Revenue from Contracts with Customers', explain how the above contracts should be recorded in GW's books for year ended 31 December 20X8. (Show supporting calculations but entries are not required)

► **ANSWER:****Part (i)**

The contract contains two distinct performance obligations i.e. selling the machine and providing the maintenance services as:

- the customer can separately benefit from the machine without the maintenance services from GW (or GW sells maintenance services separately) and
- the machine and maintenance services are separately identifiable in the contract.

Thus GW will allocate the transaction price between the two performance obligations as follows:

Performance obligations	Stand-alone	Allocation of Rs. 1,800,000	
	Rs. 000	Rs.000	Rs. 000
Machine	1,700	$1,700/2,000 \times 1,800$	1,530
Maintenance (Rs. 25,000×12)	300	$300/2,000 \times 1,800$	270
Total	2,000		1,800

Revenue related to sale of machine would be recognized at a point in time i.e. upon delivery on 1 August 20X8. While revenue related to maintenance service would be recognized over time i.e. as the services are rendered.

Till 31 December 20X8, revenue would be recognized in respect of:

- Sale of machine Rs. 1,530,000
- Maintenance service Rs. 112,500 (i.e. Rs. 270,000 × 5/12)

Remaining amount of Rs. 157,500 (i.e. Rs. 270,000 × 7/12) would appear in liabilities as contract liability.

Part (b)(ii)

The contract contains two distinct performance obligations i.e. selling the machine and providing the maintenance services.

The contract includes a significant financing component in respect of sale of machine which is evident from the difference between the amount of promised consideration of Rs. 1.95 million and the cash selling price of Rs. 1.7 million.

Revenue related to machine would be recognized upon delivery on 1 October 20X8. Revenue related to maintenance service would be recognized as the services are rendered each month.

The difference between promised consideration and cash selling price of Rs. 250,000 would be recognized as interest revenue over two years using the implicit rate of 7.1% i.e. $(1.95/1.7)^{1/2} - 1$.

Till 31 December 20X8, revenue would be recognized in respect of:

- Sale of machine Rs. 1,700,000 (on 1 October 20X8)
- Maintenance service Rs. 75,000 i.e. Rs. 25,000 for 3 months
- Interest revenue Rs. 30,175 (Rs. 1.7 million × 7.1% × 3/12)

► **Example 50:**

On 1 January 20Y1, Covaxin Telecom (CT) announced a new annual promotional package for its customers. The package comprises of a mobile phone, full year unlimited on-net calls and 1,000 minutes per month on other networks. Package price is Rs. 11,550 per quarter payable in advance on the first day of each quarter. At the end of the contract, the phone would not be returned to CT.

On the first day of the promotional announcement, CT sold 1,000 packages. Based on the data available with CT, it is expected that each customer would utilize 10,000 minutes of other networks with quarterly break-up as under:

Quarter ending	Minutes
31 March 20Y1	2,700
30 June 20Y1	2,000
30 September 20Y1	2,900
31 December 20Y1	2,400

The mobile phone has a retail value of Rs. 34,000, if sold separately. A monthly subscription for unlimited on-net calls is Rs. 500 while every call on other networks is charged at Rs. 1.5 per minute, if billed separately.

Required: Compute the quarterly revenue to be recognised for the quarters ended 31 March 20Y1 and 30 June 20Y1.

► **ANSWER:**

Allocation calculation for one contract

Performance obligation	Stand-alone prices		Allocation of Transaction price	
	Working	Rs.	Working	Rs.
Mobile Phone		34,000		28,560
On-net calls	Rs. 500 x 12 months	6,000		5,040
Other network calls	Rs. 1.5 x 10,000 calls	15,000		12,600
		55,000	[11,550 x 4 quarters]	46,200

Revenue Recognition - Quarterly

Performance obligation	Quarter ending		Quarter ending	
	31 March 20Y1	Rs.	30 June 20Y1	Rs.
Mobile Phone		28,560		0
On-net calls	Rs. 5,040 / 4	1,260	Rs. 5,040 / 4	1,260
Other network calls	Rs. 12,600 x 2700/10000	3,402	Rs. 12,600 x 2000/10000	2,520
Revenue per contract		33,222		3,780
Number of contracts		1000		1000
Total Revenue		33,222,000		3,780,000

► **Example 51:**

Financial statements of Parodia Motors Limited (PML) for the year ended 30 June 20Y1 are under preparation. While reviewing revenues from contract with customers, following matters have been identified:

- On 1 November 20Y0, PML sold Car-A to Alpha Limited (AL) for Rs. 5 million. As per the contract, Rs. 1 million would be paid immediately and the balance would be paid after 2 years. The accountant has recognized revenue to the extent of the cost of Car-A i.e. Rs. 3.5 million and remaining revenue would be recognized upon receipt of balance from AL.
- On 1 January 20Y1, PML entered into six months' contract with Beta Limited (BL) to sell Car-B for Rs. 3.5 million per unit. As per the contract, if BL purchases more than 10 units during the contract period, the price will be retrospectively reduced to Rs. 3.4 million per unit. At the inception of the contract, PML concluded that BL will meet the threshold for the discount. BL purchased 11th unit of Car-B on 28 June 20Y1 for which no revenue has been recorded. BL has made payments of all units except 11th unit which will be settled in July 20Y1.

- (iii) On 1 February 20Y1, PML sold Car-C to Gamma Limited (GL) for Rs. 3 million and recognized the entire amount as revenue. PML also provided GL a Rs. 0.2 million discount voucher for any future purchases of spare parts within one year. There is 80% likelihood that GL will redeem the discount voucher and will purchase spare parts within one year. By the end of the year, no spare parts were purchased by GL. PML normally sells Car-C for Rs. 3 million with no discount voucher.
- (iv) On 20 February 20Y1, PML sold Car-D to Delta Limited (DL) with one-year free maintenance services at a lumpsum payment of Rs. 3.6 million. Payment was made on 1 March 20Y1 upon delivery of Car-D to DL. The revenue of Rs. 1.2 million (i.e. 4/12 of Rs. 3.6 million) has been recognized. PML normally sells Car-D and annual maintenance services separately for Rs. 3.5 million and Rs. 0.3 million respectively.

Discount rate of 12% per annum may be used wherever required.

Required: Prepare correcting entries for the year ended 30 June 20Y1 in accordance with IFRS 15 'Revenue from Contracts with Customers'.

► **ANSWER:**

Parodia Motor Limited

Correcting entries for the year ended 30 June 20Y1

Sr#	Particulars	Debit	Credit
		Rs. 000	Rs. 000
(i)	Receivable – AL [4,189 W1 – 3,500]	689	
	Revenue		689
	Receivable – AL [3,189 W1 x 12% x 8/12]	255	
	Interest income		255
(ii)	Receivable – BL [3,400 – (100 x 10)]	2,400	
	Contract/refund liability – BL [100 x 10]	1,000	
	Revenue (11 th unit)		3,400
(iii)	Revenue W2	152	
	Contract/refund liability – GL		152
(iv)	Contract/refund liability – DL	2,211	
	Revenue [3,411 W4 – 1, 200]		2,211

W1: Revenue to be recognised – AL		Rs. 000
Cash received		1,000
Receivable at present value of remaining balance	[Rs. 4m x 1.12 ⁻²]	3,189
		4,189

W2: Price allocation – GL			
	Rs. 000		Rs. 000
Car C	3,000	3,000 / 3,160 x 3,000	2,848
Discount voucher (200 x 80%)	160	160 / 3,160 x 3,000	152
	3,160		3,000

W3: Price allocation – DL			
	Rs. 000		Rs. 000
Car D	3,500	$3,500 / 3,800 \times 3,600$	3,316
Annual maintenance	300	$300 / 3,800 \times 3,600$	284
	3,800		3,600

W4: Revenue to be recognised – DL		Rs. 000
Car D	W3	3,316
Annual maintenance	$284 \times W3 \times 4/12$	95
Total revenue to be recognised		3,411

► **Example 52:**

[Based on IFRS 15 Illustrative Example 63]

An entity enters into a contract with a customer on 1 January 20X8 for the sale of a machine and spare parts. The manufacturing lead time for the machine and spare parts is two years.

Upon completion of manufacturing, the entity demonstrates that the machine and spare parts meet the agreed-upon specifications in the contract. The promises to transfer the machine and spare parts are distinct.

On 31 December 20X9, the customer pays Rs. 5 million for the machine and spare parts, but only takes physical possession of the machine.

The 80% of Rs. 5 million is to be allocated to machine and remaining 20% to spare parts.

Although the customer inspects and accepts the spare parts, the customer requests that the spare parts be stored at the entity's warehouse because of its close proximity to the customer's factory. The customer has legal title to the spare parts and the parts can be identified as belonging to the customer. Furthermore, the entity stores the spare parts in a separate section of its warehouse and the parts are ready for immediate shipment at the customer's request. The entity expects to hold the spare parts for two to four years and the entity does not have the ability to use the spare parts or direct them to another customer.

The entity will receive Rs. 15,000 per month from the customer as custodial charges of spare parts at its premises.

Required: Evaluate the above situation in accordance with five-step model of IFRS 15.

► **ANSWER:**

Step 1: Identify the Contract

There is only one contract with the customer.

Step 2: Identify the Performance obligations

There are three performance obligations i.e. the promises to provide:

- (i) The machine
- (ii) The spare parts
- (iii) The custodial services for spare parts

Step 3: Determine the transaction price

There transaction price is both fixed and variable:

- (i) Rs. 5 million fixed
- (ii) Rs. 15,000 per month variable

Step 4: Allocating transaction price to Performance obligations

The allocation of transaction price shall be as follows:

- (i) The machine Rs. 4m (i.e. Rs. 5m x 80%)
- (ii) The spare parts Rs. 1m (i.e. residual approach or Rs. 5m x 20%)
- (iii) The custodial services Rs. 15,000 per month

Step 5: Recognise revenue on satisfaction of performance obligations

The revenue shall be recognised as follows:

- (i) The machine - at a point in time (control transfer) - 31 December 20X9
- (ii) The spare parts - at a point in time (control transfer) - 31 December 20X9. Bill-and-Hold arrangement criteria is met and control has been transferred.
- (iii) The custodial services - Satisfaction over time - Time based measure (monthly is suitable)

► **Example 53:**

Rhombus Limited (RL), a supplier of high quality office equipment, has entered into following contract during the year ended 31 August 2022:

On 1 July 2022, RL entered into a contract with Trapezoid Limited (TL) to sell 50 laptops at a total consideration of Rs. 10 million. 50% laptops would be delivered on 20 July 2022 and balance on 15 August 2022. RL was unconditionally entitled to receive full payment upon delivery of first lot of 25 laptops, however, TL paid full amount on 31 July 2022.

On 7 August 2022, the contract was modified as TL ordered additional 30 laptops of Rs. 190,000 each for delivery on 25 August 2022. These 30 laptops are distinct but do not reflect the stand-alone selling price. It was agreed that TL would pay for 29 laptops only instead of 30 laptops. This discount has been given in compensation of minor defects identified in 25 laptops, delivered on 20 July 2022. TL settled the balance in September 2022 as per the terms of the contract.

All laptops were delivered as agreed.

Required: Prepare necessary accounting entries for the year ended 31 August 2022 in accordance with the IFRSs. (No marks will be awarded on entries without dates)

► **Answer:****Rhombus Limited****Accounting entries for the year ended 31 August 2022**

Date	Particulars	Debit Rs. 000	Credit Rs. 000
20 Jul 22	Receivable	10,000	
	Revenue 50%		5,000
	Contract liability 50%		5,000
31 Jul 22	Bank	10,000	
	Receivable		10,000
7 Aug 22	Revenue (one laptop price)	190	
	Contract liability		190
15 Aug 22	Contract liability	4,864	
	Revenue [25 x Rs. 194.55 W1]		4,864

Date	Particulars	Debit Rs. 000	Credit Rs. 000
25 Aug 22	Receivable [190 x 29]	5,510	
	Contract liability [5,000 + 190 – 4,864]	326	
	Revenue [30 x Rs. 194.55 W1]		5,836

W1: Contract modification (distinct but do not reflect stand-alone selling price)

		Rs. 000
Consideration	Rs. 5,000 previous x Rs. 190 x 30 new items	10,700
Total units	25 previous + 30 new	55
Average	10,700 / 55	194.55

► **Example 54:**

Rhombus Limited (RL), a supplier of high quality office equipment, has entered into following contract during the year ended 31 August 2022:

On 1 January 2022, RL entered into a contract with Crescent Limited (CL) for sale of 10 units of its state of the art 3D printers. The cost and stand-alone price of goods/services included in each unit of printer are as follows:

	Unit cost	Unit price
	---- Rs. in '000 ----	
Hardware	1,800	3,600
Printing software	720	
Software upgrade to next version	350	500
Maintenance support for 1 year	210	N/A

RL sells 3D printer hardware along with the software as hardware cannot be used without the printing software. The 3D printer remains functional without the software upgrade and the maintenance support. RL sells software upgrade upon release to all of its customers. However, RL does not provide maintenance support but went against its policy to provide it to CL.

Each unit of printer was sold to CL at an overall discounted price of Rs. 4 million. As per payment terms, CL paid 30% on 1 January 2022 while 50% was paid at the time of delivery of printers (hardware plus printing software) on 1 March 2022 and remaining 20% will be paid in February 2023.

At year-end, 80% work has been completed on the new version of the printing software which is expected to be released in October 2022.

Required: Prepare necessary accounting entries for the year ended 31 August 2022 in accordance with the IFRSs. (No marks will be awarded on entries without dates).

► **Answer:****Rhombus Limited****Accounting entries for the year ended 31 August 2022**

Date	Particulars	Debit Rs. 000	Credit Rs. 000
1 Jan 22	Cash 40,000 x 30%	12,000	
	Contract liability		12,000

Date	Particulars	Debit Rs. 000	Credit Rs. 000
1 Mar 22	Cash 40,000 x 50%	20,000	
	Contract liability	12,000	
	Receivable / Contract asset (balancing)	730	
	Revenue 3,273 W1 x 10		32,730
31 Aug 22	Receivable / Contract asset	1,365	
	Revenue 273 W1 x 10 x 6/12		1,365

No revenue shall be recorded for software upgrade.

W1: Price allocation

	Stand-alone price	Allocation of Rs. 4,000,000	Transaction Price
	Rs. in 000		Rs. in 000
3D printer and software	3,600	= Rs. 4,000 x 3,600/4,400	3,273
Software upgrade	500	= Rs. 4,000 x 500/4,400	454
Maintenance 210 / (100-30)%	300	= Rs. 4,000 x 300/4,400	273
	4,400		4,000

Estimated margin on 3D printer and software = $[3,600 - 1,800 - 720] / 3,600 = 30\%$

► Example 55:

Fluorine Limited (FL), a manufacturer of ships, has entered into the following contracts during the year ended 31 December 2022:

- On 1 January 2022, FL entered into a contract with Alpha Limited (AL) to construct a cruise ship for Rs. 400 million to be delivered on 31 December 2023 i.e. the date on which control of the ship would be transferred to AL. As per the contract, 90% of agreed amount was paid immediately by AL and the balance will be paid on delivery.
Till 31 December 2022, only 40% of the construction of the ship was completed at a cost of Rs. 150 million.
- On 1 April 2022, FL entered into a contract with Beta Limited (BL) to sell three fishing boats for Rs. 50 million per boat. The amount was received on 1 April 2022 but the boats were delivered on 1 May 2022. As per the contract, if BL purchases more than six boats before 31 December 2022, FL will retrospectively reduce the price to Rs. 48 million per boat. At the inception of the contract, FL expected that BL would meet the threshold for the discount.
On 1 November 2022, BL purchased two additional boats on the same price of Rs. 50 million per boat for which the payment was made in January 2023.
Despite FL's expectation, no further order was placed by BL till 31 December 2022.
- On 1 November 2022, FL sold a luxury yacht to Gamma Limited (GL) for Rs. 100 million on cash. FL also provided GL with a Rs. 5 million discount voucher for any interior design work on yacht within six months. There is 80% likelihood that GL will award the work of interior design within six months and will avail the discount. However, no interior design work was awarded till 31 December 2022. FL normally sells such luxury yachts for Rs. 100 million without any discount voucher for interior design work.

Discount rate of 15% per annum may be used wherever required.

Required: Prepare journal entries in FL's books to record the above information for the year ended 31 December 2022 in accordance with IFRSs. (No marks will be awarded on entries without dates).

► Answer:

Fluorine Limited**General Journal**

Date	Particulars	Debit Rs. m	Credit Rs. m
Part (i)			
1 Jan 22	Bank	360	
	Contract liability [400 x 90%]		360
31 Dec 22	Finance cost PL	54	
	Contract liability [360 x 15%]		54
31 Dec 22	WIP inventory	150	
	Cash / costs incurred		150
Part (ii)			
1 Apr 22	Bank	150	
	Contract/refund liability [50 x 3]		150
1 May 22	Contract/refund liability	144	
	Revenue [48 x 3]		144
1 Nov 22	Receivable [50 x 2]	100	
	Contract/refund liability		4
	Revenue [48 x 2]		96
31 Dec 22	Contract/refund liability [2 x 5]	10	
	Revenue		10
Part (iii)			
1 Nov 22	Bank	100	
	Contract liability W1		3.85
	Revenue W1		96.15

W1: Price allocation

	Stand-alone price	Allocation of Rs. 100m	Transaction Price
	Rs. in m		Rs. in m
Luxury yacht	100	= 100 x 100 / 104	96.15
Voucher 5m x 80%	4	= 100 x 4 / 104	3.85
	104		100

► *Example 56:*

The following information pertains to three independent contracts:

- (i) Alpha entered into a contract with Beta to provide administrative support services to Beta for a period of one year. These services encompass data entry, scheduling departmental meetings and tasks, and so on, to help Beta focus on its core operations. Alpha is not entitled to any amount if the one year period is not completed.
- (ii) Gamma is developing a residential society comprising identical villas. Delta entered into contract with Gamma to buy one of the villas. The control of the villa will be transferred to Delta once the entire society is complete.
The contract specifically mentions that no customized modification will be made during the construction by Gamma. Delta is required to make payments in proportion to the work done. In case of termination by Delta, Gamma is liable to return the amount paid by Delta once the villa is sold to another party.
- (iii) Eta entered into a contract with Theta to develop a software for Theta. The software will be designed specifically to meet Theta's operational needs and will not be usable for any other customer. The contract states that Theta will pay 50% of the total contract price upfront and the remaining 50% upon completion of work. Theta does not have the right to terminate the contract unless Eta fails to perform.

Required: Analyse whether the revenue should be recognized over time in each of the above contracts in accordance with IFRS 15.

► *Answer:*

As per para 35 of IFRS 15, an entity transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognises revenue over time, if one of the following criteria is met:

- (a) The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs.
- (b) The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced.
- (c) The entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date.

Part (i)

Beta would be simultaneously receiving and consuming the benefits of Alpha's performance of administrative support services so Alpha should recognize the revenue over time. The fact that another entity would not need to re-perform the administrative support services already provided to date by Alpha also demonstrates that Beta simultaneously receives and consumes the benefits of the services performed by Alpha. As criterion (a) is fulfilled, payment terms have no effect on revenue recognition.

Part (ii)

As control of villa will be transferred to Delta upon completion of entire society, criteria (a) or (b) have not met. The villas do seem to have an alternative use for Gamma as they can be sold to another customer in case of termination of contract. Hence, the revenue shall not be recognized by Gamma over time as criterion (c) above is also not met. Revenue would be recognized when control is transferred to Delta.

Part (iii)

Theta will be able to consume the benefits of the software upon completion, so criteria (a) or (b) have not been met. As per criterion (c) above, the development of software does not create an asset with an alternative use for Theta, as the software will be designed specifically for Theta's needs and will not be applicable for other customers. Eta also has a right to payment for performance completed to date, as Theta cannot terminate the contract. Therefore, Eta should recognize revenue over time in accordance with criterion (c).

► **Example 57:**

Exquisite Limited (EL) entered into the following two contracts during the year ended 31 December 2023:

- (i) On 1 October 2023, EL entered into a contract with Alpha Limited (AL) to provide monthly payroll processing service for two months. EL concluded that the service is a single performance obligation performed over time and is measured on time basis.

EL initially proposed a fee of Rs. 620,000 for each month in cash. However, due to liquidity problem, AL declined this offer. Instead, AL agreed to compensate EL with its 5,000 ordinary shares per month of service, totalling 10,000 shares for the entire contract. According to the terms of the contract, the shares are to be delivered upon the successful completion of each month of service.

As a result, EL received 5,000 shares on 31 October 2023 and another 5,000 shares on 30 November 2023. The fair value of each AL's share was Rs. 125 on 1 October 2023, Rs. 120 on 31 October 2023, Rs. 110 on 30 November 2023, and Rs. 108 on 31 December 2023 respectively.

EL holds all shares received from AL on 31 December 2023.

- (ii) On 1 November 2023, EL also entered into a six months' contract to sell goods to Beta Limited (BL), a large global chain of retail stores. BL committed to make purchases of at least Rs. 20 million during the contract period.

The contract also required EL to make a non-refundable payment of Rs. 2 million to BL at the inception of the contract for the necessary changes to shelving to prominently display EL's products.

On 15 December 2023, EL sold goods having invoice value of Rs. 6 million to BL, which BL paid on 30 December 2023.

Required: Prepare necessary accounting entries in EL's books for the year ended 31 December 2023 in accordance with the IFRSs. (No marks will be awarded for entries without dates).

► **Answer:****Exquisite Limited****General Journal**

Date	Particulars	Debit Rs. 000	Credit Rs. 000
Part (i)			
31 Oct 23	Financial assets – AL shares	600	
	Revenue [5,000 shares x Rs. 120]		600
30 Nov 23	Financial assets – AL shares	550	
	Revenue [5,000 shares x Rs. 110]		550
31 Dec 23	FV loss (PL) [10,000 shares x Rs. 108 – 1,150,000]	70	
	Financial assets – AL shares		70
Part (ii)			
1 Nov 2023	Consideration paid to customer	2,000	
	Bank		2,000
15 Dec 23	Receivable – Beta	6,000	
	Consideration paid to customer [6m x 2/20]		600
	Revenue (balancing)		5,400
30 Dec 23	Bank	6,000	
	Receivable – Beta		6,000

► **Example 58:**

Value Limited (VL) is a water purification company that provides hardware for water treatment and its installation services. VL also provides hosting services for water quality monitoring software, allowing customers to manage water quality from anywhere in the world. During the year ended 30 June 2024, VL entered into the following two contracts:

Contract 1:

On 1 February 2024, VL entered into a contract with Epsilon Water for a total price of Rs. 10.5 million, which was paid immediately. Under the contract, VL will provide the specified hardware, installation services and hosting services. The standalone prices of the hardware, installation services and hosting services are Rs. 10 million, Rs. 2 million, and Rs. 1 million respectively. Each element of the package can be purchased independently without affecting the performance of any other element. VL regularly sells each element separately and generally does not integrate the goods and services into a single solution.

VL delivered the hardware on 1 March 2024 and completed its installation on 1 April 2024. The hosting services are to be provided over one year starting from 1 April 2024.

Contract 2:

On 1 June 2024, VL delivered 400 units of one of its water treatment hardware products to Zeta Water (ZW) at Rs. 25,000 per unit. ZW immediately paid the amount and obtained control upon delivery. Under the contract, ZW is allowed to return unused units within 30 days and receive a full refund.

At the inception of the contract, VL estimated that 5% of units would be returned based on historical data. VL's cost of the product is Rs. 18,000 per unit, and it uses the perpetual system for recording inventory transactions.

On 30 June 2024, ZW returned 25 units and was refunded in full for these units.

Required: Explain how the above contracts should be recorded in VL's books for the year ended 30 June 2024. Give journal entries and workings in support of your explanation.

► **Answer:****Contract 1**

The first step is to identify the performance obligations in the contract. A performance obligation is a promise to transfer a distinct good or service to the customer. In this contract, there are the following three performance obligations:

- Delivery of hardware
- Provision of installation services
- Hosting services

The total transaction price of Rs. 10.5 million should be allocated to each performance obligation based on their standalone selling prices. The total standalone prices sum up to Rs. 13 million (10+2+1) so there is an element of discount in the contract. The allocation of the transaction price to each performance obligation is calculated as follows:

	Stand-alone price	Allocation of Rs. 10,500,000	Transaction Price
	Rs. in '000		Rs. in '000
Hardware	10,000	$10,000 \div 13,000 \times 10,500$	8,077
Installation Services	2,000	$2,000 \div 13,000 \times 10,500$	1,615
Hosting Services	1,000	$1,000 \div 13,000 \times 10,500$	808
	13,000		10,500

1 February 2024: The amount received should be recorded as deferred revenue as none of the performance obligation has been satisfied as of this date.

Date	Description	Debit	Credit
		Rs. 000	Rs. 000
1 Feb 2024	Bank	10,500	
	Deferred Revenue		10,500

1 March 2024: The revenue from the sale of hardware should be recognized upon delivery i.e. when the control is transferred to the customer upon delivery.

Date	Description	Debit	Credit
		Rs. 000	Rs. 000
1 Mar 2024	Deferred Revenue	8,077	
	Revenue (Hardware)		8,077

1 April 2024: The revenue from installation services should be recognized upon completion of the services. Revenue is recognized when the customer obtains control of the services.

Date	Description	Debit	Credit
		Rs. 000	Rs. 000
1 Apr 2024	Deferred Revenue	1,615	
	Revenue (Installation)		1,615

30 June 2024: Revenue from Hosting Services should be recognized over time i.e. over 1-year period. On 30 June 2024, revenue for three months (April to June 2024) should be recognised which amounts to Rs. 202,000 ($808,000 \times 3 \div 12$).

Date	Description	Debit	Credit
		Rs. 000	Rs. 000
30 Jun 2024	Deferred Revenue	202	
	Revenue (Hosting Services)		202

Contract 2

1 June 2024: Revenue is recognized when control of the goods transfers to the ZW. In this case, VL expects some returns, hence the refund liability is recognized which requires recognizing a refund liability for the expected returns.

Date	Description	Debit	Credit
		Rs. 000	Rs. 000
1 Jun 2024	Cash/Bank [400 x 25]	10,000	
	Refund liability [400x5%x25]		500
	Sales (balancing)		9,500

VL should recognize the cost of goods sold when revenue is recognized. The right to recover product assets is recorded for the inventory expected to be returned.

Date	Description	Debit	Credit
		Rs. 000	Rs. 000
1 Jun 2024	Cost of goods sold [380 x 18]	6,840	
	Right to recover product	360	
	Inventory 400 x 18		7,200

30 June 2024: Adjustments to the sales are made as actual returns are greater than the expected returns. Further, the payment of refunds needs to be recorded.

Date	Description	Debit	Credit
		Rs. 000	Rs. 000
30 Jun 2024	Refund liability	500	
	Sales [5 x 25]	125	
	Cash / Bank [25 x 25]		625

Upon return by ZW, the right to recover product should be transferred to Inventory. Since the actual returns (25 units) are greater than the expected returns (20 units), cost of goods sold should be reduced to increase inventory.

Date	Description	Debit	Credit
		Rs. 000	Rs. 000
30 Jun 2024	Inventory [25 x 18]	450	
	Right to recover product [20x 18]		360
	Cost of goods sold [5 x 18]		90

7. OBJECTIVE BASED Q&A

- 01.** Which of the following is not one of the 5 steps for recognizing revenue according to IFRS 15 Revenue from contracts with customers?
- (a) Identify the contract
 - (b) Assess the likelihood of economic benefits
 - (c) Determine the contract price
 - (d) Allocate the transaction price to the performance obligations in the contract.
- 02.** Whale Limited (WL) is an agent who works on behalf of Dolphin, a famous performer. WL has just collected Rs. 100 million from a promoter in terms of ticket sales for a recent show done by Dolphin. WL earns commission of 10% in relation to Dolphin's work.
- What is the correct double entry for the receipt of the Rs? 100 million?
- (a) Dr Cash Rs. 100 million
Dr Trade Receivables Rs. 10 million
Cr Trade payables Rs. 100 million
Cr Revenue Rs. 10 million
 - (b) Dr Cash Rs. 100 million
Dr COS Rs. 90 million
Cr Revenue Rs. 100 million
Cr Trade payables Rs. 90 million
 - (c) Dr COS Rs. 90 million
Dr Cash Rs. 10 million
Cr Revenue Rs. 100 million
 - (d) Dr Cash Rs. 100 million
Cr Revenue Rs. 10 million
Cr Trade payables Rs. 90 million
- 03.** Coin Limited (CL) sells a specialized piece of equipment to Orbit Limited on 1st September 20X7 for Rs. 4m. Due to the specialized nature of the equipment, CL has additionally agreed to provide a support service for the next two years. The cost per annum to CL of providing this service will be Rs. 300,000. CL usually earns a gross margin of 20% on such contracts.
- What revenue should be included in the statement of profit or loss of CL for the year ended 31 December 20X7?
- (a) Rs. 3,343,750
 - (b) Rs. 3,250,000
 - (c) Rs. 3,375,000
 - (d) Rs. 4,000,000

- 04.** River Limited (RL) has prepared its draft financial statements for the year ended 30 September 20X4. It has included the following transactions in revenue at the amounts stated below.
- Which of these has been correctly included in revenue according to IFRS 15 Revenue from Contracts with Customers?
- (a) Agency sales of Rs. 2.5 million on which RL is entitled to a commission of 10%.
 - (b) Sale proceeds of Rs. 20 million for motor vehicles which were no longer required by RL
 - (c) Sales of Rs. 15 million on 30 September 20X4. The amount invoiced to and received from the customer was Rs. 18 million, which includes Rs. 3 million for ongoing servicing work to be done by RL over the next two years.
 - (d) Sales of Rs. 20 million on 1 October 20X3 to an established customer who (with the agreement of RL) will make full payment on 30 September 20X5. RL has a cost of capital of 10%.
- 05.** Cat Limited (CL) sold and installed an item of machinery for Rs. 800,000 on 1 November 20X7. Included within the price was 2 years servicing contract which has a value of Rs. 240,000 and a fee for installation of Rs. 50,000.
- How much should be recorded in CL's revenue in its statement of profit or loss for the year ended 31 December 20X7 in relation to the machinery sale?
- (a) Rs. 530,000
 - (b) Rs. 680,000
 - (c) Rs. 560,000
 - (d) Rs. 580,000
- 06.** Sales director of a company is close to selling a machine which it sells for Rs. 650,000, offering free service, therefore selling the entire machine for Rs. 560,000 including installation. The company never sells servicing separately.
- How should this discount be applied in relation to the sale of the machinery?
- (a) Machine only
 - (b) Machine and Installation only
 - (c) Machine and Service only
 - (d) Machine, Installation and Service
- 07.** Cheetah Limited (CL) works as an agent for a number of smaller contractors, earning commission of 10%. CL's revenue includes Rs. 6 million received from clients under these agreements with Rs. 5.4 million in cost of sales representing the amount paid to the contractors.
- What adjustment needs to be made to revenue in respect of the commission sales?
- (a) Reduce revenue by Rs. 6 million
 - (b) Reduce revenue by Rs. 5.4 million
 - (c) Increase revenue by Rs. 600,000
 - (d) No adjustment is required

08. An entity regularly sells Products A, B and C individually, thereby establishing the following stand-alone selling prices:

Product	Stand-alone selling price Rs.
Product A	40
Product B	55
Product C	45

In addition, the entity regularly sells Products B and C together for Rs. 60.

The entity enters into a contract with a customer to sell Products A, B and C in exchange for Rs. 100.

Allocate the transaction price of Rs. 100 to Product A, B and C in accordance with IFRS 15

- (a) A Rs. 40 and B Rs. 55 and C Rs. 45
- (b) A Rs. 29 and B Rs. 39 and C Rs. 32
- (c) A Rs. 40 and B Rs. 33 and C Rs. 27
- (d) A Rs. 40 and B Rs. 27 and C Rs. 33

09. An entity enters into a contract with a customer to sell Products A, B and C in exchange for Rs. 100.

Product	Stand-alone selling price
Product A	50
Product B	25
Product C	75
Total	150

Allocate the transaction price of Rs. 100 to Product A, B and C in accordance with IFRS 15

- (a) A Rs. 50 and B Rs. 25 and C Rs. 75
- (b) A Rs. 33 and B Rs. 17 and C Rs. 50
- (c) A Rs. 33 and B Rs. 50 and C Rs. 17
- (d) A Rs. 17 and B Rs. 33 and C Rs. 50

10. Which of the following items has correctly been included in Hakeem Limited (HL)'s revenue for the year to 31 December 20X1?

- (a) Rs. 2 million in relation to a fee negotiated for an advertising contract for one of HL's clients. HL acted as an agent during the deal and is entitled to 10% commission.
- (b) Rs. 500,000 relating to a sale of specialized equipment on 31 December 20X1. The full sales value was Rs. 700,000 but Rs. 200,000 relates to servicing that HL will provide over the next 2 years, so HL has not included that in revenue this year.
- (c) Rs. 800,000 relating to a sale of some surplus land owned by HL.
- (d) Rs. 1 million in relation to a sale to a new customer on 31 December 20X1. Control passed to the customer on 31 December 20X1. The Rs. 1 million is payable on 31 December 20X3. Interest rates are 10%.

11. Hover Limited (HL) is a car retailer. On 1 April 20X4, HL sold a car to a customer on the following terms: The selling price of the car was Rs. 25.3 million. The customer paid Rs. 12.65 million (half of the cost) on 1 April 20X4 and will pay the remaining Rs. 12.65 million on 31 March 20X6 (two years after the sale). The customer can obtain finance at 10% per annum.

What is the total amount which HL should credit to profit or loss in respect of this transaction in the year ended 31 March 20X5?

- (a) Rs. 23.105 million
- (b) Rs. 23.000 million
- (c) Rs. 20.909 million
- (d) Rs. 24.150 million

12. Determining the amount to be recognized in the first year of a long term contract with a customer is an example of which step in the IFRS 15's 5-step model?

- (a) Determining the transaction price
- (b) Recognizing revenue when a performance obligation is satisfied
- (c) Identifying the separate performance obligations
- (d) Allocating the transaction price to the performance obligations

13. X Limited wins a competitive bid to provide consulting services to a new customer. X Limited incurred the following costs to obtain the contract:

	Rs.
Commissions to sales employees for winning the contract	10,000
External legal fees for due diligence	15,000
Travel costs to deliver proposal	25,000
Total costs incurred	50,000

How to recognize the above costs?

- (a) Capitalize Rs. Nil and expense Rs. 50,000
- (b) Capitalize Rs. 10,000 and expense Rs. 40,000
- (c) Capitalize Rs. 25,000 and expense Rs. 25,000
- (d) Capitalize Rs. 50,000 and expense Rs. Nil

14. On 1 January 20X9, an entity enters into a non-cancellable contract to transfer a product to a customer on 31 March 20X9. The contract requires the customer to pay consideration of Rs. 1,000 in advance on 31 January 20X9 but the customer pays the consideration on 1 March 20X9. The entity transfers the product on 31 March 20X9.

What journal entry is required to be passed on 31 January 20X9?

- (a) No entry is required
- (b) Debit Cash Rs. 1,000 and Credit Contract liability Rs. 1,000
- (c) Debit Receivables Rs. 1,000 and Credit Contract liability Rs. 1,000
- (d) Debit Receivables Rs. 1,000 and Credit Revenue Rs. 1,000

15. An entity enters into 100 contracts on 31 December 20X7 with customers. Each contract includes the sale of one product for Rs.100.

Cash is received when control of a product transfers. The entity's customary business practice is to allow a customer to return any unused product within 30 days and receive a full refund. The entity's cost of each product is Rs. 60.

Using the expected value method, the entity estimates that 97 products will not be returned. The entity estimates that the costs of recovering the products will be immaterial and expects that the returned products can be resold at a profit.

What should be recognized in respect of above?

- (a) Revenue Rs. Nil and Contract Liability Rs. 10,000
- (b) Revenue Rs. 300 and Contract Liability Rs. 9,700
- (c) Revenue Rs. 9,700 and Contract Liability Rs. 300
- (d) Revenue Rs. 10,000 and Contract Liability Rs. Nil

16. Mechanical Limited (ML) sells machines, and also offers installation and technical support services. The individual selling prices of each product are shown below.

Sale price of goods	Rs. 75,000
Installation	Rs. 30,000
One-year service	Rs. 45,000

ML sold a machine on 1 May 20X1, charging a reduced price of Rs. 100,000 including installation and one year's service. ML only offers discounts when customers purchase a package of products together.

According to IFRS 15 Revenue from Contracts with Customers, how much should ML record in revenue for the year ended 31 December 20X1?

- (a) Rs. 50,000
- (b) Rs. 70,000
- (c) Rs. 90,000
- (d) Rs. 100,000

17. Car Limited (CL) sold a large number of vehicles spare parts to a new customer for Rs. 10 million on 1 July 20X7. The customer paid Rs. 990,000 up front and agreed to pay the remaining balance on 1 July 20X8. CL has a cost of capital of 6%.

How much should initially be recorded in revenue in respect of the sale of vehicles spare parts in the statement of profit or loss for the year ended 31 December 20X7?

- (a) Rs. 8,500,000
- (b) Rs. 9,010,000
- (c) Rs. 9,490,000
- (d) Rs. 10,000,000

18. Golden Limited enters into a contract with a major chain of retail stores. The customer commits to buy at least Rs.20m of products over the next 12 months. The terms of the contract require Golden Limited to make a payment of Rs.1 m to compensate the customer for changes that it will need to make to its retail stores to accommodate the products.

By the 31 December 20X1, Golden Limited has transferred products with a sales value of Rs.4 m to the customer.

How much revenue should be recognized by Golden Limited in the year ended 31 December 20X1?

- (a) Rs. 4,000,000
- (b) Rs. 3,800,000
- (c) Rs. 20,000,000
- (d) Rs. 19,000,000

19. Silver Limited sells a machine and one year's free technical support for Rs. 100,000. It usually sells the machine for Rs. 95,000 but does not sell technical support for this machine as a standalone product. Other support services offered by Silver Limited attract a markup of 50%. It is expected that the technical support will cost Silver Limited Rs. 20,000.

How much of the transaction price should be allocated to the technical support?

- (a) Rs. 20,000
- (b) Rs. 24,000
- (c) Rs. 25,000
- (d) Rs. 30,000

20. Jupiter Limited (JL) entered into a two-year contract on 1 January 20X7, with a customer for the maintenance of computer network. JL has offered the following payment options:

Option 1: Immediate payment of Rs. 200,000.

Option 2: Payment of Rs. 110,000 at the end of each year.

The applicable discount rate is 6.596%.

What amount of revenue should be recognized under option 2 on 31 December 20X7?

- (a) Rs. 110,000
- (b) Rs. 90,000
- (c) Rs. 200,000
- (d) Rs. 220,000

21. A company enters into a construction contract to build a warehouse for a customer. The agreed price is Rs.20 million and the specified completion date is 31 October 20Y0. However, the contract provides that the company should receive an incentive payment of a further Rs.2.5 million if the warehouse is completed before 30 June 20Y0. Similarly, the price will be reduced by Rs. 2 million if the warehouse is not completed until after 31 December 20Y0.

The company estimates that there is a 15% probability that the warehouse will be completed before 30 June 20Y0, an 80% probability that it will be completed by 31 October 20Y0 and a 5% probability that it will not be completed until after 31 December 20Y0.

What is the expected value of the transaction price for this contract?

- (a) Rs. 20 million
- (b) Rs. 20.275 million
- (c) Rs.20.5 million
- (d) Rs.20.75 million

22. With regard to the definition of revenue given by IFRS 15, which of the following statements is true?

- (a) Revenue includes cash received from share issues
- (b) Revenue includes cash received from borrowings
- (c) Revenue may arise from either ordinary activities or extraordinary activities
- (d) Revenue arises from ordinary activities only

23. Identifying contract with customer under IFRS 15, a contract with customer exist when all the following criteria are met when;

- (a) It is approved and enforceable, can identify each party rights, payment terms, and probable to collect consideration
- (b) It is approved, can identify each party rights, payment terms, has commercial substance and probable to collect consideration
- (c) It is approved and enforceable, can identify each party rights, has commercial substance and probable to collect consideration
- (d) It is approved, can identify payment terms, has commercial substance and probable to collect consideration

24. Step 1, “identifying the contract” of IFRS 15 states that certain conditions must be satisfied before an entity can account for a contract with a customer. Which of the following is not one of these conditions?
- (a) Each party's rights with regard to the goods or services concerned can be identified
 - (b) The payment terms can be identified
 - (c) The entity and the customer have approved the contract and are committed to perform their contractual obligations
 - (d) It is certain that the entity will collect the consideration to which it is entitled
25. Step two requires the identification of the separate performance obligations in the contract. This is often referred to as unbundling and is done at beginning of a contract. What is the key factor in identifying a separate performance obligation?
- (a) The passing of the risks and rewards to the customer
 - (b) The distinctiveness of the good or service
 - (c) The identification of the payment terms
 - (d) The enforceability of the contract
26. Step three requires the entity to determine the transaction price. This is the amount of consideration that an entity expects to be entitled to in exchange for the promised goods or services. The transaction price might include variable or contingent consideration. How does the entity estimate the amount of the variable consideration?
- (a) The expected value or the most likely amount whichever best predicts the consideration
 - (b) The lower of the expected value or the most likely amount
 - (c) The choice of the expected value or the most likely amount
 - (d) The higher of the expected value or the most likely amount
27. Step 4 requires the allocation of the transaction price to separate performance obligations. The allocation is based on the relative standalone selling prices of the goods or services promised and are made at inception of the contract. It is not adjusted to reflect subsequent changes in the standalone selling prices of those goods or services. What is the best evidence of standalone selling price?
- (a) An estimate that maximizes the use of observable inputs
 - (b) The observable price of a good or service when the entity sells that good or service separately
 - (c) Unadjusted market prices for similar goods or services
 - (d) Expected cost
28. Step 5 allows an entity to recognize revenue when (or as) each performance obligation is satisfied. Revenue is recognized in line with the pattern of transfer. If an entity does not satisfy its performance obligation over time, it satisfies it at a point in time and revenue will be recognized when control is passed at that point in time. Which of the following factors may not indicate the passing of control?
- (a) The present right to payment for the asset
 - (b) The customer has legal title to the asset
 - (c) The entity has physical possession but has transferred a portion of the economic risks
 - (d) The entity has transferred physical possession of the asset

29. Which of the following is true regarding discounts offered on a bundle of products/services?
- The discount should be applied across each performance obligation in the contract
 - The discount should be recorded within cost of sales
 - The discount should be applied to the largest component of the contract
 - The discount should be recorded as an administrative cost
30. An entity can only include variable consideration in the transaction price to the extent that it is highly probable that a subsequent change in the estimated variable consideration will not result in a significant revenue reversal. What action should the entity take if it is not appropriate to include all of the variable consideration in the transaction price?
- The entity should not include any of the variable consideration
 - The entity can use its judgment in all matters such as this
 - The entity should assess whether it should include part of the variable consideration subject to the revenue reversal test
 - The entity should assess whether it should include part of the variable consideration without the need to use the revenue reversal test
31. Which one of the following condition is not allowed when performance obligation is to be satisfied over time?
- the customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs
 - the entity's performance creates or enhances an asset that the customer controls as the asset is created or enhance
 - the customer has paid the consideration in advance and goods / services are still to be received
 - the entity's performance does not create an asset with an alternative use to the entity
32. In general, contract costs incurred in relation to a contract with a customer must be:
- Recognized as an expense when incurred
 - Recognized as an asset if they relate to a performance obligation which has been satisfied
 - Recognized as an asset if they are not expected to be recovered
 - Recognized as an asset if they relate to a performance obligation which has not yet been satisfied
33. On 1 January 2022, a company entered into a non-cancellable contract with its client to implement a software by 30 June 2022. As per contract, client was required to pay 10% advance on 31 January 2022. The client paid the advance on 15 February 2022. How will company record transaction on 31 January 2022?
- | Debit | Credit |
|-------------------------|--------------------|
| (a) Accounts receivable | Contract liability |
| (b) Contract asset | Revenue |
| (c) Accounts receivable | Revenue |
| (d) No entry | |

34. Two or more contracts with the same customer can be combined as a single contract if it meets certain criteria. Which of the following is NOT the criteria as specified in IFRS 15?
- (a) The contracts are negotiated as a package with a single commercial objective
 - (b) The amount of consideration to be paid in one contract depends on the price of the other contract
 - (c) The goods are regularly sold separately and the customers generally can benefit from the goods on its own
 - (d) The goods promised in the contracts are a single performance obligation

ANSWERS

01.	(b)	Assessing the likelihood of economic benefits is not one of the five steps. It is one of the criteria for identifying the contract with customer.															
02.	(d)	As an agent, WL should only record the commission of Rs. 10 million in revenue. As the cash has been received, WL must record that in cash and create a payable for Rs. 90 million to Dolphin.															
03.	(c)	There are two performance obligations here. The sale of the equipment should be recognizing at a point in time, and the revenue in relation to the support should be recognized over time. The services element costs Rs. 300,000 a year. As CL makes a margin of 20% a year, this would be sold for Rs. 375,000 per year ($300,000 \times 100/80$). Therefore, the total revenue on the service for 2 years = Rs. $375,000 \times 2$ = Rs. 750,000. The revenue on the goods = Rs.4m – Rs. 750,000 = Rs. 3,250,000. The revenue in relation to the service is released over 2 years. By 31 December, 4 months of the service has been performed so can be recognized in revenue ($\text{Rs. } 375,000 \times 4/12 = \text{Rs. } 125,000$). Therefore, the total revenue = Rs.3,250,000 + Rs.125,000 = Rs.3,375,000															
04.	(c)	Although the invoiced amount is Rs. 18 million, out of it Rs. 3 million has not yet been earned and must be deferred until the servicing work has been completed. This is only correct inclusion in sales. Only 10% amount should have been recognised as commission revenue in option (a). Sale proceeds from disposal of non-current assets are not revenue, instead gain on disposal should have been recorded in option (b). Present value of amount should have been included in option (d).															
05.	(d)	The revenue in relation to the installation and the machine itself can be recognized, with the revenue on the service recognized over time as the service is performed. The service will be recognized over the 2-year period. By 31 December 20X7, 2 months of the service has been performed. Therefore, Rs. 20,000 can be recognized ($\text{Rs. } 240,000 \times 2/24$). Total revenue is therefore Rs. 580,000, being the Rs. 800,000 less the Rs. 220,000 relating to the service which has not yet been recognized.															
06.	(d)	Discounts should be applied evenly across the components of a sale unless any one element is regularly sold separately at a discount. As entity does not sell the service and installation separately, the discount must be applied evenly to each of the three elements.															
07.	(b)	Revenue as an agent is made by earning commission. Therefore, the revenue on these sales should only be Rs. 600,000 (10% of Rs. 6 million). As CL currently has Rs. 6 million in revenue, Rs. 5.4 million needs to be removed, with Rs. 5.4 million also removed from cost of sales.															
08.	(c)	<table border="1"> <thead> <tr> <th>Product</th><th>Allocated price</th><th></th></tr> </thead> <tbody> <tr> <td>Product A</td><td>40</td><td>Remaining amount</td></tr> <tr> <td>Product B</td><td>33</td><td>($55/100 \times \text{Rs. } 60$)</td></tr> <tr> <td>Product C</td><td>27</td><td>($45/100 \times \text{Rs. } 60$)</td></tr> <tr> <td>Total</td><td>100</td><td></td></tr> </tbody> </table> The entire discount relates to Product B and C as when Product A is added its total stand-alone price has been added in the package price.	Product	Allocated price		Product A	40	Remaining amount	Product B	33	($55/100 \times \text{Rs. } 60$)	Product C	27	($45/100 \times \text{Rs. } 60$)	Total	100	
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Total	100																

09.	(b)	Product	Allocated price	
		Product A	33	(Rs. 50 / Rs. 150 × Rs. 100)
		Product B	17	(Rs. 25 / Rs. 150 × Rs. 100)
		Product C	50	(Rs. 75 / Rs. 150 × Rs. 100)
		Total	100	
10.	(b)	For item (b) the sale of the goods has fulfilled a contractual obligation so the revenue in relation to this can be recognized. The service will be recognized over time, so the revenue should be deferred and recognized as the obligation is fulfilled. For item (a) HL acts as an agent, so only the commission should be included in revenue. For item (c) any profit or loss on disposal should be taken to the statement of profit or loss. The proceeds should not be included within revenue. For item (d) the Rs. 1 million should be initially discounted to present value as there is a significant financing component within the transaction. The revenue would initially be recognized at Rs. 826,000, with an equivalent receivable. This receivable would then be held at amortized cost with finance income of 10% being earned each year.		
11.	(d)	At 31 March 20X5, the deferred consideration of Rs. 12.65 million would need to be discounted by 10% for one year to Rs. 11.5 million (effectively deferring a finance cost of Rs. 1.15 million). The total amount credited to profit or loss would be Rs. 24.15 million (12.65 million + 11.5 million).		
12.	(b)	Recognizing revenue when a performance obligation is satisfied, it may be a point in time or over time.		
13.	(b)	The commission to sales employees is incremental to obtaining the contract and should be capitalized as a contract asset. The external legal fees and the travelling cost are not incremental to obtaining the contract because they have been incurred regardless of whether X Limited obtained the contract or not.		
14.	(c)	The receivable is recorded when unconditional right to receive payment is established and as entity has not performed its performance obligation yet; a contract liability shall be recognized.		
15.	(c)	Revenue Rs. 9,700 (97 × Rs. 100 for products expected to be not returned) and remaining as contract liability.		
16.	(c)	The discount should be allocated to each part of the bundled sale. Applying the discount across each part gives revenue as follows: (Rs. 000) Goods Rs. 50 (Rs. 75 × Rs. 100/Rs. 150) Installation Rs. 20 (Rs. 30 × Rs. 100/Rs. 150) Service Rs. 30 (Rs. 45 × Rs. 100/Rs. 150) The revenue in relation to the goods and installation should be recognized on 1 May 2011. As 8 months of the service has been performed (from 1 May to 31 December 2011), then Rs. 20 should be recognized (Rs. 30 × 8/12). This gives a total revenue for the year of 50 + 20 + 20 = Rs. 90.		

17.	(c)	The fact that CL has given the customer a year to pay on such a large amount suggests there is a significant financing component within the sale. The Rs. 990,000 received can be recognized in revenue immediately. The remaining Rs. 9.01 million must be discounted to its present value of Rs. 8.5 million. This is then unwound over the year, with the interest recognized as finance income. Therefore, total initial revenue = Rs. 990,000 + Rs. 8,500,000 = Rs. 9,490,000.
18.	(b)	The payment made to the customer is not in exchange for a distinct good or service. Therefore, the Rs.1m paid to the customer is a reduction of the transaction price. The total transaction price is being reduced by 5% (Rs.1m/Rs.20m). Therefore, Golden Limited reduces the transaction price of each good by 5% as it is transferred. By 31 December 2011, Golden Limited should have recognized revenue of Rs.3.8m (Rs.4m × 95%).
19.	(b)	The selling price of the service would be Rs. 30,000 (Rs. 20,000 × 150%). The total standalone selling prices of the machine and support are Rs. 125,000 (Rs. 95,000 + Rs. 30,000). The transaction price allocated to the machine is Rs. 76,000 (Rs. 95,000 × 100,000 / 125,000). The transaction price allocated to the technical support is Rs.24, 000 (Rs.30, 000 × 100,000 / 125,000).
20.	(a)	No need to calculate present value under option 2 as cash is being received exactly when performance obligation is being satisfied.
21.	(b)	$(20 \times 80\%) + (22.5 \times 15\%) + (18 \times 5\%) = \text{Rs. } 20.275 \text{ million}$
22.	(d)	Revenue arises from ordinary course of business activities.
23.	(b)	The enforceability condition is primary requirement for an agreement to be contract. The five criteria are as mentioned in option (b).
24.	(d)	The requirement is “probable” not “certain”.
25.	(b)	The goods or services must be distinct in order to be identified as separate performance obligations.
26.	(a)	The entity needs to apply judgement as to which method best predicts the consideration.
27.	(b)	Other options may be used when observable price is not available.
28.	(c)	Not “portion” but significant risks and rewards must have been transferred.
29.	(a)s	The discount must be applied to all performance obligation unless it specifically relates to one or more of the specific performance obligations.
30.	(c)	It must be highly probable that inclusion of variable consideration will not result in a significant revenue reversal in the future when the uncertainty has been subsequently resolved.
31.	(c)	The customer has paid the consideration in advance and goods / services are still to be received

32.	(d)	Recognized as an asset if they relate to a performance obligation which has not yet been satisfied.
33.	(a)	Debit Accounts receivable Credit Contract liability
34.	(c)	The goods are regularly sold separately and the customers generally can benefit from the goods on its own

STICKY NOTES

STEP 1 - IDENTIFYING THE CONTRACT WITH CUSTOMER

- Contract must have following attributes:
- Contract is approved by the parties to contract,
- identify each party's rights,
- identify payment terms,
- has commercial substance,
- collection of consideration is probable

STEP 2 - IDENTIFYING PERFORMANCE OBLIGATIONS

A performance obligation is a promise by an entity to transfer goods or services to the customer, there may be more than one performance obligations in a contract and each of such promises must be identified.

STEP 3 - DETERMINING THE TRANSACTION PRICE

Transaction price is a consideration to which an entity expects to be entitled in exchange for transferring goods or services to a customer. A consideration may be fixed, variable or both. Following must be considered while determining transaction price:

- Variable consideration
- Constraining estimates of variable consideration
- Significant financing component
- Non-cash consideration
- Consideration payable to a customer

STEP 4 - ALLOCATING THE TRANSACTION PRICE TO PERFORMANCE OBLIGATIONS

In case of more than one performance obligations, transaction price should be allocated to each performance obligations (or distinct goods or services) based on the stand-alone selling prices. Except when an entity has observable evidence that the entire discount relates to only one or more, but not all, performance obligations in a contract, the entity shall allocate a discount proportionately to all performance obligations in the contract.

STEP 5 - RECOGNIZING REVENUE UPON SATISFACTION OF PERFORMANCE OBLIGATIONS

- Once performance obligations are satisfied, revenue shall be recognized.
- Performance obligation could be satisfied over time or at a point in time.

IFRS 8 OPERATING SEGMENTS

IN THIS CHAPTER:

AT A GLANCE

SPOTLIGHT

1. Operating segments
2. Reportable segments
3. Disclosure
4. Comprehensive Examples
5. Objective Based Q&A

STICKY NOTES

AT A GLANCE

Many entities operate in several different industries (or 'product markets') or diversify their operations across several geographical locations. A consequence of diversification is that companies are exposed to different rates of profitability, different growth prospects and different amounts of risk for each separate 'segment' of their operations.

IFRS 8 requires quoted companies to disclose information about their different operating segments, in order to allow users of the financial statements to gain a better understanding of the entity's financial position and performance.

Users are able to use the information about the main segments of the entity's operations to carry out ratio analysis, identify trends and make predictions about the future. Without segment information, good performance in some segments may 'hide' very poor performance in another segment, and the user of the financial statements will not see the true position of the entity.

The standard requires a segment to have its results reviewed by the chief operating decision maker. The reason for this part of the definition of an operating segment is to ensure that an entity reports segments that are used by management of the entity to monitor the business.

Operating segments may be combined if they share similar economic characteristics and meet the aggregation criteria.

An entity is required to identify reportable segments using 10% threshold, usefulness, continuing significance and 75% external revenue criteria and provide disclosures for those segments.

IFRS 8 also requires reconciliation of reportable segments' information to whole entity's financial statements. Certain entity wide disclosure are also required by IFRS 8.

1. OPERATING SEGMENTS

1.1 Usefulness of segmental information

Many entities carry out several classes of business and operate in a number of countries across the world. Each of these businesses and geographical segments carries with it different opportunities for growth, different rates of profit and varying degrees of risk.

Some business segments may be strongly influenced by the health of the economy whereas other segments may be unaffected by recession. One country may be experiencing growth; another country may be less stable because of political events.

Awareness of these cultural and environmental differences is important to investors in order to allow them to fully understand the performance and position of the entity over the past, its prospects for the future and the risks that it faces.

IFRS 8 requires that segmental information should be provided to enable investors to understand the impact that the different segments of a business may have on the business as a whole. If the user of financial statements is only provided with figures for the entity as a whole, this might hide the risks and problems or profits and opportunities of the underlying business segments.

The disaggregated financial information provided by segmental reporting allows for analytical review on a segment by segment basis which will provide greater understanding of the entity's position and performance and allow a better assessment of its future.

1.2 Scope [IFRS 8: 2 to 4]

IFRS 8 applies to entities whose debt or equity instruments are traded in a public market (e.g. stock exchange), and also to entities that are in process of becoming quoted.

When a parent entity presents both the consolidated financial statements as well as the parent's separate financial statements, segment information is required only in the consolidated financial statements.

1.3 What is an operating segment? [IFRS 8: 5 to 7]

An operating segment is a component of an entity:

- that engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same entity),
- whose operating results are regularly reviewed by the entity's chief operating decision maker (CODM) to make decisions about resources to be allocated to the segment and assess its performance, and
- for which discrete financial information is available.

An operating segment may engage in business activities for which it has yet to earn revenues, for example, start-up operations may be operating segments before earning revenues.

Not every part of an entity is necessarily an operating segment or part of an operating segment. For example, a corporate headquarters or some functional departments may not earn revenues or may earn revenues that are only incidental to the activities of the entity and would not be operating segments.

The term CODM identifies a function, not necessarily a manager with a specific title. That function is to allocate resources to and assess the performance of the operating segments of an entity. Often the CODM of an entity is its chief executive officer, or chief operating officer but, for example, it may be a group of executive directors or others.

1.4 Identifying operating segments [IFRS 8: 8 to 10 & 12]

For many entities, the three characteristics of operating segments clearly identify its operating segments. However, an entity may produce reports in which its business activities are presented in a variety of ways. If the CODM uses more than one set of segment information, other factors may identify a single set of components as constituting an entity's operating segments, including:

- the nature of the business activities of each component,
- the existence of managers responsible for them, and
- information presented to the board of directors.

1.4.1 Existence of segment managers

Generally, an operating segment has a segment manager who is directly accountable to and maintains regular contact with the CODM to discuss operating activities, financial results, forecasts, or plans for the segment.

The term 'segment manager' identifies a function, not necessarily a manager with a specific title. The CODM also may be the segment manager for some operating segments and a single manager may be the segment manager for more than one operating segment.

If the characteristics (of definition of operating segment) apply to more than one set of components of an organisation but there is only one set for which segment managers are held responsible, that set of components constitutes the operating segments.

1.4.2 Matrix Structures

The characteristics (of definition of operating segment) may apply to two or more overlapping sets of components for which managers are held responsible. That structure is sometimes referred to as a matrix form of organisation.

For example, in some entities, some managers are responsible for different product and service lines worldwide, whereas other managers are responsible for specific geographical areas. It is likely that the CODM regularly reviews the operating results of both sets of components, and financial information is available for both. In that situation, the entity shall determine which set of components constitutes the operating segments by reference to the core principle i.e. to enable users of its financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates.

1.5 Aggregation

Operating segments often exhibit similar long-term financial performance if they have similar economic characteristics. For example, similar long-term average gross margins for two operating segments would be expected if their economic characteristics were similar.

Two or more operating segments may be aggregated into a single operating segment if aggregation is consistent with the core principle of this IFRS, the segments have similar economic characteristics, and the segments are similar in each of the following respects:

- the nature of the products and services;
- the nature of the production processes;
- the type or class of customer for their products and services;
- the methods used to distribute their products or provide their services; and
- if applicable, the nature of the regulatory environment, for example, banking, insurance or public utilities.

► *Example 01:*

For enterprises that are engaged in different businesses with differing risks and opportunities, the usefulness of financial information concerning these enterprises is greatly enhanced if it is supplemented by information on individual business segments.

Required:

- (i) Explain why the information content of financial statements is improved by the inclusion of segmental data on individual business segments.
- (ii) Discuss how IFRS 8 requires that segments be analysed.

► *ANSWER:***Usefulness of segmental data**

Many entities carry out several classes of business and operate in a number of countries across the world. Each of these businesses and geographical segments carries with it different opportunities for growth, different rates of profit and varying degrees of risk. Some business segments may be strongly influenced by the health of the economy whereas other segments may be unaffected by recession. One country may be experiencing growth; another country may be less stable because of political events. Awareness of these cultural and environmental differences is important to investors in order to allow them to fully understand the performance and position of the entity over the past, its prospects for the future and the risks that it faces.

IFRS 8 requires that segmental information should be provided to enable investors to understand the impact that the different segments of a business may have on the business as a whole. If the user of financial statements is only provided with figures for the entity as a whole, this might hide the risks and problems or profits and opportunities of the underlying business segments. The disaggregated financial information provided by segmental reporting allows for analytical review on a segment by segment basis which will provide greater understanding of the entity's position and performance and allow a better assessment of its future.

Analysing segments

IFRS 8 defines an operating segment as a component of an entity that engages in business activities from which it may earn revenues and incur expenses, whose operating results are reviewed regularly by the chief operating decision maker in the entity and for which discrete financial information is available.

Not every part of a business is necessarily an operating segment or part of an operating segment. Head office is an example since head office does not usually earn revenues. Generally an operating segment has a segment manager who is directly accountable to and maintains regular contact with the chief operating decision-maker, to discuss the performance of the segment.

IFRS 8 requires that entities should report information about each operating segment that is identified and that exceeds certain quantitative thresholds for size of revenue, operating profit or loss or assets. Financial information about operating segments with similar characteristics can be aggregated.

IFRS 8 sets out the information about each reportable operating segment that should be disclosed, including total assets, profit or loss, revenue from external customers, revenue from sales to other segments, interest income and expense, depreciation, material items of income or expense and tax. The amount reported for each item should be the same measure that is reported for the segment to the chief operating decision maker of the entity.

IFRS 8 applies to quoted companies only.

2. REPORTABLE SEGMENTS

2.1 Reportable Segments [IFRS 8: 11, 13 to 15, 17 & 19]

An entity is required to report separate information about each reportable segment.

A segment is reportable segment if:

- a) It has been identified as operating segment (definition) or results from aggregating two or more of those segments; and
- b) exceeds the 10% quantitative thresholds.

IFRS 8 also specify other situations in which separate information about an operating segment shall be reported.

10% quantitative threshold	An entity shall report separately information about an operating segment that meets any of the following quantitative thresholds: a) Its reported revenue (external + inter-segment) is 10% or more of the combined revenue (internal and external) of all operating segments. b) The absolute amount of its reported profit or loss is 10% or more of the greater, in absolute amount, of i. the combined reported profit of all operating segments that did not report a loss; and ii. the combined reported loss of all operating segments that reported a loss. c) Its assets are 10% or more of the combined assets of all operating segments.
Usefulness criteria	Operating segments that do not meet any of the 10% quantitative thresholds may be considered reportable, and separately disclosed, if management believes that information about the segment would be useful to users of the financial statements.
Combining information	An entity may combine information about operating segments that do not meet the quantitative thresholds individually to produce a reportable segment only if the operating segments have similar economic characteristics and share a majority of the aggregation criteria.
Continuing significance	If management judges that a reportable segment in the immediately preceding period is of continuing significance, information about that segment shall continue to be reported separately in the current period even if it no longer meets the 10% threshold.
75% external revenue threshold	If the total external revenue reported by operating segments constitutes less than 75% of the entity's revenue, additional operating segments shall be identified as reportable segments (even if they do not meet 10% threshold) until at least 75% of the entity's revenue is included in reportable segments.
Practical limit	There may be a practical limit to the number of reportable segments that an entity separately discloses beyond which segment information may become too detailed. Although no precise limit has been determined, as the number of segments that are reportable increases above 10, the entity should consider whether a practical limit has been reached.

► *Example 02:*

The following information relates to a quoted company with five divisions of operation:

	Profit	Loss
	Rs. million	Rs. million
Division 1	10	-
Division 2	25	-
Division 3	-	40
Division 4	35	-
Division 5	40	-
	110	40

Required: Which of the divisions are reportable segments under IFRS 8 Operating segments?

► *ANSWER:*

Since Profit figure is higher, we will take 10% of that amount.

	Profit	Loss	Reportable segment (results > Rs. 11m)
	Rs. million	Rs. million	
Division 1	10	-	No
Division 2	25	-	Yes
Division 3	-	40	Yes
Division 4	35	-	Yes
Division 5	40	-	Yes
	110	40	
Greater of the two	110		
Materiality threshold (10%)	11		

Note: Division 3 is reportable as the loss of Rs. 40m is greater than Rs. 11m (ignoring the sign).

► *Example 03:*

The following information relates to Oakwood, a quoted company with five divisions of operation:

	Wood sales	Furniture sales	Veneer sales	Waste sales	Other sales	Total
	Rs. million					
Revenue from external customers	220	256	62	55	57	650
Inter segment revenue	38	2	-	5	3	48
Reported profit	54	45	12	9	10	130
Total assets	4,900	4,100	200	400	600	10,200

Required: Which of the business divisions are reportable segments under IFRS 8 Operating segments, also illustrate the criteria for segments to be classified as reportable segments?

► **ANSWER:**

IFRS 8 states that a segment is reportable if it meets any of the following criteria:

1. its internal and external revenue is more than 10% of the total entity internal and external revenue.
2. its reported profit is 10% or more of the greater of the combined profit of all segments that did not report a loss.
3. its assets are 10% or more of the combined assets of all operating segments.

Thresholds	Rs. m
10% of combined revenue [698 x 10%]	69.8
10% of (greater) profit or loss [130 x 10%]	13
10% of total assets [10,200 x 10%]	1,020

Segment	Reportable?	Reason	% of external revenue
Wood	Yes	All three criteria	34%
Furniture	Yes	All three criteria	39%
Veneer	No	None of criteria	-
Waste	No	None of criteria	-
Other	No	None of criteria	-
		Total	73%
Veneer	Yes	75% criteria	10%
			83%

From the table above, only the Wood and Furniture department sales have more than 10% of revenue, assets and profit and meet the requirements for an operating segment. The other three divisions do not meet the criteria: none of them pass the 10% test for assets, profit or revenue.

Additionally, IFRS 8 states that if total external revenue reported by operating segments constitutes less than 75% of the entity's revenue then additional operating segments must be identified as reporting segments, until 75% of revenue is included in reportable segments

The total external revenue of Wood and Furniture is Rs.476m and the total entity revenue is Rs.650m, which means that the revenue covered by reporting these two segments is only 73%. This does not meet the criteria so we must add another operating segment to be able to report on 75% of revenue. It doesn't matter that any of the other entities do not meet the original segment criteria.

In this case, we can add on any of the other segments to achieve the 75% target. If we add in Veneer sales, this gives total sales of Rs.538m, which is 83% of the sales revenue of Rs.650m. This is satisfactory for the segmental report.

2.2 Comparative information [IFRS 8: 18]

Segment data for a prior period presented for comparative purposes shall be restated to reflect the newly reportable segment as a separate segment, even if that segment did not satisfy the criteria for reportability in the prior period, unless the necessary information is not available and the cost to develop it would be excessive.

2.3 All Other Segments [IFRS 8: 16]

Information about other business activities and operating segments that are not reportable shall be combined and disclosed in an 'all other segments' category separately from other reconciling items in the reconciliations required by disclosure under IFRS 8.

The sources of the revenue included in the 'all other segments' category shall be described.

3 DISCLOSURE

3.1 Disclosure requirements [IFRS 8: 20 to 24 & 28]

An entity shall disclose information to enable users of its financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates.

3.1.1 General information

The entity shall disclose:

- factors used to identify the entity's reportable segments.
- the judgements made by management in applying the aggregation criteria.
- types of products and services.

3.1.2 Segment information of reportable segments

An entity shall disclose the following for each period for which a statement of comprehensive income is presented:

- reported segment profit or loss, including specified revenues and expenses included in reported segment profit or loss;
- segment assets and liabilities (if such amounts are regularly reported to CODM);
- the basis of measurement.

3.1.3 Reconciliation

A reconciliations of the totals of following items to corresponding entity amounts:

- segment revenues;
- reported segment profit or loss,;
- segment assets;
- segment liabilities; and
- other material segment items.

All material reconciling items shall be separately identified and described (e.g. two adjustments arising from use of two different sets of accounting policies).

Reconciliations of the SFP amounts are required for each date at which a SFP is presented. Information for prior periods shall be restated as described in IFRS 8.

3.1.4 Additional information

An entity shall also disclose the following about each reportable segment if the specified amounts are included in the measure of segment profit or loss reviewed by the CODM, or are otherwise regularly provided to the CODM, even if not included in that measure of segment profit or loss:

- revenues from external customers;
- revenues from transactions with other operating segments of the same entity;
- interest revenue;
- interest expense;
- depreciation and amortisation;
- material items of income and expense;
- the entity's interest in the profit or loss of associates and joint ventures accounted for by the equity method;
- income tax expense or income; and
- material non-cash items other than depreciation and amortisation.

An entity shall disclose the following about each reportable segment if the specified amounts are included in the measure of segment assets reviewed by the CODM or are otherwise regularly provided to the CODM, even if not included in the measure of segment assets:

- the amount of investment in associates and joint ventures accounted for by the equity method, and
- the amounts of additions to non-current assets (other than financial instruments, deferred tax assets, net defined benefit assets and rights arising under insurance contracts).

3.2 Entity wide disclosure [IFRS 8: 31 to 34]

These disclosures apply to all entities subject to IFRS 8 including those entities that have a single reportable segment:

- Revenues from external customers for each product and service, or each group of similar products and services.
- Revenues from external customers attributed to the entity's country of domicile and attributed to all foreign countries from which the entity derives revenues. Revenues from external customers attributed to an individual foreign country, if material.
- Non-current assets located in the entity's country of domicile and in all foreign countries in which the entity holds assets. Non-current assets in an individual foreign country, if material.
- Extent of reliance on major customers, including details if any customer's revenue is greater than 10% of the entity's revenue.

3.3 Measurement of items reported in segmental information [IFRS 8: 25 to 27]

The amount of each segment item reported shall be the same measure as reported to the CODM for the purposes of making decisions about allocating resources to the segment and assessing its performance. In case multiple measures are reported, use the measure most consistent with the entity's financial statements.

An entity shall provide an explanation of the measurements of segment profit or loss, segment assets and segment liabilities for each reportable segment. At a minimum, an entity shall disclose the following:

- the basis of accounting for any transactions between reportable segments.
- the nature of any differences between the measurements of following items (if not apparent from reconciliation):
 - Profit or loss (e.g. accounting policies or allocation of centrally incurred costs);
 - Assets (e.g. accounting policies or allocation of jointly used assets)
 - Liabilities (e.g. accounting policies or allocation of jointly utilised liabilities)
- the nature of any changes from prior periods in the measurement methods used to determine reported segment profit or loss and the effect, if any, of those changes on the measure of segment profit or loss.

► Example 04:

Gohar Limited (GL), a listed company, is engaged in chemicals, soda ash, polyester, paints and pharma businesses. Results of each business segment for the year ended 31 March 2015 are as follows:

Business Segments	Sales	Gross profit	Operating expenses	Assets	Liabilities
	----- Rs. in million -----				
Chemicals	1,790	1,101	63	637	442
Soda Ash	216	117	57	444	355
Polyester	227	48	23	115	94
Paints	247	26	16	127	108
Pharma	252	31	12	132	98

Inter-segment sale by Chemicals to Polyester and Soda Ash is Rs. 28 million and Rs. 10 million respectively at a contribution margin of 30%.

Operating expenses include GL's head office expenses amounting to Rs. 75 million which have not been allocated to any segment. Furthermore, assets and liabilities amounting to Rs. 150 million and Rs. 27 million have not been reported in the assets and liabilities of any segment.

Required: In accordance with the requirements of International Financial Reporting Standards:

- determine the reportable segments of Gohar Limited;
- show how these reportable segments and the necessary reconciliation would be disclosed in GL's financial statements for the year ended 31 March 2015

► **ANSWER:**

(a) Determination of reportable segments	Chemicals	Soda Ash	Polyester	Paint	Pharma	Total
	----- Rs. in million -----					
Sales	1,790	216	227	247	252	2,732
Less: Inter-segment sales	(38)	-	-	-	-	(38)
Sales to external customers	1,752	216	227	247	252	2,694
Gross profit	1,101	117	48	26	31	1,323
Operating expenses	(63)	(57)	(23)	(16)	(12)	(171)
Profit before tax	1,038	60	25	10	19	1,152
Assets	637	444	115	127	132	1,455

Reportable segment	Basis	External Revenue
Chemicals	10% threshold of revenue, assets and profit	65.03%
Soda Ash	10% threshold of assets	8.02%
		73.05%
Pharma	Highest in terms of sales (for 75% criteria)	9.35%
		82.40%

b) Disclosure in the financial statements of Gohar Limited

34- OPERATING SEGMENT RESULTS

	Chemicals	Soda Ash	Pharma	a	Total
	----- Rs. in million -----				
Revenue from external customers	1,752	216	252	474	2,694
Inter segment revenue	38	-	-	-	38
Revenue from reportable segment	1,790	216	252		2,732
Other material information					
Operating expenses	63	57	12	39	171
Segment profit before tax	1,038	60	19	35	1,152
Segment assets	637	444	132	242	1,455
Segment liabilities	442	355	98	202	1,097

34.1 - Reconciliation of reportable segment revenues, profit or loss, assets and liabilities

	Reportable segment total	Other than reportable segment total	Elimination of inter-segment transactions	Other adjustments	Gohar Limited's total
	----- Rs. in million -----				
Revenues	2,258	474	(38)	-	2,694
Operating expenses	132	39	-	75	246
Segment profit before tax	1,117	35	(11)	(75)	1,066
Segment assets	1,213	242	-	150	1,605
Segment liabilities	895	202	-	27	1,124

The reconciling items represents amounts related to corporate headquarter which are not included in segment information.

4 COMPREHENSIVE EXAMPLES

► Example 05:

Shahzad Industries Limited has recently acquired four large subsidiaries. These subsidiaries manufacture products which are of different lines from those of the parent company. The parent company manufactures plastics and related products whereas the subsidiaries manufacture the following:

	Product	Location
Subsidiary 1	Textiles	Karachi
Subsidiary 2	Car products	Lahore
Subsidiary 3	Fashion garments	Peshawar
Subsidiary 4	Furniture items	Multan

The directors have purchased these subsidiaries in order to diversify their product base but do not have any knowledge of the information required in the financial statements regarding these subsidiaries other than the statutory requirements.

Required:

- Explain to the directors the purpose of segmental reporting of financial information.
- Explain to the directors the criteria which should be used to identify the separate reportable segments. (You should illustrate your answer by reference to the above information)
- Critically evaluate IFRS 8, Operating segments, setting out any problems with the standard

► ANSWER:

Part (a)

The purposes of segmental information are:

- to provide users of financial statements with sufficient details for them to be able to appreciate the different rates of profitability, different opportunities for growth and different degrees of risk that apply to an entity's classes of business and various geographical locations.
- to appreciate more thoroughly the results and financial position of the entity by permitting a better understanding of the entity's past performance and thus a better assessment of its future prospects.
- to create awareness of the impact that changes in significant components of a business may have on the business as a whole.

Part (b)

IFRS 8 defines an operating segment as a component of an entity:

- that engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same entity).
- whose operating results are regularly reviewed by the entity's chief operating decision-maker to make decisions about resources to be allocated to the segment and assess its performance.
- for which discrete financial information is available.

In order to identify the separate reportable segments, the following criteria should be adopted:

- The reported revenue of the segment in Shahzad Industries Ltd, including both sales to external customers and inter-segment sales, is ten percent or more of the combined revenue of its four operating segments.
- The Assets of the segment in Shahzad Industries Ltd are ten percent or more of the combined assets of its four operating segments.

- (iii) The reported profit or loss of the segment in Shahzad Industries Ltd should be ten percent or more of the greater, in absolute amount, of:
- the combined reported profit of all its operating segments that did not report a loss and
 - the combined reported loss of all operating segments that reported losses.

Part (c)

IFRS 8 lays down some very broad and inclusive criteria for reporting segments. Unlike earlier attempts to define segments in more quantitative terms, segments are defined largely in terms of the breakdown and analysis used by management. This is, potentially, a very powerful method of ensuring that preparers provide useful segmental information.

There will still be problems in deciding which segments to report, if only because management may still attempt to reduce the amount of commercially sensitive information that they produce.

The growing use of executive information systems and data management within businesses makes it easier to generate reports on an ad hoc basis. It would be relatively easy to provide management with a very basic set of internal reports and analyses and leave the individual managers to prepare their own more detailed information using the interrogation software provided by the system.

If such analyses become routine then they would be reportable under IFRS 8, but that would be very difficult to check and audit.

There are problems in the measurement of segmental performance if the segments trade with each other. Disclosure of details of inter-segment pricing policy is often considered to be detrimental to the good of a company. There is little guidance on the policy for transfer pricing.

Different internal reporting structures could lead to inconsistent and incompatible segmental reports, even from companies in the same industry.

► Example 06:

Jay Limited is an integrated manufacturing company with five operating segments. Following information pertains to the year ended 31 March 2012:

Operating Segments	Internal revenue	External Revenue	Total revenue	Profit / (loss)	Assets	Liabilities
-----Rs. in million-----						
A	38	705	743	194	200	130
B	-	82	82	(22)	44	40
C	-	300	300	81	206	125
D	35	-	35	10	75	60
E	38	90	128	(63)	50	25
Total	111	1,177	1,288	200	575	380

Required: In respect of each operating segment explain whether it is a reportable segment.

► ANSWER:

As Jay Limited has both profit and loss making segments, the result of those in profit and those in loss must be totalled to see which is the greater:

	Rs. million
Profits (194+81+10)	285
Losses (22+63)	(85)
	200

So the 10% of profit or loss test must be applied by reference to Rs. 285 million.

Segment	Reportable (Yes / No)	Explanation
A	Yes	Because it generates more than 10% of revenue.
B	No	Because it fails to meet any of the criteria specified in IFRS-8
C	Yes	Because it generates more than 10% of revenue.
D	Yes	Because it has more than 10% of assets.
E	Yes	Because its losses are more than 10% of absolute profit.

Check that 75% test is satisfied: $(705+300+90)/1,177 = 93\%$

► **Example 07:**

Diamond Limited, a listed company, has six operating segments. These segments do not have similar economic characteristics. Following segment wise information is available:

Segments	Revenue			Profit/(loss)	Total assets
	External	Inter-segment	Total		
	-----Rs. in '000 -----				
A	-	24,000	24,000	(1,800)	5,400
B	184,000	8,000	192,000	(12,000)	48,000
C	22,000	4,500	26,500	19,000	4,500
D	24,000	-	24,000	(23,200)	6,000
E	23,000	-	23,000	2,300	6,500
F	25,000	3,000	28,000	2,900	18,000
	278,000	39,500	317,500	(12,800)	88,400

Required:

Identify the reportable segments under IFRSs along with brief justification.

► **ANSWER:**

Quantitative thresholds for reportable segments:			
	Total	10%	
Revenue	317,500	31,750	
Absolute profit	*37,000	3,700	
Assets	88,400	8,840	
*Higher of total profit i.e. 24,200 or total loss i.e. 37,000			

Segment	Reportable	Explanation
A	No	Because it fails to meet any of the criteria specified in IFRS-8
B	Yes	Because it meets all of the criteria specified in IFRS-8
C	Yes	Because its profit of Rs. 19,000 is greater than Rs. 3,700
D	Yes	Because its loss of Rs. 23,200 is greater than Rs. 3,700
E	No	Because it fails to meet any of the criteria specified in IFRS-8
F	Yes	Because its assets of Rs. 18,000 are greater than Rs. 8,840
Check that 75% test is satisfied: $(184,000+22,000+24,000+25,000) \div 278,000 = 91\%$		

► **Example 08:**

Roshni Limited (RL) is a listed company and is engaged in manufacturing of textile products. RL generates 30% of its revenue from exports to Middle East, out of which 60% are made to only one customer i.e. Hakeem Limited. RL has various operating segments. Apart from external sales, some of these segments make internal sales as well.

Following amounts have been extracted from RL's draft financial statements for the year ended 30 June 2020:

	Rs. in million
Revenue	2,530
Operating expenses	(2,050)
Profit before tax	455
Total assets	1,600
Total liabilities	980

Detailed financial information is reported internally to the chief operating decision maker of each segment. However, following disclosure on operating segments is prepared for inclusion in notes to the financial statements for the year ended 30 June 2020:

	Spinning	Weaving	Others	Total
	----- Rs. in million -----			
External revenue	1,010	560	960	2,530
Operating expenses	(760)	(460)	(830)	(2,050)
Net interest	(43)	18	-	(25)
Profit before tax	207	118	130	455
Assets	700	350	490	1,540

Required:

Prepare list of errors and omissions in the above disclosure. (Redrafting of disclosure is not required)

► **ANSWER:****List of errors/omissions**

- Revenue from transactions with other operating segments have not been disclosed separately.
- Revenue from reportable segments is comprised of 62% of total revenue against the requirement of 75% so another segment needs to be disclosed separately.
- Interest income of spinning and weavings segments are reported on net basis. Rather, interest income and expense needs to be disclosed separately.
- Total assets in disclosure does not match with total assets reported in financial statements.
- Segment wise liabilities have not been disclosed.
- Since export represents 30% of sales, geographical segment should also be disclosed.
- Sales to HL consist of 18% of total sales so it should also be disclosed separately.
- Depreciation and amortization should also be disclosed.
- Income tax expense should also be disclosed.
- Material items of income and expense should also be disclosed.

5 OBJECTIVE BASED Q&A

- 01.** Operating segment information should:
- (i) increase the number of reported segments and provide more information
 - (ii) enable users to see an entity through the eyes of management
 - (iii) enable an entity to provide timely segment information for external interim reporting with relatively low incremental cost
 - (iv) enhance consistency with the management discussion and analysis or other annual report disclosures
 - (v) provide various measures of segment performance
 - (vi) provide information about reduced staff
- (a)** (i) to (iii) only
(b) (i) to (vi) all
(c) (i) to (iv) only
(d) (i) to (v) only
- 02.** An operating segment is a component of an entity:
- (i) that engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same entity)
 - (ii) whose operating results are regularly reviewed by the entity's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance
 - (iii) for which discrete financial information is available
 - (iv) which is taxed separately from other components
- (a)** (i) to (ii) only
(b) (i) to (iii) only
(c) (i) to (iv) all
(d) (i), (ii) and (iv)
- 03.** A component of an entity that sells primarily or exclusively to other operating segments of the entity.
- (a)** It must be classed as an operating segment
(b) It must be excluded from being an operating segment
(c) It is included as an operating segment if the entity is managed that way
(d) It is included as an operating segment if the management so desires
- 04.** IFRS 8 shall apply to
- (i) listed companies
 - (ii) any company reporting under IFRS that wishes to provide the information
 - (iii) all other companies reporting under IFRS
- (a)** (i) to (ii) only
(b) (i) to (iii) all
(c) (i) only
(d) (ii) only

05. An operating segment may engage in business activities for which it has yet to earn revenues, for example, start-up operations and it:
- will be reportable segment before earning revenues
 - may be reportable segment before earning revenues
 - will not be reportable segment before earning revenues
 - None of above
06. Head office expenses:
- can be allocated to segments on a reasonable basis
 - must not be allocated to segments
 - must be allocated to segments based on their turnover
 - must be allocated to segments based on their profit before tax
07. Two or more operating segments may be aggregated into a single operating segment if aggregation is consistent with the core principle of IFRS 8, the segments have similar economic characteristics, and the segments are similar in each of the following respects:
- the nature of the products and services
 - the nature of the production processes
 - the type or class of client for their products and services
 - the methods used to distribute their products or provide their services
 - if applicable, the nature of the regulatory environment, for example, banking, insurance or public utilities
 - staff numbers
- (i) to (vi) all
 - (i) to (iii) only
 - (i) to (iv) only
 - (i) to (v) only
08. According to IFRSs, if a financial report contains both consolidated financial statements of a parent, as well as parent's separate financial statements, segment information is required:
- only in the consolidated financial statements
 - only in the parent's separate financial statements
 - in both sets of financial statements
 - Either in the consolidated or parent's separate financial statements
09. Operating segments of an entity have reported following profit or loss for the year:

	A	B	C	D	E	Total
	Rs. in million					
Profit / (loss)	100	25	(40)	35	(50)	70

For the purpose of determining reportable operating segments, the quantitative threshold of 10% would be applied on the amount of :

- Rs. 70 million
- Rs. 90 million
- Rs. 100 million
- Rs. 160 million

10. As a percentage of revenue, profit or loss, or assets, a segment should be at least:
- 5%
 - 10%
 - 15%
 - 20%
11. The total amount of revenue that should be covered by reportable segments is, at least:
- 50%
 - 60%
 - 70%
 - 75%
12. The total amount of revenue that should be covered by reportable segments is, at least:
- 75% of inter-segment revenue
 - 75% of external revenue
 - 75% of combined revenue
 - None of above
13. Which of the following geographical information is required to be disclosed:
- revenues from external clients attributed to the entity's country of domicile and attributed to all foreign countries in total from which the entity derives revenues.
 - non-current assets located in the entity's country of domicile and located in all foreign countries in total in which the entity holds assets.
- (i) only
 - (ii) only
 - (i) and (ii) both
 - Neither (i) nor (ii)
14. Operating segments of an entity have reported following profit or loss for the year:

	A	B	C	D	E	Total
	Rs. in million					
Profit / (loss)	100	25	(40)	35	(50)	70

Reportable segments on the basis of quantitative threshold of 10% of profit or loss are:

- A and E
- A, B and D
- A, C, D and E
- A, B, C, D and E (all)

15. Operating segments of an entity have reported following revenue for the year:

	A	B	C	D	E	Total
	Rs. in million					
External revenue	100	200	300	400	500	1,500
Inter-segment revenue	10	25	65	180	500	780
	110	225	365	480	1,000	2,280

Reportable segments on the basis of quantitative threshold of 10% of revenue are:

- (a) A, B, C, D and E (all)
- (b) Only B, C, D and E
- (c) Only C, D and E
- (d) Only D and E

ANSWERS

01.	(d)	Information about reduced staff is not required by IFRS 8
02.	(b)	Taxation is not criteria for defining operating segment
03.	(c)	It may be included if entity is so managed (not based on desire).
04.	(c)	IFRS 8 is applicable to listed companies only.
05.	(b)	It may be reportable segment if it meets the criteria.
06.	(a)	These can be allocated on reasonable basis.
07.	(d)	Staff number is not the factor to combine two or more segments.
08.	(a)	only in the consolidated financial statements
09.	(d)	Total of segments reporting profits = Rs. 100m + 25m + 35m = Rs. 160 million Total of segments reporting loss = Rs. 40m + 50m = Rs. 90 million Greater amount = Rs. 160 million
10.	(b)	The quantitative threshold is 10% in accordance with IFRS 8.
11.	(d)	The revenue threshold for total of reportable segments is 75% in accordance with IFRS 8.
12.	(b)	The total external (not combined) revenue reported by operating segments must constitute at least 75% of the entity's revenue.
13.	(c)	Both items are required to be disclosed (entity wide disclosure).
14.	(d)	Total of segments reporting profits = Rs. 100m + 25m + 35m = Rs. 160 million Total of segments reporting loss = Rs. 40m + 50m = Rs. 90 million 10% of greater of above two = 10% x Rs. 160 million = Rs. 16 million Profit or loss of all segments exceed threshold of Rs. 16 million.
15.	(c)	10% of total combined revenue is Rs. 228 million (i.e. 10% of Rs. 2,280m). Segment A and B do not meet the above threshold.

STICKY NOTES

Operating segment – Key points

SCOPE	- Listed companies (or in process) - Consolidated financial statements (for group)
Definition	An operating segment is a component of an entity: - that engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same entity), - whose operating results are regularly reviewed by the entity's chief operating decision maker (CODM) to make decisions about resources to be allocated to the segment and assess its performance, and - for which discrete financial information is available.
When CODM uses more than one set of segment information	Consider following factors: - the nature of the business activities of each component, - the existence of managers responsible for them, and - information presented to the board of directors.
Aggregation	Two or more operating segments may be aggregated into a single operating segment if aggregation is consistent with the core principle of this IFRS, the segments have similar economic characteristics, and the segments are similar in each of the following respects: - the nature of the products and services; - the nature of the production processes; - the type or class of customer for their products and services; - the methods used to distribute their products or provide their services; and - if applicable, the nature of the regulatory environment, for example, banking, insurance or public utilities.

Reportable Segments – Summary

10% quantitative threshold	An entity shall report separately information about an operating segment that meets any of the following quantitative thresholds: a) Its reported revenue (external + inter-segment) is 10% or more of the combined revenue (internal and external) of all operating segments. b) The absolute amount of its reported profit or loss is 10% or more of the greater, in absolute amount, of i. the combined reported profit of all operating segments that did not report a loss; and ii. the combined reported loss of all operating segments that reported a loss. c) Its assets are 10% or more of the combined assets of all operating segments.
Other criteria	Management believes that segment information would be useful. If the operating segments have similar economic characteristics and share a majority of the aggregation criteria. Based on management judgement, a reportable segment in the immediately preceding period is of continuing significance
75% external revenue threshold	If the total external revenue reported by operating segments constitutes less than 75% of the entity's revenue, additional operating segments shall be identified as reportable segments (even if they do not meet 10% threshold) until at least 75% of the entity's revenue is included in reportable segments.
Practical limit	Consider practical limit on number of reportable segments if number of reportable segment reaches 10.

Disclosure – Summary

Minimum disclosure	• General information of reportable segments • Reported segment profit or loss
If reported to CODM	Segment assets and liabilities.
Reconciliation with corresponding entity's amounts	• segment revenues; • reported segment profit or loss;; • segment assets; • segment liabilities; and • other material segment items.
Additional information if reviewed by or provided to CODM	• revenues from external customers; • revenues from transactions with other operating segments of the same entity; • interest revenue; • interest expense; • depreciation and amortisation; • material items of income and expense; • the entity's interest in the profit or loss of associates and joint ventures accounted for by the equity method; • income tax expense or income; and • material non-cash items other than depreciation and amortisation. • the amount of investment in associates and joint ventures accounted for by the equity method, and • the amounts of additions to non-current assets.
Entity wide disclosures	• Revenues from external customers for each product and service, or each group of similar products and services. • External revenue from Pakistan, rest of the world and any individual foreign country (if material). • Non-current assets located in Pakistan, rest of the world and any individual foreign country (if material). • •Extent of reliance on major customers, including details if any customer's revenue is greater than 10% of the entity's revenue.
The basis of measurement shall also be disclosed.	

IAS 12

INCOME TAXES

IN THIS CHAPTER:

AT A GLANCE

SPOTLIGHT

1. Current tax
2. Deferred tax
3. Presentation and disclosure
4. Comprehensive Examples
5. Objective Based Q&A

STICKY NOTES

AT A GLANCE

IAS 12 implements the statement of financial position approach of accounting for income taxes which recognises both the current tax consequences of transactions and events and the future tax consequences of the future recovery or settlement of the carrying amount of an entity's assets and liabilities.

Differences between the carrying amount and tax base of assets and liabilities, and carried forward tax losses and credits, are recognised, with limited exceptions, as deferred tax liabilities or deferred tax assets.

The recognition of deferred tax asset is also subject to availability of future taxable profits which are reassessed at the end of each reporting period.

Current tax for the current and prior periods is recognised as a liability to the extent that it has not yet been settled, and as an asset to the extent that the amounts already paid exceed the amount due. Current tax assets and liabilities are measured at the amount expected to be paid to (recovered from) taxation authorities, using the rates/laws that have been enacted or substantively enacted by the end of reporting period.

When an entity recognises an asset and liability as per IFRS rules, it expects to recover or settle the carrying amount of that asset or liability. In other words, asset may be used to make up other assets or is sold to earn profit and liabilities are settled by paying them off. Usually, the recovery from an asset or settlement of liability results in taxation to the entity. When the rules in tax laws for recognition and settlement of asset and liabilities are not same as the rules in IFRSs, there arise a temporary difference for future tax payments / (receipts). The impact on tax that will have impact of future due to difference between tax laws and IFRSs is called deferred tax.

1. CURRENT TAX

1.1 Taxation of profits

Entities pay income tax on their profits on an annual basis. The tax charge is based on their accounting profit as adjusted according to the income tax law.

A series of adjustments is made against an entity's accounting profit to arrive at its taxable profit. These adjustments involve:

- Adding back inadmissible deductions according to tax law (e.g. accounting depreciation, provision for bad debts, fines etc.).
- Deducting back income that are not taxable (e.g. exempt income or income receivable to be taxed on cash basis).
- Deducting admissible deductions according to tax law but not recognised as expense in calculation of accounting profit (e.g. research costs).
- Adding income according to tax law but not included in accounting profit of the current year (e.g. unearned income taxed on receipt basis).

The tax rate is applied to the taxable profit to calculate how much an entity owes in tax for the period. IAS 12 describes this as current tax.

1.2 Definitions [IAS 12: 5]

"Accounting profit" is profit or loss for a period before deducting tax expense (as per IFRSs).

"Taxable profit (tax loss)" is the profit (loss) for a period, determined in accordance with the rules established by the taxation authorities, upon which income taxes are payable (recoverable).

"Tax expense (tax income)" is the aggregate amount included in the determination of profit or loss for the period in respect of current tax and deferred tax.

"Current tax" is the amount of income taxes payable (recoverable) in respect of the taxable profit (tax loss) for a period.

1.3 Recognition [IAS 12: 12]

Current tax for current and prior periods shall, to the extent unpaid, be recognised as a liability. If the amount already paid in respect of current and prior periods exceeds the amount due for those periods, the excess shall be recognised as an asset.

It means current tax expense of current year net of advance tax (if any) is presented as liability or asset.

1.4 Measurement [IAS 12: 46]

Current tax liabilities (assets) for the current and prior periods shall be measured at the amount expected to be paid to (recovered from) the taxation authorities, using the tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period.

1.5 Computation

An exam question might require you to perform a basic taxation computation from information given in the question.

► **Example 01:**

Kashif Traders (KT) had an accounting profit before of tax of Rs. 1,000,000. Below is a list of admissible and inadmissible deductions under Income Tax Ordinance 2001:

	Rs.
Inadmissible Deductions:	
- Accounting Depreciation	100,000
- Bad and doubtful debts expense in PL	15,000
Admissible Deductions:	
- Tax Depreciation	150,000
- Trade debts actually written off	5,000

Tax rate applicable on KT is 30%.

Required: Compute the current tax payable from the above information.

► **ANSWER:**

Kashif Traders – Tax computation	Rs.
Accounting profit before tax	1,000,000
Add back: Accounting depreciation	100,000
Add back: Bad and doubtful debts	15,000
Less: Tax depreciation	(150,000)
Less: Bad debts actually written off	(5,000)
Taxable profit	960,000
	Tax rate 30%
Current tax payable	288,000

► **Example 02:**

Jhelum Traders (JT) had an accounting profit of Rs. 789,000 for the year ended 31 December 2017. The following information is relevant:

- The accounting profit was after depreciation of Rs. 70,000 and included a profit on disposal (capital gain) of Rs. 97,000. Accounting depreciation is not allowable for tax purposes. Capital gains are not taxable.
- At 1 January 2017 the tax written down value of machinery was Rs. 120,000 and for buildings was Rs. 600,000. Tax depreciation is claimable at 10% per annum for buildings and 15% per annum for machinery applied to tax written down value at the start of the year.
- JT had incurred borrowing costs of Rs. 70,000 in the year of which Rs. 10,000 had been capitalised in accordance with IAS 23. All borrowing costs are deductible for tax purposes.
- JT had paid fines of Rs. 125,000 due to non-compliances with the requirements of the Companies Act, 2017. Fines are not tax deductible.
- JT holds some assets under leases. During the year it had recognised finance cost in respect of the leases was Rs. 15,000 and rentals paid were Rs. 80,000. The depreciation on right of use assets is included in accounting depreciation above. Lease rentals are deductible in full for tax purposes. Tax is paid at 30%

Required: Compute the current tax payable for JT for the year 2017.

► ANSWER:

Jhelum Traders – Tax computation		Rs.
Accounting profit before tax		789,000
Add: Accounting depreciation	(i)	70,000
Less: Capital gain	(i)	(97,000)
Less: Tax depreciation (Rs. 120,000 x 15% + Rs. 600,000 x 10%)	(ii)	(78,000)
Less: Borrowing costs	(iii)	(10,000)
Add: Fine paid	(iv)	125,000
Add: Finance cost on lease	(v)	15,000
Less: Lease rental paid	(v)	(80,000)
Taxable profit		734,000
	Tax rate	30%
Current tax payable		220,200

1.6 Over-estimate or under-estimate of tax from previous year

When the financial statements are prepared, the tax charge on the profits for the year is likely to be an estimate. The figure for tax on profits in the statement of profit or loss is therefore not the amount of tax that will eventually be payable, because it is only an estimate. The actual tax charge, agreed with the tax authorities sometime later, is likely to be different.

In these circumstances, the tax charge for the year is adjusted for any under-estimate or over-estimate of tax in the previous year.

- An under-estimate of tax on the previous year's profits is added to the tax charge for the current year.
- An over-estimate of tax on the previous year's profits is deducted from the tax charge for the current year.

The journal entries relating to current tax would be:

Recording accrual at year end	Debit Tax expense Credit Current tax payable
On final assessment (usually after the financial statements have been authorized for issue)	Under provision (lesser amount was accrued) Debit Tax expense Credit Current tax payable
	Over provision (higher amount was accrued) Debit Current tax payable Credit Tax expense
Payment	Debit Current tax payable Credit Bank

It is also likely that the amount of current tax expense and the amount of tax liability in respect of current tax will differ.

Tax charge in statement of profit or loss	Tax on current year's taxable profits + under estimate – over estimate
Tax liability in statement of financial position	Tax on current year's taxable profits – amount already paid

► **Example 03:**

Fresh Company has a financial year ending on 31 December. At 31 December 2016 it had a liability for income tax of Rs. 77,000. The tax on profits for the year to 31 December 2017 was Rs. 114,000.

The tax charge for the year to 31 December 2016 was over-estimated by Rs. 6,000.

During the year to 31 December 2017, the company made payments of Rs. 123,000 (i.e. Rs. 71,000 for payment of last year's tax and Rs. 52,000 advance tax for the current year) in income tax.

Required: Prepare ledgers and calculate current tax expense and liability for the year ended 31 December 2017.

► **ANSWER:**

Tax expense				
	Rs.			Rs.
Tax payable (2017)	114,000		Tax payable (over)	6,000
			Profit or loss	108,000
	114,000			114,000

Tax payable				
	Rs.			Rs.
Tax expense (over)	6,000		b/d (from 2016)	77,000
Bank (paid)	71,000		Tax expense (2017)	114,000
Bank (paid)	52,000			
c/d	62,000			
	191,000			191,000

SPL extracts (31 December 2017)		Rs.
Current tax expense		
Current year		114,000
Prior year		(6,000)
		108,000
SFP extracts (31 December 2017)		
Current tax payable [114,000 - 52,000 paid]		62,000

2. DEFERRED TAX

2.1 Calculation of deferred tax expense

The calculation of deferred tax expense usually involves following steps:

- Determine “carrying amount” and “tax base” of each asset and liability
- Calculate “temporary differences” and identify these as either “taxable” or “deductible”.
- Apply “tax rate” to identified temporary differences, unused tax losses and adjust unused tax credits and the resulting amount would be “deferred tax liability or asset” (closing balance).
- Compare the closing balance of deferred tax liability or asset with opening balance, the difference will be charged to “profit or loss” or to items presented “outside profit or loss” in accordance with IAS 12. A journal entry shall be passed accordingly.

2.2 Carrying amount and tax base [IAS 12: 5, 7 to 10 & Conceptual Framework: 5.1]

Determining the carrying amount is straight forward as this is the amount at which an asset, a liability or equity is recognised in the statement of financial position (as per IFRSs) is referred to as its **‘carrying amount’**. So the carrying amount to an item of PPE would be cost less accumulated depreciation, for inventory it would be lower of cost and net realisable value and for provisions it would be the best estimate at which such provision has been recognised.

The **‘tax base’** of an asset or liability is the amount attributed to that asset or liability for tax purposes.

Some items have a tax base but are not recognised as assets and liabilities in the statement of financial position. For example, research costs are recognised as an expense in determining accounting profit in the period in which they are incurred but may not be permitted as a deduction in determining taxable profit (tax loss) until a later period.

Tax base of an asset

If economic benefits* are taxable in future	Tax base = Future deductions for tax purposes
If economic benefits* are not taxable in future	Tax base = Carrying amount

* economic benefits that will flow to an entity when it recovers the carrying amount of the asset.

► Example 04:

Calculate the tax base for each of the following asset, separately:

- A machine cost Rs. 100. For tax and accounting purposes, depreciation of Rs. 30 has already been deducted in the current and prior periods and the remaining cost will be deductible for tax purposes in future periods.
- Interest receivable has a carrying amount of Rs. 100. The related interest revenue will be taxed on a cash basis.
- Trade receivables have carrying amount of Rs. 100. The related revenue has already been included in taxable profit (tax loss).
- Dividends receivables from a subsidiary have a carrying amount of Rs. 100. The dividends are not taxable.
- A loan receivable has a carrying amount of Rs. 100. The repayment of the loan will have no tax consequences.

► **ANSWER:**

- (i) Tax Base = Future deductions = Rs. 70
- (ii) Tax Base = Future deductions = Rs. Nil
- (iii) Tax Base = Carrying amount = Rs. 100
- (iv) Tax Base = Carrying amount = Rs. 100
- (v) Tax Base = Carrying amount = Rs. 100

Tax base of liabilities

Unearned or deferred income or revenue	Tax Base = Carrying amount – amount NOT taxable in future
All other liabilities	Tax Base = Carrying amount - Future deductions for tax

► **Example 05:**

Calculate the tax base for each of the following liability, separately:

- (i) Current liabilities include interest revenue received in advance, with a carrying amount of Rs. 100. The related interest revenue was taxed on a cash basis already.
- (ii) Liabilities include deferred grant income, with a carrying amount of Rs. 100. The related grant income is exempt (not taxable).
- (iii) Current liabilities include service revenue received in advance, with a carrying amount of Rs. 100. The related service revenue shall be taxed next year when services will be rendered.
- (iv) Current liabilities include accrued expenses with a carrying amount of Rs.100. The related expenses will be deducted for tax purposes on a cash basis.
- (v) Current liabilities include accrued expenses with a carrying amount of Rs.100. The related expense has already been deducted for tax purposes.
- (vi) Current liabilities include accrued fines and penalties with a carrying amount of Rs.100. Fines and penalties are not deductible for tax purposes.
- (vii) A loan payable has a carrying amount of Rs.100. The repayment of the loan will have no tax consequences

► **ANSWER:**

- (i) Tax Base = Carrying amount – amount NOT taxable in future = $100 - 100 = \text{Rs. Nil}$
- (ii) Tax Base = Carrying amount – amount NOT taxable in future = $100 - 100 = \text{Rs. Nil}$
- (iii) Tax Base = Carrying amount – amount NOT taxable in future = $100 - 0 = \text{Rs. 100}$
- (iv) Tax Base = Carrying amount - Future deductions for tax = $100 - 100 = \text{Rs. Nil}$
- (v) Tax Base = Carrying amount - Future deductions for tax = $100 - 0 = \text{Rs. 100}$
- (vi) Tax Base = Carrying amount - Future deductions for tax = $100 - 0 = \text{Rs. 100}$
- (vii) Tax Base = Carrying amount - Future deductions for tax = $100 - 0 = \text{Rs. 100}$

2.3 Temporary differences [IAS 12: 5]

When carrying amount equals tax base, there is no mismatch (temporary difference) and no deferred tax shall arise. Conversely, when carrying amount is different from tax base, there is a mismatch (temporary difference) and deferred tax shall arise.

“Temporary differences” are differences between the carrying amount of an asset or liability in the statement of financial position and its tax base.

Temporary differences may be either:

- taxable temporary differences: that will result in taxable amounts (more tax in future); or
- deductible temporary differences: that will result in amounts that are deductible (tax savings in future)

in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.

The following table provides guidance to identify temporary differences as either taxable or deductible:

Item	Comparison	Temporary difference	Deferred tax liability or asset
Assets	Carrying amount > Tax base	Taxable	Liability
	Carrying amount < Tax base	Deductible	Asset
Liabilities	Carrying amount > Tax base	Deductible	Asset
	Carrying amount < Tax base	Taxable	Liability

► **Example 06:**

Calculate the temporary differences for each of following situations independently and also identify whether such temporary difference is taxable or deductible:

- A plant was acquired at start of the year for Rs. 100 million. It has useful life of five years and nil residual value. Tax authorities allow 30% depreciation on reducing balance basis.
- An inventory costing Rs. 10 million was written down to its net realisable value of Rs. 8 million. Tax authorities do not allow write down adjustments.
- A provision for litigation has been recognised at Rs. 4 million. Tax authorities will allow the expense only when paid.
- A financial liability has been measured at fair value of Rs. 7 million. However, tax base of this liability is Rs. 8 million.

► **ANSWER:**

- The carrying amount of plant at year end would be Rs. 80 million (i.e. Rs. 100 million less depreciation over five years useful life). The tax base would be Rs. 70 million (i.e. Rs. 100 million less 30% tax depreciation).
This would result in taxable temporary difference of Rs. 10 million.
On disposal, the tax gain will be Rs. 10 million more resulting in payment of more tax.
- The carrying amount of inventory is Rs. 8 million while tax base is Rs. 10 million. This would result in deductible temporary difference of Rs. 2 million.
On sale, the tax authorities will allow Rs. 2 million extra deduction resulting in tax savings in the future.
- The carrying amount of provision is Rs. 4 million and tax base is Nil. The temporary difference of Rs. 4 million is deductible.
On payment, the tax authorities will allow deduction resulting in tax savings in the future.
- The carrying amount of provision is Rs. 7 million and tax base is Rs. 8 million. The temporary difference of Rs. 1 million is taxable.
On settlement, the tax loss shall be lower (or tax gain shall be higher) resulting in more payment of tax.

2.4 Measurement/Tax rate [IAS 12: 47, 53 & 54]

Deferred tax assets and liabilities shall be measured at the tax rates that are expected to apply to the period when the asset is realised or the liability is settled, based on tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period.

There could be different tax rates for different assets and liabilities and for deferred tax calculations, relevant rates need to be taken. For example, if dividend receivable is recorded in an entity's financial statement and tax authorities only tax dividend when it is received, although corporate rate of tax on entity is 29%, but tax on dividends is 15%, therefore, deferred tax liability will be recorded on taxable temporary difference using the rate of 15% and not 29%.

Deferred tax assets and liabilities shall not be discounted. IAS 12 does not require or permit the discounting of deferred tax assets and liabilities as the reliable determination of deferred tax assets and liabilities on a discounted basis requires detailed scheduling of the timing of the reversal of each temporary difference. In many cases such scheduling is impracticable or highly complex.

2.5 Deferred tax liability [IAS 12: 5, 15 & 22]

Deferred tax liabilities are the amounts of income taxes payable in future periods in respect of taxable temporary differences.

A deferred tax liability shall be recognised for all taxable temporary differences, except to the extent that the deferred tax liability arises from:

- (a) the initial recognition of goodwill; or
- (b) the initial recognition of an asset or liability in a transaction that (i) is not a business combination; and (ii) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).

► Example 07:

An entity intends to use an asset which cost Rs. 1,000 throughout its useful life of five years and then dispose of it for a residual value of nil. The tax rate is 40%. Depreciation of the asset is not deductible for tax purposes. On disposal, any capital gain would not be taxable and any capital loss would not be deductible.

Required: Briefly discuss the accounting treatment of deferred tax for the above asset.

► ANSWER:

As it recovers the carrying amount of the asset, the entity will earn taxable income of Rs. 1,000 and pay tax of Rs. 400 (over five years useful life). The entity does not recognise the resulting deferred tax liability of Rs. 400 because it results from the initial recognition of the asset.

In the following year, the carrying amount of the asset is Rs. 800. In earning taxable income of Rs. 800, the entity will pay tax of Rs. 320 (over remaining life of four years). The entity does not recognise the deferred tax liability of Rs. 320 because it results from the initial recognition of the asset.

Notice that although defined as temporary difference, this particular difference of carrying amount and tax base of Nil is, in fact, of permanent nature as depreciation charged to profit or loss will never be allowed as deduction by tax authorities.

2.6 Deferred tax asset [IAS 12: 5, 24, 33 & 37]

Deferred tax assets are the amounts of income taxes recoverable in future periods in respect of:

- (a) deductible temporary differences;
- (b) the carry forward of unused tax losses; and
- (c) the carry forward of unused tax credits.

A deferred tax asset shall be recognised for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised, unless the deferred tax asset arises from the initial recognition of an asset or liability in a transaction that (i) is not a business combination; and (ii) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).

► *Example 08:*

An entity received government grant of Rs. 2 million related to an asset. The grant shall be recognised over two years. The grant income is exempt under the law and has no tax consequences when received or when recognised in profit or loss.

Required: Briefly discuss the accounting treatment of deferred tax for the above deferred grant presented as liability.

► *ANSWER:*

The government grant shall have carrying amount of Rs. 2 million and tax base of Nil on initial recognition. Notice that although defined as temporary difference, this particular difference of carrying amount and tax base of Nil is, in fact, of permanent nature as grant income recognised in profit or loss will never be considered as taxable income by tax authorities. Therefore, no deferred tax shall arise.

► *Example 09:*

Rose Limited (RL) is finalizing its financial statements for the year ended 31 December 2017. In this respect, the following information has been gathered:

- (i) Applicable tax rate is 30% except stated otherwise.
- (ii) During the year RL incurred advertising cost of Rs. 15 million. This cost is to be allowed as tax deduction over 5 years from 2017 to 2021.
- (iii) Trade and other payables amounted to Rs. 40 million as on 31 December 2017 which include unearned commission of Rs. 10 million. Commission is taxable when it is earned by the company. Tax base of remaining trade and other payables is Rs. 25 million.
- (iv) Other receivables amounted to Rs. 17 million as on 31 December 2017 which include dividend receivable of Rs. 8 million. Dividend income was taxable on receipt basis at 20% in 2017. However, with effect from 1 January 2018, dividend received is exempt from tax. Tax base of remaining other receivables is Rs. 6 million.
- (v) On 1 April 2017, RL invested Rs. 40 million in a fixed deposit account for one year at 10% per annum. Interest will be received on maturity. Interest was taxable on receipt basis at 10% in 2017. However, with effect from 1 January 2018, interest received is taxable at 15%.
- (vi) On 1 January 2016, a machine was acquired on lease for a period of 4 years at annual lease rental of Rs. 28 million, payable in advance. Interest rate implicit in the lease is 10%. Under the tax laws, all lease related payments are allowed in the year of payment.
- (vii) Details of fixed assets are as follows:
 - On 1 January 2017 RL acquired a plant at a cost of Rs. 250 million. It has been depreciated on straight line basis over a useful life of six years. RL is also obliged to incur decommissioning cost of Rs. 50 million at the end of useful life of the plant. Applicable discount rate is 8%.
 - On 1 July 2017 RL sold one of its four buildings for Rs. 60 million. These buildings were acquired on 1 January 2013 at a cost of Rs. 100 million each having useful life of 30 years.

The dismantling costs will be allowed for tax purposes when paid. Tax depreciation rate for all owned fixed assets is 10% on reducing balance method. Further, full year's tax depreciation is allowed in year of purchase while no depreciation is allowed in year of disposal.

Required: Compute the deferred tax liability / asset to be recognised in RL's statement of financial position as on 31 December 2017.

► ANSWER:

Computation of deferred tax – 31 December 2017

Description	Carrying amount	Tax base	Temporary Difference	Tax rate	Deferred tax liability (asset)
	Rs. million				Rs. million
Advertising costs (ii)	-	12	12 D	30%	(3.6)
Trade & other payable (iii)					
- Unearned commission	10	10	-		
- Other	30	25	5 D	30%	(1.5)
Other receivables (iv)					
- Dividend receivable	8	8	-		
- Other	9	6	3 T	30%	0.9
Interest receivable (v)	3 W1	-	3 T	15%	0.45
Right of use asset (vi)	48.82 W3	-	48.82 T	30%	14.65
Lease liability (vi)	53.45 W4	-	53.45 D	30%	(16.04)
Plant (vii)	234.59 W5	225 W5	9.59 T	30%	2.88
Provision (vii)	34.03 W5	-	34.03 D	30%	(10.21)
Buildings (vii)	250 W6	177.15 W7	72.85 T	30%	21.86
Deferred tax liability					9.39

W1: Rs. 40 million x 10% x 9/12 = Rs. 3 million

W2: PV of lease payments Rs. 28 million x $[(1 - 1.10^{-4+1}) / 0.10] + 1$ = Rs. 97.63 million

W3: Rs. 97.63 million / 4 years x 2 years = Rs. 48.82 million

W4: Lease schedule (Payment in advance)					
Payment Date	Opening balance	Payment	Net Balance	Interest @ 10%	Closing Balance
Rs. m					
1 Jan 2016	97.63	(28)	69.63	6.96	76.59
1 Jan 2017	76.59	(28)	48.59	4.86	53.45

W5: Plant and related decommissioning liability			
	Plant		Provision
	Accounting	Tax	Accounting
Rs. million			
Cost	250	250	
Provision [Rs. 50m x 1.08 ⁻⁶]	31.51		31.51
	281.51		
Accounting depreciation [Rs. 281.51m / 6 years]	(46.92)		
Tax depreciation [Rs. 250m x 10%]		(25)	
Finance costs [Rs. 31.51m x 8%]			2.52
As at 31 December 2017	234.59	225	34.03

W6: Rs. 300 million x 25/30 years = Rs. 250 million

W7: Rs. 300 x 0.90⁵ = Rs. 177.15 million

2.6.1 Re-assessment of unrecognised deferred tax asset [IAS 12: 37]

At the end of each reporting period, an entity reassesses unrecognised deferred tax assets. The entity recognises a previously unrecognised deferred tax asset to the extent that it has become probable that future taxable profit will allow the deferred tax asset to be recovered. For example, an improvement in trading conditions may make it more probable that the entity will be able to generate sufficient taxable profit in the future for the deferred tax asset to meet the recognition criteria.

► **Example 10:**

Fatima Limited disclosed in its financial statements for the year ended December 31, 2018, that it has available tax losses of Rs.60 million. The company losses are available for only 5 years. The company expects that it is unlikely to utilize all the losses and, therefore, does not recognize a deferred tax asset. Tax rate is 35% for the year and will remain same for future periods.

In 2019, the company restructures its business and expects that this restructuring will result in future taxable profits upto Rs. 50 million in next 5 years. The company, therefore, shall recognize at December 31, 2019 a deferred tax asset for the available tax losses to the extent future taxable profits will be available i.e. Rs.17.5 million (Rs.50 million x 35%).

2.7 Current and deferred tax charge [IAS 12: 58, 59, 61A & 64]

Accounting for the current and deferred tax effects of a transaction or other event is consistent with the accounting for the transaction or event itself.

Transaction recognised in:	Related tax effect:	Examples
Other Comprehensive Income	Other Comprehensive Income	Gain on revaluation (IAS 16) Gain on FVTOCI Investments (IFRS 9)
Directly in Equity	Directly in Equity	Retrospective application on change of accounting policy or retrospective adjustment for correction of prior period errors (IAS 8)
Business Combination	Goodwill	Not examinable at this level.
Profit or Loss	Profit or Loss	Most deferred tax liabilities and deferred tax assets arise where income or expense is included in accounting profit in one period, but is included in taxable profit (tax loss) in a different period. The resulting deferred tax is recognised in profit or loss. Examples are when: (a) interest, royalty or dividend revenue is received in arrears and is included in accounting profit but is included in taxable profit (tax loss) on a cash basis; and (b) costs of intangible assets have been capitalised in accordance with IAS 38 and are being amortised in profit or loss, but were deducted for tax purposes when they were incurred.
Transfer within equity	An entity may transfer the amount from Revaluation Surplus to Retained Earnings, (for incremental depreciation or on disposal) in accordance with IAS 16 or IAS 38. Such transfer is presented in statement of changes in equity net of tax.	

► **Example 11:**

Mars Limited (ML) is engaged in the manufacturing of chemicals. On July 1, 2014 it obtained a motor vehicle on lease from a bank. Details of the lease agreement are as follows:

- (i) Instalments of Rs. 480,000 are to be paid annually in advance.
- (ii) The lease term and useful life is 4 years and 5 years respectively.
- (iii) The interest rate implicit in the lease is 13.701%.
- (iv) Present value of lease payments has been calculated as Rs. 1,600,000

ML follows a policy of depreciating the motor vehicles over their useful life, on the straight-line method. However, the tax department allows only the lease payments as a deduction from taxable profits.

On 30 June 2015, ML revalued its land from cost of Rs. 2,000,000 to its fair value of Rs. 2,400,000. Tax authorities do not include revaluation gains in calculation of taxable profits.

The tax rate applicable to ML is 30%. ML's accounting profit before tax for the year ended June 30, 2015 is Rs. 4,900,000. Since it is first year of ML's operations, there was no deferred tax liability balance as at June 30, 2014.

There are no temporary differences other than those evident from the information provided above.

Required: Prepare journal entries in the books of Mars Limited for the year ended June 30, 2015 to record current tax and deferred tax (revaluation and lease entries are not required).

► **ANSWER:**

Date	Particulars	Debit Rs.	Credit Rs.
30 June 2015	Current tax expense W1	1,492,035	
	Current tax payable		1,492,035
30 June 2015	Deferred tax expense (OCI)	120,000	
	Deferred tax income (PL)		22,035
	Deferred tax liability		97,965

W1: Computation of current tax

	Rs.
Accounting profit before tax	4,900,000
Add: Depreciation on right of use asset [Rs. 1,600,000 / 4 years]	400,000
Add: Interest expense [(Rs. 1,600,000 – 480,000) x 13.701%]	153,451
Less: Lease payments	(480,000)
Taxable profit	4,973,451
	Tax rate 30%
Current tax	1,492,035

W2: Computation of deferred tax

Description	Carrying amount	Tax base	Temporary Difference	Tax rate	Deferred tax liability (asset)
	Rs.				Rs.
Right of use asset W2.1	1,200,000	-	1,200,000 T	30%	360,000 PL
Lease liability W2.2	1,273,451	-	1,273,451 D	30%	(382,035) PL
PPE (Land)	2,400,000	2,000,000	400,000 T	30%	120,000 OCI
Deferred tax liability					97,965

W2.1: Rs. 1,600,000 – 400,000 depreciation = Rs. 1,200,000

W2.2: Rs. 1,600,000 – 480,000 payment + 153,451 interest = Rs. 1,273,451

2.8 Why deferred tax adjustment is necessary?

The accounting profit is based on IFRSs while current tax expense is based on tax laws that often differ from requirements of IFRSs. The recording of current tax expense, therefore, creates an accounting mismatch. This mismatch is usually temporary and would result in more tax payments or tax savings in the future periods. The recognition of deferred tax ensures that such accounting mismatch is eliminated by recording deferred tax expense (or income) that matches the accounting profit calculated in accordance with IFRSs.

It must be noted that recognition of deferred tax is purely an accounting adjustment and does not directly result in payment of tax. However, a deferred tax liability indicates that in future the entity is likely to pay higher current tax.

► **Example 12:**

Kashif Limited (KL) made accounting profit before tax of Rs. 50,000 in each of the years, 2021, 2022 and 2023 and pays tax at 30%.

KL bought an item of plant on 1 January 2021 for Rs. 10,000. This asset is to be depreciated on a straight line basis over 3 years and has an estimated residual value of Rs. 1,000.

Accounting depreciation is not allowed as a taxable deduction in the jurisdiction in which KL operates. Instead tax depreciation at 40% reducing balance method is allowed.

On 31 December 2023, KL disposed the asset for Rs. 1,000. The gain on disposal is taxable and loss on disposal is deductible under relevant tax laws.

Required:

Prepare extracts of statement of profit or loss from 2021 to 2023 showing profit before tax, tax expense and profit after tax:

- Ignore deferred tax
- Recognise deferred tax using asset/liability approach and income approach.

► **ANSWER:****Part (a) Ignore deferred tax**

Statement of profit or loss (extracts)	2021	2022	2023	Total
	Rupees			
Profit before tax	50,000	50,000	50,000	150,000
Less: Current tax W1	(14,700)	(15,180)	(15,120)	(45,000)
Profit after tax	35,300	34,820	34,880	105,000

Notice the mismatch caused by recognising current tax, although the profit before tax is same in all years, the profit after tax is different as current tax expense has been calculated in accordance with different set of rules.

Part (b) Recognise deferred tax

Statement of profit or loss (extracts)	2021	2022	2023	Total
	Rupees			
Profit before tax	50,000	50,000	50,000	150,000
Current tax (expense) W1	(14,700)	(15,180)	(15,120)	(45,000)
Deferred tax (expense) income W2	(300)	180	120	0
Profit after tax	35,000	35,000	35,000	105,000

Notice that recognising deferred tax adjustment has achieved the application of matching concept.

W1: Computation of current tax

	2021	2022	2023	Total
	Rupees			
Accounting profit	50,000	50,000	50,000	150,000
Add: Accounting depreciation	3,000	3,000	3,000	9,000
Less: Tax depreciation 40%	(4,000)	(2,400)	(1,440)	(7,840)
Less: Tax loss on disposal	-	-	(1,160)	(1,160)
Taxable profit	49,000	50,600	50,400	150,000
Tax rate	30%	30%	30%	30%
Current tax expense	14,700	15,180	15,120	45,000

W2: Computation of deferred tax

Asset / liability approach	2021	2022	2023	Total
	Rupees			
Carrying amount	7,000	4,000	0	
Tax base	6,000	3,600	0	
Temporary difference	1,000	400	0	
Tax rate	30%	30%	30%	
Deferred tax liability (closing)	300	120	0	
Deferred tax liability (opening)	0	300	120	
Deferred tax (expense) / income	(300)	180	120	0

IAS 12 uses asset/liability approach to calculation of deferred tax.

W3: Computation of deferred tax

Income approach	2021	2022	2023	Total
	Rupees			
Taxable profit W1	(49,000)	(50,600)	(50,400)	(150,000)
Accounting profit	50,000	50,000	50,000	150,000
Timing difference	(1,000)	600	400	0
Tax rate	30%	30%	30%	
Deferred tax (expense) / income	(300)	180	120	0

Notice that although in this simple scenario, income approach resulted in same calculation of deferred tax as calculated under asset/liability approach, however, at times this approach fails to deal with advanced issues e.g. items recognised outside profit or loss, permanent differences, etc.

3. PRESENTATION AND DISCLOSURE

3.1 Presentation [IAS 12: 71, 72 & 74]

IAS 12 Income taxes contains rules on when current tax liabilities may be offset against current tax assets.

3.1.1 Offset of current tax liabilities and assets

A company must offset current tax assets and current tax liabilities if, and only if, it:

- has a legally enforceable right to set off the recognised amounts; and
- intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

An entity will normally have a legally enforceable right to set off a current tax asset against a current tax liability when they relate to income taxes levied by the same taxation authority and the taxation authority permits the entity to make or receive a single net payment.

3.1.2 Offset of deferred tax liabilities and assets

A company must offset deferred tax assets and deferred tax liabilities if, and only if:

- the entity has a legally enforceable right to set off current tax assets against current tax liabilities; and
- the deferred tax assets and the deferred tax liabilities relate to income taxes levied by the same taxation authority on either:
 - the same taxable entity; or
 - different taxable entities which intend either to settle current tax liabilities and assets on a net basis, or to realise the assets and settle the liabilities simultaneously, in each future period in which significant amounts of deferred tax liabilities or assets are expected to be settled or recovered.

The existence of deferred tax liability is strong evidence that a deferred tax asset from the same tax authority will be recoverable.

► Example 13:

The following deferred tax positions relate to the same entity:

	Situation 1	Situation 2
	Rs. 000	
Deferred tax liability	12,000	5,000
Deferred tax asset	(8,000)	(8,000)
	4,000	(3,000)

In situation 1, the financial statements will report the net position as a liability of Rs. 4 million. The existence of the liability indicates that the company will be able to recover the asset, so the asset can be set off against the liability.

In situation 2, setting off the asset against the liability leaves a deferred tax asset of Rs. 3 million. This asset may only be recognised if the entity believes it is probable that it will be recovered in the foreseeable future.

3.2 Disclosure [IAS 12: 79 to 81 & 86]

3.2.1 Major components of tax expense (income)

The major components of tax expense (income) must be disclosed separately. Components of tax expense (income) may include:

- (a) current tax expense (income);
- (b) any adjustments recognised in the period for current tax of prior periods;
- (c) the amount of deferred tax expense (income) relating to the origination and reversal of temporary differences;
- (d) the amount of deferred tax expense (income) relating to changes in tax rates or the imposition of new taxes;
- (e) the amount of the benefit arising from a previously unrecognised tax loss, tax credit or temporary difference of a prior period that is used to reduce current tax expense;
- (f) deferred tax expense arising from the write-down, or reversal of a previous write-down, of a deferred tax asset;
- (g) the amount of tax expense (income) relating to those changes in accounting policies and errors that are included in profit or loss in accordance with IAS 8, because they cannot be accounted for retrospectively.

► **Example 14:**

The following data relates to Adeel Limited (AL) for the year ended 30 June 2022:

- (i) Current tax for the current year has been computed at Rs. 129,000
- (ii) Last year current tax was estimated to be Rs. 116,000, however, on finalisation of assessment only Rs. 111,000 had to be paid.
- (iii) The opening balance of deferred tax liability is Rs. 30,000 (calculated at 30% on taxable temporary differences of Rs. 100,000).
- (iv) At 30 June 2022, AL has taxable temporary differences of Rs. 180,000 and during the year tax rate changed to 25%.

Required: Prepare a note on taxation expense for the year ended 30 June 2022, so far as information allows, reflecting major components of tax.

► **ANSWER:**

Taxation expense		Rs.
Current tax		
Current year		129,000
Prior year adjustment	Rs. 111,000 – 116,000	(5,000)
		124,000
Deferred tax		
Change in tax rate	Rs. 30,000 x (25%-30%)/30%	(5,000)
Arising during the year	Rs. (180,000 x 25%) - 25,000	20,000
	Rs. (180,000 x 25%) - 30,000	15,000
		139,000

3.2.2 Additional disclosure

The following must also be disclosed:

- (a) the aggregate current and deferred tax relating to items that are charged or credited directly to equity;
 - (b) the amount of income tax relating to each component of other comprehensive income;
 - (c) an explanation of changes in the applicable tax rate(s) compared to the previous accounting period;
 - (d) the amount (and expiry date, if any) of deductible temporary differences, unused tax losses, and unused tax credits for which no deferred tax asset is recognised in the statement of financial position;
 - (e) in respect of each type of temporary difference, and in respect of each type of unused tax losses and unused tax credits:
- the amount of the deferred tax assets and liabilities recognised in the statement of financial position for each period presented;
 - the amount of the deferred tax income or expense recognised in profit or loss, if this is not apparent from the changes in the amounts recognised in the statement of financial position

3.2.3 Disclosure: tax reconciliation

An entity must also disclose an explanation of the relationship between tax expense (income) and accounting profit in either or both of the following forms:

- (a) a numerical reconciliation between tax expense (income) and the product of accounting profit multiplied by the applicable tax rate(s), disclosing also the basis on which the applicable tax rate(s) is (are) computed; or
- (b) a numerical reconciliation between the average effective tax rate and the applicable tax rate, disclosing also the basis on which the applicable tax rate is computed.

Average effective tax rate = Tax expense (or income) / Accounting profit x 100%

The tax reconciliation includes exempt income, disallowed expenses and effect of tax rates that are either lower or higher than applicable tax rate.

► **Example 15:**

Bee Limited (BL) had an accounting profit before tax of Rs. 500,000. This income of Rs. 30,000 which is not taxable (exempt) and expenses of Rs. 10,000 which are not allowed as deduction (neither when incurred nor when paid).

Accounting depreciation in the year was Rs. 100,000 and tax allowable depreciation was Rs. 150,000. This means that a taxable temporary difference of Rs. 50,000 originated in the year.

Applicable tax rate is 30%.

Required: Compute tax expense for BL and prepare tax reconciliation in absolute amount and in percentages.

► **ANSWER:**

Taxation expense		Rs.
Current tax	W1	129,000
Deferred tax	Rs. 50,000 x 30%	15,000
		144,000

Tax reconciliation	Rs.	%*
Accounting profit at applicable tax rate (Rs. 500,000 x 30%)	150,000	30
Less: Effect of exempt income (Rs. 30,000 x 30%)	(9,000)	(1.8)
Add: Effect of disallowed expenses (Rs. 10,000 x 30%)	3,000	0.6
Tax expense ; effective tax rate	144,000	28.8

*% = relevant amount in absolute numbers / accounting profit x 100

W1: Computation of current tax	Rs.
Accounting profit	500,000
Add: Accounting depreciation	100,000
Less: Tax depreciation	(150,000)
Less: Exempt income	(30,000)
Add: Disallowed expenses	10,000
Taxable profit	430,000
Tax rate	30%

► **Example 17:**

Given below is the statement of profit or loss of Shakir Industries for the year ended December 31, 2015:

	2015
	Rs. m
Sales	143.00
Cost of goods sold	(96.60)
Gross profit	46.40
Operating expenses	(28.70)
Operating profit	17.70
Other income	3.40
Profit before interest and tax	21.10
Financial charges	(5.30)
Profit before tax	15.80

Following information is available:

- Operating expenses include an amount of Rs. 0.7 million paid as penalty to SECP on non-compliance of certain requirements of the Companies Act, 2017.
- During the year, the company recorded Rs. 2.4 million expense for warranty provision. The actual payment on account of warranty was Rs. 1.6 million.

- (iii) Lease payments made during the year amounted to Rs. 0.65 million which include financial charges of Rs. 0.15 million. As at December 31, 2015, lease liability stood at Rs. 1.2 million. The movement in right of use assets is as follows:

	Rs. m
Opening balance – 01/01/2015	2.50
Depreciation for the year	(0.7)
Closing balance – 31/12/2015	1.80

- (iv) The details of owned fixed assets are as follows:

	Accounting	Tax
	Rs. m	Rs. m
Opening balance– 01/01/2015	12.50	10.20
Purchased during the year	5.3	5.3
Depreciation for the year	(1.1)	(1.65)
Closing balance– 31/12/2015	16.70	13.85

- (v) Capital work-in-progress as on December 31, 2015 include financial charges of Rs. 2.3 million which have been capitalised in accordance with IAS-23 “Borrowing Costs”. However, the entire financial charges are admissible, under the Income Tax Ordinance, 2001.
- (vi) Deferred tax liability and provision for warranty as at January 1, 2015 was Rs. 0.84 million and Rs. 0.7 million respectively.
- (vii) Applicable income tax rate is 35%.

Required: Based on the available information, compute the current and deferred tax expenses for the year ended December 31, 2015. Also prepare tax reconciliation.

► **ANSWER:**

Shakir Industries – Year end 31 December 2015

Computation of current tax	Rs. million
Accounting profit (before tax)	15.80
Add: Penalty paid to SECP	0.70
Add: Warranty expense	2.40
Less: Warranty payment	(1.60)
Add: Depreciation on right of use asset	0.70
Add: Interest on lease liability	0.15
Less: Lease payments	(0.65)
Add: Accounting depreciation	1.10
Less: Tax depreciation	(1.65)
Less: Borrowing costs	(2.30)
Taxable profit	14.65
Tax rate	35%
	5.13

Computation of deferred tax	Carrying amount	Tax base	Temporary Difference	Tax rate	Deferred tax liability (asset)
	Rs. million				Rs. million
Provision for warranty	1.50 W1	-	1.50 D	35%	(0.53)
Right of use	1.80	-	1.80 T	35%	0.63
Lease liability	1.20	-	1.20 D	35%	(0.42)
Owned fixed assets	16.70	13.85	2.85 T	35%	1.00
Borrowing cost (CWIP)	2.30	-	2.30 T	35%	0.81
Deferred tax liability					1.49
Less: Opening balance					(0.84)
Expense					0.65

W1: Rs. 0.70m opening + 2.40m expense – 1.60m payment = Rs. 1.50m

Tax expense	Rs. million
Current tax	5.13
Deferred tax	0.65
	5.78

Tax reconciliation	Rs. million
Accounting profit	15.80
Applicable tax rate	35%
	5.53
Add: Penalty (disallowed) Rs. 0.70 x 35%	0.25
Tax expense	5.78

► **Example 18:**

Bilal Engineering Limited earned profit before tax amounting to Rs. 50 million during the year ended December 31, 2015. The accountant of the company has submitted draft accounts to the Finance Manager along with the following information which he believes could be useful in determining the amount of taxation:

- (i) Accounting depreciation for the year is Rs. 10 million.
- (ii) A motor vehicle having fair value (i.e. equal to present value of lease payments) Rs. 1 million was taken on lease on 1 January 2015. Related clauses of the lease agreement are as under:
 - Annual instalment of Rs. 0.3 million is payable annually in advance.
 - The interest rate implicit in the lease is 10% per annum.
 - Accounting depreciation on the leased vehicle is included in the depreciation referred to in para (i) above.

- (iii) Tax depreciation on the assets owned by the company is Rs. 7million.
- (iv) Research and development expenses of Rs. 15 million were incurred in 2015 and are being amortised over a period of 15 years. For tax purposes research and development expenses are allowed to be written off in 10 years. However, 10% of these expenses were not verifiable and have not been claimed.
- (v) Expenses amounting to Rs. 2.5 million were disallowed in 2014. Out of these Rs. 1.5 million were allowed in appeal, during the current year. The company had initially expected that the full amount would be allowed but has decided not to file a further appeal.
- (vi) The applicable tax rate is 30%.

Required:

- (a) Prepare journal entries in respect of taxation, for the year ended December 31, 2015.
- (b) Prepare a reconciliation to explain the relationship between tax expense and accounting profit as is required to be disclosed under IAS 12 Income Taxes.

► **ANSWER:****Part (a) Journal entries**

Date	Particulars	Debit Rs. m	Credit Rs. m
31 Dec 2015	Current tax expense	16.02	
	Current tax payable		16.02
31 Dec 2015	Deferred tax asset	0.27	
	Deferred tax income		0.27

Computation of current tax	Rs. million
Accounting profit (before tax)	50
Add: Accounting depreciation	10
Add: Interest on lease liability (Rs. 1m – 0.3m) x 10%	0.07
Less: Lease payments	(0.3)
Less: Tax depreciation	(7)
Add: Accounting amortisation Rs. 15m / 15 years	1
Less: Tax amortisation (Rs. 15m x 90%) / 10 years	(1.35)
Taxable profit	52.42
Tax rate	30%
Current tax (current year)	15.72
Current tax (prior year disallowed expense Rs. 1m x 30%)	0.30
	16.02

Computation of deferred tax	Carrying amount	Tax base	Temporary Difference	Tax rate	Deferred tax liability (asset)
	Rs. million				Rs. million
Accumulated depreciation	10	7	3 D	30%	(0.9)
Right of use (at cost)	1	-	1 T	30%	0.3
Lease liability	0.77 W1	-	0.77 D	30%	(0.23)
R&D	14	12.15	1.85 T	30%	0.56
Deferred tax liability (asset)					(0.27)
Less: Opening balance					0
Expense (income)					(0.27)

W1: Rs. 1m opening – 0.3m payment + 0.07m interest = Rs. 0.77m

Part (b)

Tax reconciliation	Rs. million
Accounting profit	50
Applicable tax rate	30%
	15
Add: prior period expenses (disallowed) Rs. 1m x 30%	0.30
Add: R&D expenses (not verifiable) Rs. 1.5m x 30%	0.45
Tax expense (16.02 – 0.27)	15.75

► Example 19:

Waqar Limited has provided you the following information for determining its tax and deferred tax expense for the year 2014 and 2015:

- During the year ended December 31, 2015, the company's accounting profit before tax amounted to Rs. 40 million (2014: Rs. 30 million). The profit includes capital gains amounting to Rs. 10 million (2014: Rs. 8 million) which are exempt from tax.
- The accounting written down values of the fixed assets, as at December 31, 2013 were as follows:

	Cost	Accumulated depreciation	Written down value
	Rs. million		
Machinery	200	25	175
Furniture and fittings	50	10	40

- No additions or disposals of fixed assets were made in the years 2014 and 2015.
- Machinery was acquired on January 1, 2013 and is being depreciated on straight-line basis over its estimated useful life of 8 years. The tax base of machinery as at December 31, 2013 was Rs. 90 million.
- Furniture and fittings are also depreciated on the straight line basis at the rate of 10% per annum. The tax base of furniture and fittings as at December 31, 2013 was Rs. 40.5 million.

- (vi) Normal rate of tax depreciation on both types of assets is 10% on written down value.
- (vii) The applicable tax rate was 35% since 2013, however, during 2015 it was reduced to 30%.

Required:

For the year 2014 and 2015:

- (a) Calculate the corporate income tax liability for the year.
- (b) Calculate the deferred tax balance that is required in the statement of financial position as at the year-end.
- (c) Prepare a note showing the movement on the deferred tax account and thus calculate the deferred tax charge for the year.
- (d) Prepare the statement of profit or loss note which shows the compilation of the tax expense.
- (e) Prepare a note to reconcile the product of the accounting profit and the tax rate to the tax expense.

► **ANSWER:****Waqar Limited**

Year end 31 December 2014 & 2015

(a) Computation of current tax	2015	2014
	Rs. million	
Accounting profit (before tax)	40	30
Less: Exempt capital gains	(10)	(8)
Add: Accounting depreciation (machinery) [Rs. 200m/8 years]	25	25
Add: Accounting depreciation (furniture) [Rs. 50m x 10%]	5	5
Less: Tax depreciation (machinery) [Rs. 90m & Rs.81m x 10%]	(8.1)	(9)
Less: Tax depreciation (furniture) [Rs. 40.5m & Rs. 36.45m x 10%]	(3.65)	(4.05)
Taxable profit	48.25	38.95
Tax rate	30%	35%
Current tax	14.48	13.63

Part (b) Deferred tax calculation

Computation of deferred tax	Carrying amount	Tax base	Temporary Difference	Tax rate	Deferred tax liability (asset)
	Rs. million				Rs. million
Year 2013					
Machinery	175	90	85 T	35%	29.75
Furniture & Fittings	40	40.5	0.5 D	35%	(0.18)
Deferred tax liability (asset)					29.57
Year 2014					
Machinery W1	150	81	69 T	35%	24.15
Furniture & Fittings W2	35	36.45	1.45 D	35%	(0.51)

Computation of deferred tax	Carrying amount	Tax base	Temporary Difference	Tax rate	Deferred tax liability (asset)
	Rs. million				Rs. million
Deferred tax liability (asset)					23.64
Year 2015					
Machinery W3	125	72.9	52.1 T	30%	15.63
Furniture & Fittings W4	30	32.8	2.8 D	30%	(0.84)
Deferred tax liability (asset)					14.79

W1: Rs. 175m – 25m = Rs. 150m & Rs. 90m x 90% = Rs. 81m

W2: Rs. 40m – 5m = Rs. 35m & Rs. 40.5m x 90% = Rs. 36.45m

W3: Rs. 150m – 25m = Rs. 125m & Rs. 81m x 90% = Rs. 72.9m

W4: Rs. 35m – 5m = Rs. 30m & Rs. 36.45m x 90% = Rs. 32.8m

(c) Deferred tax movement	2015	2014
	Rs. million	
Closing balance: liability (asset) (b)	14.79	23.64
Opening balance liability (asset)	23.64	29.57
Expense (income) in profit or loss	(8.85)	(5.93)

(d) Tax expense	2015	2014
	Rs. million	
Current tax	14.48	13.63
Deferred tax	(8.85)	(5.93)
	5.63	7.7

(e) Tax reconciliation	2015	2014
	Rs. million	
Accounting profit	40	30
Applicable tax rate	30%	35%
	12	10.5
Less: Exempt capital gain [Rs. 10m x 30%; Rs. 8m x 35%]	(3)	(2.8)
Less: Decrease in rate Rs. 23.64m x (30-35)/35	(3.37)	
Tax expense	5.63	7.7

► **Example 20:**

XYZ Limited had an accounting profit before tax of Rs. 90,000 for the year ended 31st December 2016. The tax rate is 30%. Opening deferred tax balance was Rs. 3,600.

The following balances and information are relevant as at 31st December 2016.

	Carrying amount	Tax base	Note
Non-current assets	Rs.	Rs.	
Property	63,000		1
Plant and machinery	100,000	90,000	2
Right of use assets (under lease)	80,000		3
Receivables:			
Trade receivables	73,000		4
Interest receivable	1,000		5
Payables			
Fine (not allowed as tax deduction)	10,000		
Lease liability	85,867		3
Interest payable	3,300		5

Note 1: The property cost the company Rs.70,000 at the start of the year. It is being depreciated on a 10% straight line basis for accounting purposes. The company's tax advisers have said that the company can claim Rs.42,000 accelerated depreciation as a taxable expense in this year's tax computation.

Note 2: The balances in respect of plant and machinery are after providing for accounting depreciation of Rs.12,000 and tax allowable depreciation of Rs.10,000 respectively.

Note 3: The asset under lease was acquired on 1 Jan 2016 and have been depreciated over useful life of 5 years. Rental expense for leases is tax deductible. The annual rental for the asset is Rs. 28,800 (including Rs. 14,667 for interest) and was paid on 31st December 2016.

Note 4: The receivables figure is shown net of an allowance for doubtful balances of Rs. 7,000. This is the first year that such an allowance has been recognised. A deduction for debts is only allowed for tax purposes when the debtor enters liquidation.

Note 5: Interest income is taxed, and interest expense is allowable on a cash basis. There were no opening balances on interest receivable and interest payable.

Required:

Calculate current and deferred tax, movement of deferred tax liability, note showing components of tax expense and reconciliation disclosure for the year ended 31 December 2016.

► ANSWER:

XYZ Limited (Year ended: 31 December 2016)

Current tax computation	Rs.
Accounting profit	90,000
Add: Accounting depreciation on property	7,000
Less: Tax depreciation on property	(42,000)
Add: Accounting depreciation on plant and machinery	12,000
Less: Tax depreciation on plant and machinery	(10,000)
Add: Depreciation of leased asset	20,000
Add: Interest expense (on lease)	14,667
Less: Lease rental paid	(28,800)
Add: Increase in allowance for doubtful debts	7,000
Add: Interest not paid yet	3,300
Add: Fines (disallowed)	10,000
Less: Interest not received yet	(1,000)
Tax profit	82,167
Tax rate	30%
Current tax	24,650

Deferred tax	Carrying value	Tax base	Temp. Diff.
	Rs.	Rs.	Rs.
Property	63,000	28,000	35,000 T
Plant and machinery	100,000	90,000	10,000 T
Right of use assets	80,000	0	80,000 T
Lease liability	85,867	0	85,867 D
Trade receivables	73,000	80,000	7,000 D
Interest receivables	1,000	0	1,000 T
Interest payable	3,300	0	3,300 D
Total taxable temporary differences			29,833 T
Tax rate			30%
Deferred tax			8,950
Opening balance			3,600
Profit or loss			5,350

Tax expense	Rs.
Current tax expense	24,650
Deferred tax expense	5,350
Tax expense	30,000

Tax Reconciliation	Rs.
Tax @ applicable rate [90,000 x 30%]	27,000
Add: Effect of disallowed expenses: fines [10,000 x 30%]	3,000
Tax expense	30,000

► **Example 21:**

The following information relates to Galaxy International (GI), a listed company, which was incorporated on January 1, 2014.

- The (loss) / profit before taxation for the years ended December 31, 2014 and 2015 amounted to (Rs. 1.75 million) and Rs. 23.5 million respectively.
- The details of accounting and tax depreciation on fixed assets is as follows:

	2015	2014
	Rs. m	Rs. m
Accounting depreciation	15	15
Tax depreciation	6	45
- In 2014, GI accrued certain expenses amounting to Rs. 2 million which were disallowed by the tax authorities. However, these expenses are expected to be allowed on the basis of payment in 2015.
- GI earned interest on Special Investment Bonds amounting to Rs. 1.0 million and Rs. 1.25 million in the years 2014 and 2015 respectively. This income is exempt from tax.
- GI recorded provision (and related expense) during the years 2014 and 2015 amounted to Rs. 1.7 million and Rs. 2.2 million respectively. No payment has so far been made on account of these provisions.
- The applicable tax rate is 35%.

Required:

Prepare a note on taxation for inclusion in the company's financial statements for the year ended December 31, 2015 giving appropriate disclosures relating to current and deferred tax expenses including a reconciliation to explain the relationship between tax expenses and accounting profit.

► **ANSWER:**

Galaxy International (Year ended 31 December 2015)

Taxation	2015	2014
	Rs. m	Rs. m
Current tax expense W1	0.84	-
Deferred tax expense (income) W2	6.948	(0.963)
Charge to income statement	7.788	(0.963)

Reconciliation	Rs. m	Rs. m
Tax at applicable rate Rs. 23.5m x 35%; (Rs. 1.75m) x 35%	8.225	(0.613)
Less: Effect of exempt income Rs. 1.25m x 35%; Rs. 1m x 35%	(0.437)	(0.35)
Actual tax (current + deferred)	7.788	(0.963)

W1: Current tax	2015	2014
	Rs. m	Rs. m
Accounting profit / (loss) before tax	23.5	(1.75)
Add: Accounting depreciation	15	15
Less: Tax depreciation	(6)	(45)
Add: Expenses unpaid	-	2
Less: Expenses paid	(2)	-
Less: Exempt interest income	(1.25)	(1)
Add: Expense related to provision	2.2	1.7
Less: Payment related to provision	-	-
Tax profit / (loss)	31.45	(29.05)
Tax loss adjusted	(29.05)	
	2.40	
Current tax expense @ 35%	0.84	Nil

W2: Deferred tax	CA	TB	Temp. Diff	Tax Rate	DTL / DTA
2014	Rs. m	Rs. m	Rs. m		Rs. m
Accumulated depreciation	15	45	30 T	35%	10.5 L
Accrued expenses	2	0	2 D	35%	0.70 A
Provision	1.7	0	1.7 D	35%	0.595 A
					9.205 L
Unused tax losses Rs. 29.05 x 35%					10.168 A
Deferred tax asset (income)					0.963 A
2015					
Accumulated depreciation	30	51	21 T	35%	7.35 L
Provision	1.7 + 2.2	0	3.9 D	35%	1.365 A
Deferred tax liability					5.985 L
Opening deferred tax asset					0.963 A
Deferred tax expense					6.948

► **Example 22:**

The following information relates to Apricot Limited (AL), a listed company, for the financial year ended 31 December 2015:

- The profit before tax for the year amounted to Rs. 60 million (2014: Rs. 45 million).
- The accounting and tax written down value of fixed assets as on 31 December 2013 was Rs. 104 million and Rs. 97 million respectively. Accounting depreciation for the year is Rs. 10 million (2014: Rs. 9 million) whereas tax depreciation for the year is Rs. 8 million (2014: Rs. 7 million).
- During the year, AL sold a machine for Rs. 3 million and recognized a profit of Rs. 0.5 million. The tax written down value of the machine as on 31 December 2014 was Rs. 2 million. There were no other additions/disposals of fixed assets in 2014 and 2015.

- (iv) AL earned capital gain of Rs. 6 million (2014: Nil) on sale of shares of a listed company. This income is exempt from tax.
- (v) Bad debt expenses (bad and doubtful debts) recognized during the year was Rs. 5 million (2014: Rs. 7 million).
- (vi) Bad debts actually written off during the year amounted to Rs. 3 million (2014: Rs. 4 million).
- (vii) Deferred tax asset and provision for bad debts as on 31 December 2013 was Rs. 7.44 million and Rs. 9 million respectively.
- (viii) The company's assessed brought forward losses up to 31 December 2013 amounted to Rs. 19.25 million.
- (ix) Applicable tax rate is 35%.

Required:

Prepare a note on taxation for inclusion in AL's financial statements for the year ended 31 December 2015 giving appropriate disclosures relating to current and deferred tax expenses including comparative figures for 2014 and a reconciliation to explain the relationship between tax expense and accounting profit.

► **ANSWER:****Apricot Limited (Year ended 31 December 2015)**

Taxation	2015		2014
	Rs. m		Rs. m
Current tax expense W1	20.48		10.76
Deferred tax expense (income) W2	(1.58)		4.99
	18.90		15.75

Relationship between tax expense and accounting profit	2015		2014
	Rs. m		Rs. m
Tax at applicable rate (60 x 35%) ; (45 x 35%)	21		15.75
Less: Tax effect of exempt income 6 x 35%	(2.10)		
	18.90		15.75

W1 – Computation of Current Tax	2015		2014
	Rs. m		Rs. m
Profit before tax	60		45
Add: Accounting depreciation	10		9
Less: Tax depreciation	(8)		(7)
Less: Accounting gain on disposal	(0.5)		-
Add: Tax gain on disposal	1		-
Less: Exempt Capital gain	(6)		
Add: Bad and doubtful debts expense	5		7
Less: Bad debts actually written off	(3)		(4)
Taxable income	58.5		50
Brought forward losses	-		(19.25)
	58.5		30.75
Tax liability (@ 35%)	20.48		10.76

W2 – Computation of Deferred Tax

Year 2014	CA	TB	TD	Rate	DT L/A
	Rs. m				Rs. m
Fixed Assets W4	95	90	5 T	35%	1.75 L
Provision for bad debts W5	12	0	12 D	35%	4.2 A
Closing Balance					2.45 A
Opening Balance					7.44 A
Deferred tax expense (income)					4.99

Year 2015	CA	TB	TD	Rate	DT L/A
	Rs. m				Rs. m
Fixed Assets W4	82.5	80	2.5 T	35%	0.87 L
Provision for bad debts W5	14	0	14 D	35%	4.9 A
Closing Balance					4.03 A
Opening Balance					2.45 A
Deferred tax expense (income)					(1.58)

W4 – Fixed Assets	Accounting	Tax
	Rs. m	Rs. m
Balance 31 December 2013	104	97
Depreciation for the year 2014	(9)	(7)
Balance 31 December 2014	95	90
Disposal during year 2015	(2.5)	(2)
Depreciation for the year 2015	(10)	(8)
Closing balance	82.5	80

W5 – Provision for bad debts	2015	2014
	Rs. m	Rs. m
Opening balance	12	9
Doubtful debts expense for the year (5 – 3) ; (7 – 4)	2	3
Closing balance	14	12

4. COMPREHENSIVE EXAMPLES

► Example 23:

Following are the relevant extracts from the financial statements of Floor & Tiles Limited (FTL) for the year ended 31 December 2015:

	Rs in million
Profit before tax	80
Provision for gratuity for the year	12
Bad debts expense for the year	10
Capital gain (exempt from tax)	5

The following information is also available:

- (i) Opening balances of deferred tax liability, provision for bad debts and provision for gratuity were Rs. 5.28 million, Rs. 2 million and Rs. 13 million respectively.
- (ii) The cost and other details related to buildings (owned) included in property, plant and equipment are as follows:

	Rs. in million
Opening balance (purchased on 1 January 2013)	350
Cost of a building sold on 30 April 2015 (for Rs. 35 million)	30
Purchased on 1 July 2015	40

- (iii) Accounting depreciation on buildings is calculated @ 5% per annum on straight line basis whereas tax depreciation is calculated @ 10% on reducing balance method. Accounting depreciation of all other owned assets included in property, plant and equipment is same as tax depreciation.
- (iv) On 1 January 2015, a machine costing Rs. 120 million was acquired on lease. Some of the relevant information is as follows:
 - The lease term as well as the useful life is 5 years.
 - Annual lease rentals amounting to Rs. 30 million are payable in advance.
 - The interest rate implicit in the lease is 12.59%.
 - This machine would be depreciated over its useful life on straight line method.
- (v) On 1 June 2015, an amount of Rs. 1 million was paid as penalty to the provincial government due to non-compliance of environmental laws.
- (vi) The amount of gratuity paid to outgoing members was Rs. 10 million.
- (vii) During the year, entertainment expenses and repair expenses amounting to Rs. 6 million and Rs. 8 million respectively, pertaining to year ended 31 December 2013 were disallowed. FTL has decided to file appeal only against the decision regarding repair expenses.
- (viii) Applicable tax rate is 32%.

Required: Prepare a note on taxation (expense) for inclusion in FTL's financial statements for the year ended 31 December 2015 giving appropriate disclosures relating to current and deferred tax expenses including a reconciliation to explain the relationship between tax expense and accounting profit.

► ANSWER:

Floor & Tiles Limited

5.	Taxation		Rs. m
	Current tax		
	- Current year	W1	26.6
	- Prior year	[6 x 32%]	1.92
	Deferred tax	W2	(2.28)
			26.24

5.1	Tax Reconciliation		
	Relationship b/w Tax expense and Accounting profit		
			Rs. m
	Tax at applicable rate	[80 x 32%]	25.6
	Less: Exempt capital gain	[5 x 32%]	(1.6)
	Add: Disallowed penalty expense	[1 x 32%]	0.32
	Add: Prior year tax	[6 x 32%]	1.92
	Tax Expense	[Current + Deferred]	26.24

		%
Applicable tax rate		32
Less: Exempt capital gain	[5 / 80 x 32]	(2)
Add: Disallowed penalty expense	[1 / 80 x 32]	0.4
Add: Prior year tax	[6 / 80 x 32]	2.4
Average effective tax rate	[26.24 / 80 x 100]	32.8

W1: Current Tax		Rs. m
Accounting profit		80
Add: Gratuity Expense Provision		12
Less: Gratuity Paid		(10)
Add: Bad debts Expense Provision		10
Less: Exempt Capital Gain		(5)
Add: Accounting Depreciation	W3	17.5
Less: Tax Depreciation	W3	(29.92)
Less: Accounting Disposal gain	W3	(8.5)
Add: Tax Disposal gain	W3	10.7
Add: Depreciation on ROU asset	W4	24

W1: Current Tax		Rs. m
Add: Finance cost on lease	W4	11.33
Less: Lease rental paid	W4	(30)
Add: Penalty		1
Taxable Profit		83.11
	Tax rate	32%
Current tax (Current year)		26.6

W2: Deferred Tax	Workings	Carrying Amount	Tax Base	Temp. Difference
		Rs. m		
Provision for gratuity	[13 + 12 - 10]	15	-	15 D
Provision for bad debts	[2 + 10]	12	-	12 D
Building	W3	311	269.28	41.72 T
Right of use asset	W4	96	-	96 T
Lease liability	W4	101.33	-	101.33 D
				9.39 T
Tax rate				32%
Closing deferred tax liability				3
Less: Opening deferred tax liability				(5.28)
Deferred tax expense (income)				(2.28)

W3: Building	5% Straight line basis	Accounting Rs. m	10% Reducing balance	Tax Rs. m
Cost 1 January 2013		350		350
Depreciation 2013	[350 x 5%]	(17.5)	[350 x 10%]	(35)
				315
Depreciation 2014	[350 x 5%]	(17.5)	[315 x 10%]	(32)
WDV on 1 January 2015		315		283.5
Addition		40		40
Disposal		(26.5)		(24.3)
Depreciation (disposed)	[30 x 5% x 4/12]	0.5		0
Depreciation (addition)	[40 x 5% x 6/12]	1.0	[40 x 10%]	4
Depreciation (other)	[(350 - 30) x 5%]	16	[(283.5-24.3) x 10%]	25.92
		(17.5)		(29.92)
WDV on 31 December 2015		311		269.28

WDV of disposed asset and Gain		Rs. m		Rs. m
Cost 1 January 2013		30		30
Depreciation 2013	[30 x 5%]	(1.5)	[30 x 10%]	(3)
				27
Depreciation 2014	[30 x 5%]	(1.5)	[27 x 10%]	(2.7)
WDV on 1 January 2015		27		24.3
Depreciation upto April	[30 x 5% x 4/12]	(0.5)		0
WDV on disposal		26.5		24.3
Disposal proceeds		35		35
Gain on disposal		8.5		10.7

W4: Lease arrangement		Rs. m
Lease liability		
Initial recognition	Rs. 30m x [(1 - 1.1259 ⁻⁵⁺¹) / 0.1259] + 1	120
Payment		(30)
		90
Interest @12.59%		11.33
		101.33
Right of use asset		
Initial recognition	[equal to lease liability]	120
Depreciation	[120 / 5 years]	(24)
		96

► **Example 25:**

Triangle Limited (TL) was incorporated in 2017. The following information has been gathered for preparing the disclosures related to taxation for the year ended 31 December 2018:

- (i) Profit before tax for the year amounted to Rs. 125 million (2017: Rs. 110 million)
- (ii) Accounting depreciation for the year was Rs. 25 million (2017: Rs. 18 million)
- (iii) Tax depreciation for the year was Rs. 21 million (2017: Rs. 42 million)
- (iv) Rent is allowed for tax purposes on payment basis. Rent accrued as at 31 December 2018 amounted to Rs. 1 million (2017: Rs. 3 million)
- (v) Insurance is also allowed for tax purposes on payment basis. Prepaid insurance as at 31 December 2018 amounted to Rs. 5 million (2017: Rs. 4 million)
- (vi) Other income includes:
 - interest of Rs. 10 million (2017: Rs. 7 million)
 - dividend of Rs. 6 million (2017: Rs. 8 million)
- (vii) Borrowing cost of Rs. 2 million was capitalized in 2018 on an under construction building. Borrowing cost is allowed for tax purposes in the year in which it is incurred.

(viii) Applicable tax rates are as follows:

	*2018	2017
Dividend income	35%	20%
Interest income	Exempt	30%
All other incomes	35%	30%

*The rates were changed through the Finance Act enacted on 10 January 2018.

Required:

Prepare the following:

- Note on taxation for inclusion in TL's financial statements for the year ended 31 December 2018 and a reconciliation to explain the relationship between tax expense and accounting profit. (Show comparative figures)
- Computation of deferred tax liability/asset in respect of each temporary difference as at 31 December 2017 and 2018.

► ANSWER:

Part (a)

Triangle Limited

Notes to the financial statements for the year ended 31 December 2018

		2018	2017
Taxation		Rs. m	Rs. m
Current tax	W1	39.9	24.7
Deferred tax	(b)	1.6	7.5
		41.5	32.2

Tax Reconciliation

Relationship b/w Tax expense and Accounting profit		Rs. m	Rs. m
Tax at applicable rate	[125 x 35%] & [110 x 30%]	43.8	33.0
Less: Lower rate on dividend	0 & [8 x 10%]	-	(0.8)
Less: Exempt Interest income	[10 x 35%] & 0	(3.5)	-
Add: Change in rate	[7.5 DT x 5/30]	1.25	-
Tax Expense	[Current + Deferred]	41.50	32.2

Relationship b/w Tax expense and Accounting profit		%	%
Applicable tax rate		35	30
Less: Lower rate on dividend	0 & [0.8/110 x 100]	-	(0.73)
Less: Exempt Interest income	[3.5/125 x 100] & 0	(2.8)	
Add: Change in rate	[1.25/125 x 100]	1.0	
Average effective tax rate	[Tax exp / PBT]	33.2	29.27

Part (b)**Triangle Limited****Computation of Deferred Tax Liability**

Year 2018	Ref.	Carrying Amount	Tax Base	Temp. Difference	Liability @35%
		Rs. m			
Accumulated depreciation	(ii), (iii)	43	63	20 T	7
		[18 + 25]	[42 + 21]		
Accrued rent	(iv)	1	-	1 D	(0.35)
Prepaid insurance	(v)	5	-	5 T	1.75
Capitalised borrowing costs	(vii)	2	-	2 T	0.7
Deferred tax liability					9.1
- Opening balance					(7.5)
Deferred tax expense					1.6

Year 2017	Ref.	Carrying Amount	Tax Base	Temp. Difference	Liability @30%
		Rs. m			
Accumulated depreciation	(ii), (iii)	18	42	24 T	7.2
Accrued rent	(iv)	3	-	3 D	(0.9)
Prepaid insurance	(v)	4	-	4 T	1.20
Deferred tax liability					7.5
- Opening balance					-
Deferred tax expense					7.5

W1 – Current tax	Ref.	2018	2017
		Rs. m	Rs. m
Accounting Profit	(i)	125	110
Add: Accounting Depreciation	(ii)	25	18
Less: Tax Depreciation	(iii)	(21)	(42)
Less/Add: Accrued rent 2017	(iv)	(3)	3
Add: Accrued rent 2018	(iv)	1	
Add/Less: Prepaid Insurance 2017	(v)	4	(4)
Less: Prepaid Insurance 2018	(v)	(5)	
Less: Borrowing Costs	(vi)	(2)	
Less: Interest income (different rate)	(vi)	(10)	(7)
Less: Dividend income (different rate)	(vi)	(6)	(8)
Taxable Profit Other than Interest and Dividend		108	70
Current Tax Expense:			
Interest income [10 x 0%] & [7 x 30%]		0	2.1
Dividend income [6 x 35%] & [8 x 20%]		2.1	1.6
Other [108 x 35%] & [70 x 30%]		37.8	21
		39.9	24.7

► **Example 24:**

Orange Limited (OL) is in the process of finalizing its financial statements for the year ended 30 June 2018. The following information has been gathered for preparing the disclosures related to taxation:

- (i) Profit before tax for the year ended 30 June 2018 was Rs. 508 million.
- (ii) Accounting depreciation for the year exceeds tax depreciation by Rs. 45 million.
- (iii) During the year, OL sold a machine whose accounting WDV exceeded tax WDV by Rs. 15 million.
- (iv) OL carries trademark of Rs. 90 million having indefinite useful life which was acquired on 1 July 2015. Tax authorities allow its amortization over 10 years on straight line basis.
- (v) OL sells goods with a 1-year warranty and it is estimated that warranty expenses are 2% of annual sales. Actual payments during the year related to warranty claims were Rs. 54 million. Of these, Rs. 38 million pertain to goods sold during the previous year.
Sales for the year ended 30 June 2018 was Rs. 1,750 million. Under the tax laws, these expenses are allowed on payment basis.
- (vi) During the year, OL expensed out payments of Rs. 17.5 million related to restructuring of one of its business segments. As per tax laws, these expenses are to be allowed as tax expense over a period of 5 years from 2018 to 2022.
- (vii) Expenses include:
 - accruals of Rs. 26 million which will be allowed for tax purpose on payment basis.
 - cash donations of Rs. 5 million which are not allowed as tax expense.
- (viii) Other income includes:
 - commission receivable of Rs. 12 million.
 - dividend receivable of Rs. 35 million.

Both incomes were taxable on receipt basis at 30% up to 30 June 2018. With effect from 1 July 2018 commission income is exempt from tax whereas dividend income is taxable at 10% on receipt basis.

- (ix) On 30 June 2018, OL received advance rent of Rs. 16 million. Rent income is taxable on receipt basis.
- (x) Net deferred tax liability as on 1 July 2017 arose on account of:

	Rs. in million
Property, plant and equipment	34.5
Trademark	5.4
Provision for warranty	(14.7)
	25.2

- (xi) Applicable tax rate is 30% except stated otherwise.

Required:

- (a) Prepare a note on taxation for inclusion in OL's financial statements for the year ended 30 June 2018 including a reconciliation to explain the relationship between tax expense and accounting profit.
- (b) Compute the deferred tax liability/asset in respect of each temporary difference.

(Comparative figures are not required)

► **ANSWER:****Part (a)****Orange Limited****Notes to the financial statements for the year ended 30 June 2018**

Taxation		Rs. m
Current tax	W1	162.9
Deferred tax	(b)	(19.6)
		143.3

Tax Reconciliation		Rs. m
Relationship b/w Tax expense and Accounting profit		Rs. m
Tax at applicable rate	[508 x 30%]	152.4
Add: Disallowed cash donations	[5 x 30%]	1.5
Less: Exempt commission income	[12 x 30%]	(3.6)
Less: Lower rate on dividend income	[35 x 20%]	(7)
Tax Expense	[Current + Deferred]	143.3

Relationship b/w Tax expense and Accounting profit		%
Applicable tax rate		30
Add: Disallowed cash donations	[5 / 508 x 30]	0.3
Less: Exempt commission income	[12 / 508 x 30]	(0.71)
Less: Lower rate on dividend income	[35 / 508 x 20]	(1.38)
Average effective tax rate	[143.3 / 508 x 100]	28.21

Part (b)**Orange Limited****Deferred Tax Liability / Asset as on 30 June 2018**

Description	Ref.	Carrying Amount	Tax Base	Temp. Difference
		Rs. m		
Property, plant and equipment	W2			55 Taxable
Trademark	(iv)	90	63	27 Taxable
			[90 - 90/10x3]	
Provision for warranty	W3	19	-	19 Deductible
Restructuring costs	(vi)	-	14	14 Deductible
			[17.5 - 3.5]	
Accrued expenses	(vii)	26	-	26 Deductible
Dividend receivable	(viii)	35	-	35 Taxable
Unearned rent	(ix)	16	-	16 Deductible
			[16 - 16]	

Deferred tax	Working	Liability (asset)
		Rs. m
On Taxable TD: Dividend RA	[35 x 10%]	3.5
On Taxable TD: Other	[(55 + 27) x 30%]	24.6
On Deductible TD	[(19 + 14 + 26 + 16) x 30%]	(22.5)
Closing Balance		5.6
Less: opening balance		25.2
Deferred tax expense (income)		(19.6)

W1 – Current tax		Ref	Rs. m
Accounting profit before tax		(i)	508
Add: Excess accounting depreciation		(ii)	45
Add: Excess tax gain (or lower tax loss) on disposal		(iii)	15
Less: Amortisation of trademark	[90 / 10 years]	(iv)	(9)
Add: Warranty expense (Accounting)	[35-11]	W2	24
Less: Warranty payments		(v)	(54)
Add: Restructuring expenses disallowed		(vi)	17.5
Less: Restructuring expenses amortisation	[17.5 / 5 years]		(3.5)
Accrued expenses (cash basis)		(vii)	26
Cash donations (inadmissible)			5
Commission income (on receipt basis)		(viii)	(12)
Dividend income (on receipt basis)			(35)
Unearned rent income (on receipt basis)		(ix)	16
Taxable Profit			543
Tax @ 30%			162.9

W2: Taxable Temporary difference on PPE	Temp. Diff.
	Rs. m
Opening (work back from opening deferred tax liability) [34.5 / 30 x 100]	115 Taxable
Less: More Depreciation	(45)
Less: More WDV of disposed asset	(15)
	55 Taxable

W3-Provision for warranty			
	Rs. m		Rs. m
Bank – previous year	38	b/d [14.7 x 100 / 30]	49
PL (Reversal last year) [49–38]	11		
Bank – current year [54–38]	16	PL (1,750 x 2%)	35
c/d	19		
	84		84

► **Example 26:**

Dua Limited (DL) is in the process of finalizing its financial statements for the year ended 31 December 2019. The following information have been gathered for preparing the disclosures relating to taxation:

- (i) Accounting loss before tax for the year amounted to Rs. 140 million. It includes:
- an amount of Rs. 2 million recovered from a customer whose debt had been written off in 2018. As per tax laws, receivable written offs are allowed as deduction.
 - dividend of Rs. 16 million earned against equity investment in a UK based company. As per tax laws, this dividend income is exempt from tax in Pakistan as 20% tax was paid in UK.
- (ii) The movement of owned property, plant and equipment for 2019 is as follows:

	Accounting WDV	Tax base
	----- Rs. in million -----	
Opening balance	1,700	1,116
Additions	460	480
Impairment	(72)	—*
Depreciation	(470)	(284)
Disposals	(144)	(92)
Closing balance	1,474	1,220

* impairment is not allowed for tax purposes.

Difference of Rs. 20 million in 'Additions' represents foreign exchange loss on acquisition which was considered as part of the cost of the asset as per tax laws.

- (iii) As per tax laws, research expense for the year is allowable in the next year. Research expense for the year amounted to Rs. 25 million (2018: Rs. 64 million).
- (iv) Rent expense is allowed for tax purposes on payment basis. Rent prepaid as at 31 December 2019 amounted to Rs. 6 million (2018: Rs. 1 million).
- (v) As on 31 December 2018, DL had carried forward tax losses of Rs. 90 million against which DL had always expected that it is probable that future taxable profit will be available.
- (vi) Tax rate is 35%.

Required:

- (a) Prepare a note on taxation for inclusion in DL's financial statements for the year ended 31 December 2019 and a reconciliation to explain the relationship between tax expense and accounting profit.
- (b) Compute deferred tax liability/asset in respect of each temporary difference as at 31 December 2019 and 2018.

► **ANSWER:****Part (a)****Dua Limited****Notes to the financial statements for the year ended 31 December 2019**

Taxation		Rs. m
Current tax	W1	17.2
Deferred tax	(b)	(68.6)
		(51.4)

Tax Reconciliation

Relationship b/w Tax expense and Accounting profit		Rs. m
Tax at applicable rate	[(140) x 35%]	(49)
Less: Lower rate on dividend	[16 x 15%]	(2.4)
Tax Expense	[Current + Deferred]	(51.4)

Relationship b/w Tax expense and Accounting profit		%
Applicable tax rate		(35)
Less: Lower rate on dividend	[2.4 / 140 x 100]	(1.71)
Average effective tax rate	[Tax exp / PBT]	(36.71)

Part (b)**Dua Limited****Computation of Deferred Tax Liability**

Year 2019	Ref.	Carrying Amount	Tax Base	Temp. Difference	DT @35%
		Rs. m			
PPE	(ii)	1,474	1,220	254 T	88.9
Research costs	(iii)	-	25	25 D	(8.75)
Prepaid rent	(iv)	6	-	6 T	2.1
Deferred Tax liability (asset)					82.25
Less: Opening balance					(150.9)
Deferred tax expense (income)					(68.6)

Year 2018	Ref.	Carrying Amount	Tax Base	Temp. Difference	DT @35%
		Rs. m			
PPE	(ii)	1,700	1,116	584 T	204.4
Research costs	(iii)	-	64	64 D	(22.4)
Prepaid rent	(iv)	1	-	1 T	0.35
Deferred Tax liability (Temporary Differences)					182.35
Less: DT asset on unused tax losses					[90 x 35%] (31.5)
Deferred Tax liability (asset)					150.85

W1 – Current tax	Ref	Working	2019
			Rs. m
Accounting Profit (loss)	(i)		(140)
Less: Dividend income (Foreign tax)	(i)		(16)
Add: Exchange loss Capitalised	(ii)		20
Add: Impairment loss	(ii)		72
Add: Excess Accounting Depreciation	(ii)	[470 - 284]	186
Add: Excess tax gain on disposals	(ii)	[144 - 92]	52
Less: Research expense of previous year	(iii)		(64)
Add: Research expense of this year	(iii)		25
Add: Prepaid expense of last year	(iv)		1
Less: Prepaid expense of this year	(iv)		(6)
			130
Less: Adjustment of unused tax losses	(v)		(90)
Taxable profit other than Dividend			40
Current Tax Expense:			
Dividend income	[16 x 20%]		3.2
Other	[40 x 35%]		14
			17.2

► **Example 27:**

Following information has been gathered for preparing the disclosures related to taxation of Lux Limited (LL) for the year ended 31 December 2020:

- (i) Accounting profit before tax for the year amounted to Rs. 1,270 million.
- (ii) Accounting depreciation exceeds tax depreciation by Rs. 100 million (2019: Rs. 150 million). Accounting depreciation also includes incremental depreciation of Rs. 40 million (2019: Rs. 60 million). As on 1 January 2019, carrying value of property, plant and equipment exceeded their tax base by Rs. 500 million.
- (iii) Liabilities of LL as at 31 December 2020 include:
 - balances of Rs. 100 million (2019: Rs. 70 million) which are outstanding for more than 3 years. As per tax laws, liabilities outstanding for more than 3 years are added to income and are subsequently allowed as expense on payment basis.
 - unearned commission of Rs. 80 million (2019: Rs. 15 million). Commission is taxable on receipt basis.
- (iv) Interest accrued as at 31 December 2020 amounted to Rs. 40 million (2019: Rs. 30 million). Interest income for the year is Rs. 55 million. Interest income is taxable at 20% on receipt basis.
- (v) Expenses include payments of donations of Rs. 50 million (2019: Rs. 80 million). Donation is allowable in tax by 200% of actual amount.

- (vi) LL recorded an expense of Rs. 35 million (2019: nil) to bring an inventory item to its net realizable value. This adjustment is not allowable for tax purposes.
- (vii) LL acquired 5% equity in Palmolive Limited for Rs. 425 million on 1 August 2020. The investment was classified at fair value through other comprehensive income. As at 31 December 2020, LL recorded Rs. 65 million as gain for change in fair value. As per tax laws, gain or loss on investment is taxable at the time of sale.
- (viii) Applicable tax rate is 30% except stated otherwise.

Required:

- (a) Prepare a note on taxation for inclusion in LL's financial statements for the year ended 31 December 2020 and a reconciliation to explain the relationship between the tax expense and accounting profit.
- (b) Compute deferred tax liability/asset in respect of each temporary difference as at 31 December 2020 and 2019.

► **ANSWER:****Part (a)****Lux Limited****Notes to the financial statements for the year ended 31 December 2020**

Tax expense		Rs. m
Current tax	W1	427.5
Deferred tax	(b)	(67)
		360.5

Tax Reconciliation

Relationship b/w Tax expense and Accounting profit		Rs. m
Tax at applicable rate	[1,270 x 30%]	381
Less: Lower rate on interest income	[55 x 10%]	(5.5)
Less: Extra deduction on donation	[50 x 30%]	(15)
Tax Expense	[Current + Deferred]	360.5

Relationship b/w Tax expense and Accounting profit		%
Applicable tax rate		30
Less: Lower rate on interest income	[5.5 / 1,270 x 100]	(0.43)
Less: Extra deduction on donation	[15 / 1,270 x 100]	(1.18)
Average effective tax rate	[Tax exp / PBT]	28.39

Part (b)**Lux Limited****Computation of Deferred Tax Liability**

Year 2020	Ref.	Carrying Amount	Tax Base	Temp. Difference	Tax rate	Deferred Tax
		Rs. m				
PPE [350 - 100]	(ii)			250 T	30%	75
Liabilities written back	(iii)	100	-	100 D	30%	(30)
Unearned commission	(iii)	80	-	80 D	30%	(24)
Interest receivable	(iv)	40	-	40 T	20%	8
NRV adjustment	(vi)	-	35	35 D	30%	(10.5)
equity investment	(vii)	490	425	65 T	30%	19.5
DT Liability						38.0
Less: Opening Balance						(85.5)
Total charge (credit)						(47.5)
Less: Charge related to Other comprehensive income						(19.5)
Expense (income) in profit or loss						(67)

Year 2019	Ref.	Carrying Amount	Tax Base	Temp. Difference	Tax rate	Deferred Tax
		Rs. m				
PPE [500 - 150]	(ii)			350 T	30%	105
Liabilities written back	(iii)	70	-	70 D	30%	(21)
Unearned commission	(iii)	15	-	15 D	30%	(4.5)
Interest receivable @ 20%	(iv)	30	-	30 T	20%	6
DT Liability						85.5

W1 – Current tax	Ref	Workings	2020
			Rs. m
Accounting Profit	(i)		1,270
Add: Excess of accounting depreciation	(ii)		100
Add: Increase in write-back of liabilities	(iii)	[100 - 70]	30
Less: Unearned commission of last year	(iii)		(15)
Add: Unearned commission of this year	(iii)		80
Less: Interest income (to be taxed on receipt)	(iv)		(55)
Less: Additional deduction on donation	(v)		(50)
Add: NRV Adjustment disallowed	(vi)		35
Taxable Profit Other than Interest			1,395

Current Tax Expense:			
Interest on receipt basis	W2	[45 x 20%]	9
Other		[1,395 x 30%]	418.5
			427.5

W2 - Interest Receivable					
	Rs. m				Rs. m
b/d	30			Cash	45
P&L	55			c/d	40
	85				85

► **Example 28:**

Following information has been gathered for preparing the disclosures related to taxation of Mabroom Limited (ML) for the year ended 31 December 2020:

- (i) Accounting profit before tax for the year amounted to Rs. 50 million.
- (ii) Accounting amortization exceeded tax amortization by Rs. 20 million (2019: Rs. 12 million). As at 31 December 2020, carrying values of intangible assets exceeded their tax base by Rs. 145 million.
- (iii) During the year, ML incurred advertising cost of Rs. 12 million. This cost is to be allowed as tax deduction over 3 years from 2020 to 2022.
- (iv) During the year, entertainment expenses amounting to Rs. 10 million pertaining to year ended 31 December 2018 were disallowed. Similar entertainment expenses for the current year were amounted to Rs. 7 million.
- (v) Provision for warranty as at 31 December 2020 was Rs. 23 million (2019: Rs. 18 million). Under tax laws, warranty expense is allowed on payment basis.
- (vi) During the year, ML recorded dividend income of Rs. 6 million out of which Rs. 2 million was not received till 31 December 2020. Under tax laws, dividend is taxable on receipt basis at the rate of 15%.
- (vii) On 1 April 2020, a manufacturing plant was acquired on lease for a period of 4 years at an annual lease rental of Rs. 40 million, payable in arrears. Interest rate implicit in the lease is 10% per annum. Under tax laws, all lease rentals are allowed on payment basis.
- (viii) Applicable tax rate (other than dividend income) is 35% for 2020 and prior years. However, this rate has been reduced by 5% for 2021 and future years through Finance Act enacted on 20 December 2020.

Required:

- (a) Prepare a note on taxation for inclusion in ML's financial statements for the year ended 31 December 2020 and a reconciliation to explain the relationship between the tax expense and accounting profit.
- (b) Compute deferred tax liability/asset in respect of each temporary difference as at 31 December 2020 and 2019.

► **ANSWER:****Part (a)****Mabroom Limited****Notes to the financial statements for the year ended 31 December 2020**

Taxation		Rs. m
Current tax - for the year	W1	41.65
- prior year	[10 (iv) x 35%]	3.50
Deferred tax	Part (b)	(26.94)
		18.21

Tax Reconciliation

Relationship b/w Tax expense and Accounting profit		Rs. m
Tax at applicable rate	[50 x 35%]	17.50
Add: Effect of prior year tax	[10 (iv) x 35%]	3.50
Add: Disallowed entertainment expenses	[7 (iv) x 35%]	2.45
Less: Lower rate on dividend	[6 x 20%]	(1.20)
Less: Effect of change in tax rate	[(24.51 - 0.30) x 5/30]	(4.04)
Tax Expense	[Current + Deferred]	18.21

Part (b)**Mabroom Limited****Computation of Deferred Tax Liability**

Year 2020	Ref.	Carrying Amount	Tax Base	Temp. Difference	Tax rate	DTL (A)
Rs. m						
Intangible assets	(ii)	145	-	145 T	30%	43.50
Deferred advertising costs	(iii)	-	8	8 D	30%	(2.40)
Provision for warranty	(v)	23	-	23 D	30%	(6.90)
Dividend receivable	(vi)	2	-	2 T	15%	0.30
ROU asset W1.1	(vii)	103.02	-	103.02 T	30%	30.90
Lease liability W1.1	(vii)	136.30	-	136.30 D	30%	(40.89)
Deferred Tax liability (asset)						24.51
Less: Opening balance						(51.45)
Deferred tax expense (income)						(26.94)

Year 2019	Ref.	Carrying Amount	Tax Base	Temp. Difference	Tax rate	DTL (A)
Rs. m						
Intangible assets (145 + 20)	(ii)	165	-	165 T	35%	57.75
Provision for warranty	(v)	18	-	18 D	35%	(6.30)
Deferred Tax liability (asset)						51.45

W1 – Current tax	Ref	Working	2020 Rs. m
Accounting Profit	(i)		50
Add: Excess accounting amortisation	(ii)		20
Add: Deferred advertising cost	(iii)		12
Less: Amortisation of advertising cost	(iii)	[12 / 3 years]	(4)
Add: Disallowed entertainment expenses	(iv)		7
Add: Excess of warranty provision over payments	(v)	[23 - 18]	5
Less: Dividend income taxable at lower rate	(vi)		(6)
Add: Interest on lease liability	(vii)	W1.1	9.51
Add: Depreciation on ROU asset	(vii)	W1.1	23.77
Less: Lease rentals	(vii)	(not paid yet)	0
Taxable profit other than Dividend			117.28
Current Tax: for the year			
Dividend income		[4 x 15%]	0.60
Other		[117.28 x 35%]	41.05
			41.65

W1.1: Lease arrangement	Asset	Liability
	Rs. m	Rs. m
Initial recognition Rs. 40 million x $[(1 - 1.10^{-4}) / 0.10]$	126.79	126.79
Add: Interest $[126.79 \times 10\% \times 9/12]$		9.51
Less: Depreciation $[126.79 / 4 \text{ years} \times 9/12]$	(23.77)	
	103.02	136.30

► **Example 29:**

Following information has been gathered for preparing the disclosures related to taxation of Surprise Limited (SL) for the year ended 31 December 2021:

- (i) Accounting profit before tax for the year amounted to Rs. 130 million.
- (ii) Tax depreciation exceeds accounting depreciation by Rs. 9 million and revaluation loss recognized against revaluation surplus is Rs. 6 million. Under tax laws, revaluation has no effect.
- (iii) Interest income exceeds interest receipt by Rs. 12 million while commission receipt exceeds commission income by Rs. 15 million. Under tax laws, both are taxable on receipt basis.
- (iv) Out of total donations of Rs. 5 million, only 60% are allowable in tax.
- (v) Development cost of Rs. 25 million incurred in 2021 has been expensed out. Under tax laws, development cost are amortized at the rate of 28% per annum on reducing balance basis.
- (vi) Capital work in progress as at 31 December 2021 includes borrowing cost of Rs. 8 million incurred in 2021. Under tax laws, borrowing cost is allowed in the year in which it is incurred.
- (vii) On 1 January 2021, SL acquired shares in Funny Limited (FL) for Rs. 70 million. The investment in FL was subsequently measured at fair value through profit or loss. During the year, SL received Rs. 4 million as dividend from FL. At year-end, a gain of Rs. 10 million was recognized as fair value adjustment. Under tax laws, capital gain is taxable at 15% at the time of sale while dividend received is taxable at 10%. The intention of SL for holding investment in FL is to take benefit in the form of capital gain.
- (viii) Deferred tax liability/(asset) in respect of temporary differences for SL as at 31 December 2020 was as follows:

	Rs. in million
Property, plant and equipment	18
Interest receivable	3
Unearned commission	(9)
	12

- (ix) Applicable tax rate is 30% except stated otherwise.
- (x) Unused assessed tax losses were Rs. 50 million till 31 December 2020. However, deferred tax asset was recognized only to the extent of Rs. 12 million (i.e. on tax losses of Rs. 40 million) due to limited availability of expected future taxable profits.

Required:

- (a) Prepare a note on taxation for inclusion in SL's financial statements for the year ended 31 December 2021 and a reconciliation to explain the relationship between the tax expense and accounting profit.
- (b) Compute deferred tax liability/asset in respect of each temporary difference as at 31 December 2021.

► **Answer:****Part (a)**

Surprise Limited

Notes to the financial statements for the year ended 31 December 2021

Tax expense		
Current tax	W1	22
Deferred tax	(b)	12.3
		34.3

Tax Reconciliation		
Relationship b/w Tax expense and Accounting profit		Rs. m
Tax at applicable rate	[130 x 30%]	39
Less: Lower rate on dividend income	[4 x (30-10)%]	(0.8)
Less: Lower rate on capital gain	[10 x (30-15)%]	(1.5)
Add: Donation not allowable in tax	[5 x 40% x 30%]	0.6
Less: Previously unrecognised deferred tax	[(50-40) x 30%]	(3)
Tax Expense	[Current + Deferred]	34.3

Part (b)

Surprise Limited

Computation of Deferred Tax Liability

31 December 2021	Ref.	Calculation	Temp. Difference	Tax rate	Deferred Tax
			Rs. m		Rs. m
PPE	(ii)	[60 - 6 loss + 9 Dep]	63 T	30%	18.9
Interest receivable	(iii)	[10 + 12 more accrual]	22 T	30%	6.6
Unearned commission	(iii)	[30 + 15 more unearned]	45 D	30%	(13.5)
Development costs	(v)	[25 - 7 amortisation]	18 D	30%	(5.4)
Capital work in progress	(vi)	[8 Borrowing cost]	8 T	30%	2.4
Investment at FVTPL	(vii)	[80 CA - 70 TB]	10 T	15%	1.5
DT Liability					10.5
Less: Opening Balance		[12 DTL - 12 DTA]			-
Total charge (credit)					10.5
Add: Credit to Rev. Surplus	(ii)	[6 loss x 30%]			1.8
Expense (income) in profit or loss					12.3
Temporary difference last year					
PPE		DTL 18 / 30% =	60	Taxable	
Interest receivable		DTL 3 / 30% =	10	Taxable	
Unearned commission		DTA (9) / 30% =	30	Deductible	

W1 – Current tax	Ref	Workings	2021
			Rs. m
Accounting Profit	(i)		130
Less: Excess of tax depreciation	(ii)		(9)
Less: Interest income (to be taxed on receipt)	(iii)		(12)
Add: Unearned commission received	(iii)		15
Add: Donations not allowable in tax	(iv)	[5 x 40%]	2
Add: Development costs	(v)		25
Less: Amortisation of development costs	(v)	[25 x 28%]	(7)
Less: Borrowing costs (included in CWIP)	(vi)		(8)
Less: Dividend income taxable at lower rate	(vii)		(4)
Less: Fair value adjustment on investment	(vii)		(10)
Taxable Profit [before loss adjustment]			122
Less: Unused tax losses adjusted			(50)
Taxable Profit [after loss]			72
Current Tax Expense:			
On dividend		[4 x 10%]	0.4
Other		[72 x 30%]	21.6
			22

► **Example 30:**

Following information has been gathered for preparing the disclosures related to taxation of Prism Limited (PL) for the year ended 31 December 2021:

- (i) Accounting profit before tax for the year after making all necessary adjustments was Rs. 105 million.
- (ii) On 1 July 2020, PL acquired an investment property for Rs. 50 million. The fair values of property as on 31 December 2020 and 2021 were Rs. 55 million and Rs. 65 million respectively. PL follows fair value model for accounting purposes. Under tax laws, depreciation is allowed at 10% per annum on cost. Further, full year's tax depreciation is allowed in the year of purchase.
- (iii) On 1 January 2021, PL purchased a license having indefinite life from a foreign company at a cost of Rs. 116 million. Upon payment, PL recorded foreign exchange gain of Rs. 16 million. Under tax laws, foreign exchange differences arising on payment are added to/deducted from the cost of asset while amortisation is allowed at 10% per annum.
- (iv) PL commissioned a new plant at a cost of Rs. 210 million which became operational on 1 January 2021. PL is also obliged to incur decommissioning cost of Rs. 40 million at the end of useful life of eight years. Applicable discount rate is 12% per annum. Under tax laws, decommissioning cost is allowable deduction at the time of payment while depreciation on plant is allowed at 10% per annum.
- (v) On 1 May 2021, PL acquired 5% equity investment for Rs. 75 million. In October 2021, dividend of Rs. 8 million was received on this investment. As at 31 December 2021, PL recorded Rs. 15 million as gain for change in fair value which was taken to other comprehensive income. Under tax laws, gain on investment is taxable at the time of sale while dividend income is exempt from tax.
- (vi) As on 31 December 2021, taxable temporary differences on other items amounted to Rs. 30 million (2020: Rs. 39 million). These differences have arisen due to items taken to profit or loss.
- (vii) The tax rate for the year is 35% (2020: 32%).

Required:

- (a) Prepare a note on taxation for inclusion in PL's financial statements for the year ended 31 December 2021 and a reconciliation to explain the relationship between the tax expense and accounting profit.
- (b) Compute deferred tax liability/asset in respect of each temporary difference as at 31 December 2021 and 2020.

► **Answer:****Part (a)**

Notes to the financial statements for the year ended 31 December 2021		
Tax expense		Rs. m
Current tax	W1	25.97
Deferred tax	(b)	9.45
		35.42
Tax Reconciliation		
Relationship b/w Tax expense and Accounting profit		Rs. m
Tax at applicable rate	[105 x 35%]	36.75
Less: Exempt dividend income	[8 x 35%]	(2.80)
Add: Increase in rate on opening deferred tax	[15.68 x 3/32]	1.47
Tax Expense	[Current + Deferred]	35.42

Part (b) Computation of Deferred Tax Liability

Year 2021	Ref.	Carrying Amount	Tax Base	Temp. Difference	Tax rate	Deferred Tax
Rs. m						
Investment property	(ii)	65	40 N2	25 T	35%	8.75
License	(iii)	116	90 N3	26 T	35%	9.10
Provision for decommissioning	(iv)	18.09 N4	0	18.09 D	35%	(6.33)
Plant	(iv)	197.9 N5	189 N6	8.9 T	35%	3.11
Equity investment	(v)	90	75	15 T	35%	5.25
Other differences	(vi)			30 T	35%	10.50
DT Liability						30.38
Less: Opening Balance						(15.68)
Total charge (credit)						14.70
Less: Charge related to OCI	(v)	[15 gain on equity investment x 35%]				(5.25)
Expense (income) in profit or loss						9.45

Year 2020	Ref.	Carrying Amount	Tax Base	Temp. Difference	Tax rate	Deferred Tax
Rs. m						
Investment property	(ii)	55	45 N1	10 T	32%	3.20
Other differences	(vi)			39 T	32%	12.48
DT Liability						15.68
N1: $50 - (50 \times 10\%) = \text{Rs. } 45$						
N2: $50 - (50 \times 10\% \times 2 \text{ years}) = \text{Rs. } 40$						
N3: $116 - 16 = 100 - 10 \text{ tax amortisation} = 90$						
N4: $40 \times 1.12^{-8} = 16.15 \times 112\% = 18.09$						
N5: $210 + 16.15 \text{ provision} = 226.15 - 226.15/8 \text{ years} = 197.9$						
N6: $210 - (210 \times 10\%) = 189$						

W1 - Current tax	Ref	Workings	2021 Rs. m
Accounting Profit	(i)		105.00
Less: Gain on investment property	(ii)	[65 - 55]	(10.00)
Less: Tax depreciation (investment property)	(ii)	[50 x 10%]	(5.00)
Less: Foreign exchange gain	(iii)		(16.00)
Less: Tax amortisation (license)	(iii)	[(116 - 16) x 10%]	(10.00)
Add: Finance cost on decommissioning provision	(iv)	[16.15 x 12%]	1.94
Add: Accounting depreciation (plant)	(iv)	[226.15 / 8 years]	28.27
Less: Tax depreciation (plant)	(iv)	[210 x 10%]	(21.00)
Less: Exempt dividend income	(v)		(8.00)
Add: Extra accounting expenses	(vi)	[39 - 30]	9.00
Taxable Profit			74.21
Current Tax Expense		@ 35%	25.97

► **Example 31:**

The first year's financial statements of Titanium Limited (TL) for the year ended 31 December 2022 are under preparation. The following matters have been identified which may have implications of deferred tax:

- TL acquired an equity investment for Rs. 85 million which was subsequently measured at fair value through profit or loss. On 31 December 2022, TL recorded Rs. 20 million as gain for change in the fair value. Under the tax laws, gain on investment is taxable at the time of sale.
- TL purchased factory building for Rs. 1,200 million in 2022 which was depreciated by Rs. 80 million. On 31 December 2022, the factory building was revalued at Rs. 1,260 million. Under the tax laws, depreciation at the rate of 10% per annum is allowed as a tax expense while revaluation does not affect taxable profit.
- Development cost of Rs. 20 million incurred in 2022 has been expensed out. Under the tax laws, development cost is amortized over ten years.

- (iv) TL received government grant of Rs 12 million related to an equipment. The grant is recognised as income over three years. Under the tax laws, the government grant is exempt from tax.
- (v) TL incurred a tax loss of Rs. 260 million for the year ended 31 December 2022. Under the tax laws, all unused tax losses are adjustable from future profits within next six years.

Applicable tax rate is 35%.

Required: Discuss how the deferred tax related to each of the above matters should be dealt with in TL's financial statements for the year ended 31 December 2022.

► **Answer:**

- (i) The carrying value of the investment is Rs. 105 million [i.e. $85+20$] while its tax base is Rs. 85 million as at 31 December 2022 i.e. the amount that will be deductible for tax purpose upon sale. This should result in taxable temporary difference of Rs. 20 million on which deferred tax liability/expense of Rs. 7 million [i.e. $20 \times 35\%$] shall be recognised. Since the fair value gain is reported in profit or loss, the related deferred tax expense is also recognised in profit or loss.
- (ii) The carrying value of the factory building is Rs. 1,260 million while its tax base is Rs. 1,080 million [i.e. $1,200 \times 90\%$] as at 31 December 2022 i.e. the amount that will be deductible for tax purpose in future years. This should result in taxable temporary difference of Rs. 180 million on which deferred tax liability/expense of Rs. 63 million [i.e. $180 \times 35\%$] shall be recognised. The effect arising due to the difference in depreciation i.e. Rs. 14 million [i.e. $(120-80) \times 35\%$], would be taken to profit or loss. While the remaining effect of liability arising due to revaluation adjustment i.e. Rs. 49 million [i.e. $(180-40) \times 35\%$], would be taken to other comprehensive income.
- (iii) The carrying value of development cost is Nil (being expensed out) while its tax base is Rs. 18 million [i.e. $20 \times 90\%$] as at 31 December 2022 i.e. the amount that will be deductible for tax purpose in future years. This should result in deductible temporary difference of Rs. 18 million on which deferred tax asset / income of Rs. 6.3 million [i.e. $18 \times 35\%$] shall be recognised. Since the development cost is taken to profit or loss, the corresponding effect should also be credited to profit or loss.
- (iv) At 31 December 2022, the carrying value of the government grant is Rs. 8 million [i.e. $12 - (12 \div 3)$] The tax base is NIL [i.e. Carrying amount 8 – amount not taxable in future 8]. Apparently, a deductible temporary difference of Rs. 8 million shall arise. However, no deferred tax asset/income would arise. IAS 12 prohibits this since effectively the difference is permanent in nature because grant income is exempt and would never be included in tax profits [IAS 12 Para 24 and 33].
- (v) The tax loss of Rs. 260 million for the year 2022 shall result in deferred tax asset of Rs. 91 million [i.e. $260 \times 35\%$]. The deferred tax asset shall be recognised to the extent that TL is probable that taxable profit will be available against which unused tax losses can be utilized. If TL will earn sufficient profits within next six years then deferred tax asset should be recognized and corresponding effect should be credited to statement of profit or loss. However, if TL is not expected to earn sufficient profit in future than deferred tax asset would not be recognized and will be reassessed for recognition at each year end.

► **Example 32:**

The following balances have been extracted from the statement of financial position of Uchhali Limited (UL) as on 31 December 2022:

	2022	2021
	---- Rs. in million ----	
Investment property	420	-
Inventories	840	780
Interest receivable	65	80
Accumulated losses	460	390
Accrued expenses	232	250

Additional information:

- (i) UL has only one investment property, which was purchased during 2022 at a cost of Rs. 450 million. The fair value of the property as on 31 December 2022 amounted to Rs. 610 million. UL follows cost model for accounting purposes. Under tax laws, capital gain on investment property is taxable at the time of sale, while depreciation is not allowed.
- (ii) Inventories imported during the year 2022 amounted to Rs. 660 million, of which 40% remained unsold as on 31 December 2022. Payment of imported inventories resulted in a foreign exchange loss of Rs. 100 million. Under tax laws, the foreign exchange loss is considered as the part of cost of inventories.
- (iii) Interest income for the year 2022 amounted to Rs. 120 million, of which Rs. 65 million was receivable as on 31 December 2022. Under tax laws, interest income was taxable on an accrual basis in 2021. However, with effect from 1 January 2022, interest is taxable on a receipt basis.
- (iv) Accrued expenses include payables for penalties of Rs. 42 million (2021: Rs. 6 million). During the year, UL also paid penalties of Rs. 56 million. Under tax laws, penalties are not deductible; however, other expenses are allowed on payment basis.
- (v) UL has unused tax losses amounting to Rs. 550 million as on 31 December 2022.
- (vi) It is expected that, after three years, sufficient taxable profits will be earned to utilise the benefit of unused losses and deductible temporary differences.
- (vii) The applicable tax rates are as follows:

	*2023 and onwards	2022 and before
Interest income	20%	15%
All other incomes	30%	25%

***Enacted before 31 December 2022**

Required: Compute the deferred tax liability or asset that should be recognized in UL's statement of financial position as on 31 December 2022.

► **Answer:**

Computation of deferred tax liability / (asset) as on 31 December 2022

Description	Carryin g value	Tax base	Difference	Tax rate	Liability/ (Asset)
	----- Rs. in million -----				Rs. m
Investment property	420	450	(30)	30%	(9)
Inventories:					
- Imported [660 x 40%]	264	304*			
- Other	576	576			
	840	880	(40)	30%	(12)
Interest receivable	65	-	65	20%	13
Accrued expenses					
- penalties	(42)	(42)			
- others [232-42]	(190)	-			
	(232)	(42)	(190)	30%	(57)
Unused tax losses 550×30%					(165)
					(230)

*264+(100×40%)=304

► **Example 33:**

On 1 January 2022, Namal Leasing Limited (NLL) leased a manufacturing plant to Haleji Limited (HL). Details are as follows:

- (i) The non-cancellable lease term is five years during which annual instalment of Rs. 60 million is payable by HL in arrears.
- (ii) The interest rate implicit in the lease is 16% per annum.
- (iii) NLL incurred an initial direct cost of Rs. 4 million for arranging the lease.
- (iv) The estimated residual value of the plant at the end of the lease is Rs. 125 million, of which Rs. 90 million has been guaranteed by HL.

The following information is also available:

- (i) NLL's profit before tax for the year after all adjustments was Rs. 350 million.
- (ii) Applicable tax rate is 30%
- (iii) Tax authorities treat each lease as an operating lease.

Required: Prepare the relevant extracts from NLL's statement of profit or loss for the year ended 31 December 2022, and the statement of financial position as on that date.

► **Answer:****Namal Leasing Limited****Statement of profit or loss for the year ended 31 December 2022**

		Rs. in million
Interest income	$255.95 \times 16\%$	40.95
Taxation:		
– Current	(W-1)	(102.86)
– Deferred	$(350 - 342.85) \times 30\%$	(2.14)

Namal Leasing Limited**Statement of financial position as on 31 December 2022**

		Rs. in million
Non-current assets:		
Lease receivable	(W-1) $236.9 - 22.1$	214.80
Current assets:		
Lease receivable	$60 - (W-1) 236.9 \times 16\%$	22.10
Non-current liabilities:		
Deferred tax liability		2.14

W-1: Net investment in lease

		Rs. in million
PV of annual instalment	60×3.2743	196.44
PV of GRV	90×1.16^{-5}	42.85
PV of UGRV	35×1.16^{-5}	16.66
		255.95
Interest for the year		40.95
First instalment		(60.00)
		236.90

W-2: Current tax

		Rs. in million
Profit as per accounting records		350.00
Interest income		(40.95)
Rent income		60.00
Depreciation expense	(255.96–125)÷5	(26.19)
Taxable income		342.86
Current tax @ 30%		102.86

► **Example 34:**

Handsome Limited (HL) is in the process of finalizing its financial statements for the year ended 31 December 2023. The following information has been gathered for preparing the disclosures related to taxation:

- (i) Profit before tax for the year ended 31 December 2023 was Rs. 466 million.
- (ii) Tax depreciation exceeds accounting depreciation by Rs. 116 million. An impairment loss of Rs. 50 million was also recognised in profit or loss. Under tax laws, impairment does not affect taxable profit.
- (iii) During the year, HL sold a machine whose tax WDV exceeded accounting WDV by Rs. 35 million.
- (iv) Interest income for the year was Rs. 60 million, of which Rs. 15 million was accrued as at 31 December 2023. Through a finance act enacted on 18 December 2023, interest income which was previously exempt, will now be taxable from 2024 on receipt basis.
- (v) Salaries expenses and insurance expenses amounting to Rs. 32 million and Rs. 16 million respectively, pertaining to the year ended 31 December 2022, were disallowed by tax authorities due to non-deduction of withholding tax. HL has decided not to file appeal on this.
- (vi) Stores and spares as at 31 December 2023 were Rs. 180 million after deducting a loss of Rs. 19 million for net realizable value. This adjustment is not allowable for tax purposes.
- (vii) Dividend income for the year is Rs. 28 million. Dividends are taxable at a reduced rate of 10%.
- (viii) During the year, HL paid fines of Rs. 24 million which are not deductible for tax purposes.
- (ix) During the year, HL expensed out payments of Rs. 70 million related to the restructuring of one of its business segments. As per tax laws, these payments are to be allowed as an expense over a period of 5 years from 2023 to 2027.
- (x) Net deferred tax asset as on 1 January 2023 arose on account of:

	Rs. in million
Property, plant and equipment	42
Unused tax losses	(54)
	(12)

- (xi) During 2022, HL incurred a tax loss of Rs. 284 million, against which HL expected at that time to be able to utilize Rs. 180 million against future taxable income.
- (xii) Applicable tax rate is 30% except for dividend income.

Required:

- (a) Prepare a note on taxation for inclusion in HL's financial statements for the year ended 31 December 2023, including a reconciliation to explain the relationship between tax expenses and accounting profit.
- (b) Compute the deferred tax liability/asset in respect of each temporary difference as at 31 December 2023. (Comparative figures are not required)

► Answer:

Part (a)

Notes to the financial statements for the year ended 31 December 2023			
Tax expense			Rs. m
Current tax:	Current year	W1	30.4
	Prior year	[(32+16) x 30%]	14.4
Deferred tax		(b)	66.3
			111.1
Tax Reconciliation			
Relationship b/w Tax expense and Accounting profit			Rs. m
Tax at applicable rate		[466 x 30%]	139.8
Less: Exempt interest income		[45 x 30%]	(13.5)
Add: Prior year tax due to disallowed expenses		[(32+16) x 30%]	14.4
Less: Dividend income taxable at lower rate		[28 x (30-10)%]	(5.6)
Add: Effect of disallowed fine		[24 x 30%]	7.2
Less: Previously unrecognised deferred tax		[(284-180) x 30%]	(31.2)
Tax Expense		[Current + Deferred]	111.1

Part (b)

Computation of Deferred Tax Liability						
31 December 2023	Ref.	CA	TB	T (D) Temp. Diff.	Tax rate	DTL (A)
		Rs. m	Rs. m	Rs. m		Rs. m
PPE [140 + 116 - 50 + 35]				241	30%	72.3
Interest receivable	(iv)	15	0	15	30%	4.5
Stores and spares	(vi)	180	199	(19)	30%	(5.7)
Restructuring costs	(ix)	0	56	(56)	30%	(16.8)
Closing DT Liability						54.3
Opening DT Asset	(x)					12
Expense (income) in PL				[54.3 - (-12)]		66.3

W1 – Current tax	Ref	Workings	2023
			Rs. m
Accounting Profit	(i)		466
Less: Excess of tax depreciation	(ii)		(116)
Add: Impairment loss (not allowed in tax)	(ii)		50
Less: Extra tax loss on disposal of machine	(iii)		(35)
Less: Exempt interest income	(iv)		(45)
Less: Interest income taxable on receipt basis	(iv)		(15)
Add: Write down to NRV	(vi)		19
Less: Dividend income taxable at lower rate	(vii)		(28)
Add: Fine (disallowed expense)	(viii)		24
Add: Restructuring expense	(ix)		70
Less: Amortisation of restructuring costs	(ix)	[70 / 5 years]	(14)
Taxable Profit [before loss adjustment]			376
Less: Unused tax losses adjusted	(xi)		(284)
Taxable Profit [after loss]			92
Current Tax Expense of current year:			
On dividend	(vii)	[28 x 10%]	2.8
Other	(xii)	[92 x 30%]	27.6
			30.4

► **Example 35:**

Fact Limited (FL) entered into the following transactions during the year 2023:

Part (a)

- (i) On 1 January 2023, FL purchased bonds issued by Chi Limited for Rs. 25 million. The par value of these bonds is Rs. 30 million and redemption will be at par. A transaction cost of Rs. 0.5 million was also incurred at the time of purchase. The bonds are held within a business model whose objective is to hold the bonds in order to collect contractual cash flows.

The coupon interest rate is 8%, payable annually on 31 December. The effective interest rate on the bond is 15% per annum.

On 31 December 2023, the fair value of the bonds was Rs. 28 million.

- (ii) On 1 April 2023, FL purchased 30,000 shares of Delta Limited (DL) representing a 1.5% shareholding, at Rs. 360 per share, with a par value of Rs. 50 each. A transaction cost of Rs. 0.3 million was also incurred at the time of purchase. On initial recognition, FL elected to measure the investment at fair value through other comprehensive income.

On 30 September 2023, DL announced an interim cash dividend of 40%. DL reported a net profit of Rs. 240 million for the year ended 31 December 2023. The fair value of each share of DL was Rs. 430 as at 31 December 2023.

Required: Prepare relevant extracts from FL's statement of profit or loss and other comprehensive income for the year ended 31 December 2023 and statement of financial position at that date.

Part (b)

For the purpose of answering this part, use the information provided in Part (a). The additional information regarding taxation rules applicable to FL is given below:

- (i) Transaction costs incurred on purchase of financial assets are allowable as expense upon purchase.
- (ii) Applicable tax rate is 30%.

Required: Compute the deferred tax liability or asset that should be recognized in FL's statement of financial position as at 31 December 2023. Also, state whether the corresponding effect should be recognized in 'profit or loss' or in items presented 'outside profit or loss'.

► *Answer:*

Part (a)**Fact Limited****Statement of financial position as at 31 December 2023**

		Rs. in million
Assets		
Investment in bonds – CL	W1	26.93
Investment in shares – DL	430×30,000	12.90

W1: $25.5(\text{i.e. } 25+0.5) + 3.83(\text{i.e. } 25.5 \times 15\%) - 2.4(\text{i.e. } 30 \times 8\%) = 26.93$

Statement of profit or loss and other comprehensive income**For the year ended 31 December 2023**

		Rs. in million
Profit or loss:		
Interest on bonds		3.83
Dividend income	$30,000 \times 50 \times 40\%$	0.60
Other comprehensive income:		
Fair value gain	$12.90 - 11.1(\text{i.e. } 10.8 + 0.3)$	1.80

Part (b)**Fact Limited****Deferred tax liability /(asset) as on 31 December 2023**

Description	Carrying value	Tax base	Difference	Tax rate	Liability/ (Asset)
	----- Rs. in million -----				Rs. m
Investment in bonds	26.93	25.00	1.93	30%	0.58
Investment in shares	12.90	10.80	2.1	30%	0.63

The whole effect of deferred tax liability on bonds would be taken to profit or loss.

In respect of deferred tax liability on shares, Rs. 0.54 million (i.e. $1.80 \times 30\%$) would be taken to other comprehensive income and remaining to the profit or loss

5. OBJECTIVE BASED Q&A

- 01.** A piece of machinery cost Rs. 500,000. Tax depreciation to date has amounted to Rs. 220,000 and depreciation charged in the financial statements to date is Rs. 100,000. The rate of income tax is 30%.

Which of the following statements is incorrect according to IAS 12 Income Taxes?

- (a) The deferred tax liability in relation to the asset is Rs. 36,000
- (b) The tax base of the asset is Rs. 280,000
- (c) There is a deductible difference of Rs. 120,000
- (d) There is a taxable temporary difference of Rs. 120,000

- 02.** Tall Limited (TL)'s accounting records shown the following:

	Rs. 000
Income tax payable for the year	60,000
Over provision in relation to the previous year	4,500
Opening deferred tax liability	2,600
Closing for deferred tax liability	3,200

What is the income tax expense that will be shown in the statement of profit or loss for the year?

- (a) Rs. 54,900,000
- (b) Rs. 67,700,000
- (c) Rs. 65,100,000
- (d) Rs. 56,100,000

- 03.** The following information has been extracted from the accounting records of Candle Limited:

	Rs. 000
Estimated income tax for the year ended 30 September 2020	Rs. 75,000
Income tax paid for the year ended 30 September 2020	Rs. 80,000
Estimated income tax for the year ended 30 September 2021	Rs. 83,000

What figures will be shown in the statement of comprehensive income for the year ended 30 September 2021 in respect of income tax?

- (a) Rs. 75,000,000
- (b) Rs. 80,000,000
- (c) Rs. 88,000,000
- (d) Rs. 83,000,000

04. Home Limited (HL) has the following balances included on its trial balance at 30 June 2014.

	Rs. 000
Taxation	4,000 Credit
Deferred taxation	12,000 Credit

The taxation balance relates to an over-provision from 30 June 2013.

At 30 June 2014, the directors estimate that the provision necessary for taxation on current year profits is Rs. 15,000,000.

The carrying amount of HL's non-current assets exceeds the tax written-down value by Rs. 30,000,000. The rate of tax is 30%.

What is the charge for taxation that will appear in the statement of profit or loss for the year to 30 June 2014?

- (a) Rs. 23,000,000
- (b) Rs. 28,000,000
- (c) Rs. 8,000,000
- (d) Rs. 12,000,000

05. Hall Limited has the following balances included on its trial balance at 30 June 2014:

	Rs. 000
Taxation	7,000 Credit
Deferred taxation	16,000 Credit

The taxation balance relates to an overprovision from 30 June 2013.

At 30 June 2014, the directors estimate that the provision necessary for taxation on current year profits is Rs. 12 million. The balance on the deferred tax account needs to be increased to Rs. 23 million, which includes the impact of the increase in property valuation below.

During the year Hall Limited revalued its property for the first time, resulting in a gain of Rs. 10 million. The rate of tax is 30%.

What is the charge for taxation that will appear in the statement of profit or loss for the year to 30 June 2014?

- (a) Rs. 9 million
- (b) Rs. 12 million
- (c) Rs. 23 million
- (d) Rs. 1 million

06. Vase Limited (VL)'s assistant accountant has discovered that there is a debit balance on the trial balance of Rs. 3,000 relating to the over/under-provision of tax from the prior year.

What impact will this have on VL's current year financial statements?

- (a) Increase the tax liability by Rs. 3,000 in the statement of financial position
- (b) Decrease the tax liability by Rs. 3,000 in the statement of financial position
- (c) Increase the tax expense by Rs. 3,000 in the statement of profit or loss
- (d) Decrease the tax expense by Rs. 3,000 in the statement of profit or loss

07. A company's trial balance shows a debit balance of Rs. 2.1 million brought forward on current tax and a credit balance of Rs. 5.4 million on deferred tax. The tax charge for the current year is estimated at Rs. 16.2 million and the carrying amounts of net assets are Rs. 13 million in excess of their tax base. The income tax rate is 30%.

What amount will be shown as income tax in the statement of profit or loss for the year?

- (a) Rs. 15.6 million
- (b) Rs. 12.6 million
- (c) Rs. 16.8 million
- (d) Rs. 18.3 million

08. A company's trial balance at 31 December 2013 shows a debit balance of Rs. 700,000 on current tax and a credit balance of Rs. 8,400,000 on deferred tax. The directors have estimated the provision for income tax for the year at Rs. 4.5 million and the required deferred tax provision is Rs. 5.6 million, Rs. 1.2 million of which relates to a property revaluation.

What is the profit or loss income tax charge for the year ended 31 December 2013?

- (a) Rs. 1 million
- (b) Rs. 2.4 million
- (c) Rs. 1.2 million
- (d) Rs. 3.6 million

09. The following information relates to an entity.

- (i) At 1 January 2018 the carrying amount of non-current assets exceeded their tax written down value by Rs. 850,000.
- (ii) For the year to 31 December 2018 the entity claimed depreciation for tax purposes of Rs. 500,000 and charged depreciation of Rs. 450,000 in the financial statements.
- (iii) During the year ended 31 December 2018 the entity revalued a property. The revaluation surplus was Rs. 250,000. There are no current plans to sell the property.
- (iv) The tax rate was 30%.

What is the deferred tax liability required by IAS 12 Income Taxes at 31 December 2018?

- (a) Rs. 240,000
- (b) Rs. 270,000
- (c) Rs. 315,000
- (d) Rs. 345,000

10. The accountant of an entity is confused by the term 'tax base'. What is meant by 'tax base'?

- (a) The amount of tax payable in a future period
- (b) The tax regime under which an entity is assessed for tax
- (c) The amount attributed to an asset or liability for tax purposes
- (d) The amount of tax deductible in a future period

11. The carrying amount of Jewel Limited (JL)'s property, plant and equipment at 31 December 2013 was Rs. 310,000 and the tax written down value was Rs. 230,000.

The following data relates to the year ended 31 December 2014:

- (i) At the end of the year the carrying amount of property, plant and equipment was Rs. 460,000 and the tax written down value was Rs. 270,000. During the year some items were revalued by Rs. 90,000. No items had previously required revaluation. In the tax jurisdiction in which JL operates revaluations of assets do not affect the tax base of an asset or taxable profit. Gains due to revaluations are taxable on sale.
- (ii) JL began development of a new product during the year and capitalised Rs. 60,000 in accordance with IAS 38. The expenditure was deducted for tax purposes as it was incurred. None of the expenditure had been amortised by the year end.

What is the taxable temporary difference to be accounted for at 31 December 2014 in relation to property, plant and equipment and development expenditure?

	Property, plant & equipment	Development expenditure
(a)	Rs. 270,000	Rs. 60,000
(b)	Rs. 270,000	Nil
(c)	Rs. 190,000	Rs. 60,000
(d)	Rs. 190,000	Nil

12. The carrying amount of Jewel Limited (JL)'s property, plant and equipment at 31 December 2013 was Rs. 310,000 and the tax written down value was Rs. 230,000.

At the end of the year, 31 December 2014, the carrying amount of property, plant and equipment was Rs. 460,000 and the tax written down value was Rs. 270,000. During the year some items were revalued by Rs. 90,000. No items had previously required revaluation. In the tax jurisdiction in which JL operates revaluations of assets do not affect the tax base of an asset or taxable profit. Gains due to revaluations are taxable on sale.

The corporate income tax rate is 30%. The current tax charge was calculated for the year as Rs. 45,000.

What amount should be charged to the revaluation surplus at 31 December 2014 in respect of deferred tax?

- (a) Rs. 60,000
- (b) Rs. 90,000
- (c) Rs. 18,000
- (d) Rs. 27,000

13. The carrying amount of Jewel Limited (JL)'s property, plant and equipment at 31 December 2013 was Rs. 310,000 and the tax written down value was Rs. 230,000.

At the end of the year, 31 December 2014, the carrying amount of property, plant and equipment was Rs. 460,000 and the tax written down value was Rs. 270,000. During the year some items were revalued by Rs. 90,000. No items had previously required revaluation. In the tax jurisdiction in which JL operates revaluations of assets do not affect the tax base of an asset or taxable profit. Gains due to revaluations are taxable on sale.

The corporate income tax rate is 30%. The current tax charge was calculated for the year as Rs. 45,000.

What amount will be shown as current tax payable in the statement of financial position of JL at 31 December 2014?

- (a) Rs. 45,000
- (b) Rs. 72,000
- (c) Rs. 63,000
- (d) Rs. 75,000

14. Deferred tax assets and liabilities arise from taxable and deductible temporary differences. Which one of the following is not a circumstance giving rise to a temporary difference?
- Depreciation accelerated for tax purposes
 - Development costs amortised in profit or loss but tax was deductible in full when incurred
 - Accrued expenses which have already been deducted for tax purposes
 - Revenue included in accounting profit when invoiced but only liable for tax when the cash is received.
15. Which of the following statements regarding taxation of lease arrangement are true?
- Depreciation expense and interest expense should be added back in accounting profit to calculate current tax
 - Rental payments should be deducted from accounting profit for calculating current tax
 - Right of use asset has tax base of nil resulting in taxable temporary difference
- Lease liabilities have tax base of nil resulting deductible temporary difference
- (i), (ii) and (iii)
 - (ii), (iii) and (iv)
 - (i), (ii) and (iv)
 - (i), (ii), (iii) and (iv) all
16. Venice Limited (VL)'s assistant accountant estimated the tax expense for the year ended 31 December 2018 at Rs. 43,000. However, he had ignored deferred tax. At 1 January 2018 VL had a deferred tax liability of Rs. 130,000. At 31 December 2018 VL had temporary taxable differences of Rs. 360,000. VL pays tax at 25%. All movements in deferred tax are taken to the statement of profit or loss. What will be recorded as the tax expense in the statement of profit or loss for the year ended 31 December 2018?
- Rs. 83,000
 - Rs. 43,000
 - Rs. 40,000
 - Rs. 3,000

17. The statements of financial position of Nitrogen Limited (NL) include the following extracts:

Statements of financial position as at 30 September	2012	2011
	Rs. m	Rs. m
Non-current liabilities		
Deferred tax	310	140
Current liabilities		
Taxation	130	160

The tax charge in the statement of profit or loss for the year ended 30 September 2012 is Rs. 270 million. What amount of tax was paid during the year to 30 September 2012?

- Rs. 30 million
- Rs. 130 million
- Rs. 160 million
- Rs. 270 million

18. The trial balance of Hall Limited (HL) at 31 March 2016 showed credit balances of Rs. 800,000 on current tax and Rs. 2.6 million on deferred tax.
- A property was revalued during the year giving rise to deferred tax of Rs. 3.75 million. This has been included in the deferred tax provision of Rs. 6.75 million at 31 March 2016.
- The income tax charge for the year ended 31 March 2016 is estimated at Rs. 19.4 million.
- What will be shown as the income tax charge in the statement of profit or loss of HL at 31 March 2016?
- (a) Rs. 18.6 million
 - (b) Rs. 19 million
 - (c) Rs. 19.4 million
 - (d) Rs. 19.8 million
19. Orange Limited (OL) is in the process of finalizing its financial statements for the year ended 30 June 2018. OL sells goods with a 1-year warranty and it is estimated that warranty expenses are 2% of annual sales. Actual payments during the year related to warranty claims were Rs. 54 million. Of these, Rs. 38 million pertain to goods sold during the previous year. Opening balance of provision for warranty was Rs. 49 million.
- Sales for the year ended 30 June 2018 was Rs. 1,750 million. Under the tax laws, these expenses are allowed on payment basis. Applicable tax rate is 30%.
- What is the amount of deferred tax expense or income in respect of above for the year ended 30 June 2018?
- (a) Rs. 49 million expense
 - (b) Rs. 5.7 million income
 - (c) Rs. 5.7 million expense
 - (d) Rs. 9 million expense
20. Orange Limited (OL) is in the process of finalizing its financial statements for the year ended 30 June 2018. Profit before tax for the year ended 30 June 2018 was Rs. 508 million.
- OL sells goods with a 1-year warranty and it is estimated that warranty expenses are 2% of annual sales. Actual payments during the year related to warranty claims were Rs. 54 million. Of these, Rs. 38 million pertain to goods sold during the previous year. Opening balance of provision for warranty was Rs. 49 million.
- Sales for the year ended 30 June 2018 was Rs. 1,750 million. Under the tax laws, these expenses are allowed on payment basis. Applicable tax rate is 30%.
- What is the amount of current tax after considering above information for the year ended 30 June 2018?
- (a) Rs. 152.4 million
 - (b) Rs. 159.6 million
 - (c) Rs. 143.4 million
 - (d) Rs. 136.2 million
21. Which of the following does NOT give rise to deferred tax?
- (a) Difference between accounting depreciation and tax depreciation
 - (b) Expenses charged in the statement of profit or loss but not allowable in tax
 - (c) Revaluation of a non-current asset but not allowable in tax
 - (d) Unused tax losses

22. Which TWO of the following are examples, where carrying amount is always equal to tax base?
- (a) Accrued expenses that have already been deducted in determining the current tax
 - (b) Allowance for bad debts where tax relief is granted when the debt is written-off
 - (c) Accrued income that will never be taxable
 - (d) Capitalized development costs which are allowable in tax upon payment
23. The following information relates to a building of Jet Limited (JL).
- At 1 January 2018, the carrying amount of the building exceeded its tax base by Rs. 1,275,000.
 - In 2018, JL claimed tax depreciation of Rs. 750,000 and charged accounting depreciation of Rs. 675,000.
 - As at 31 December 2018, JL increased the carrying amount of the building by Rs. 375,000 on account of revaluation. Revaluation is not allowed in tax.
 - Applicable tax rate is 32%.
- The deferred tax liability as at 31 December 2018 in respect of building is:
- (a) Rs. 384,000
 - (b) Rs. 432,000
 - (c) Rs. 504,000
 - (d) Rs. 552,000
24. Which of the following scenarios would NOT result in the recognition of a deferred tax liability/asset?
- (a) Accelerated depreciation for tax purposes compared to accounting purposes.
 - (b) Revaluation of property, plant, and equipment where the revaluation is not recognized for tax purposes.
 - (c) Interest income taxed only when received.
 - (d) Dividend income taxable at a rate lower than the normal tax rate.

ANSWERS

01.	(c)	As carrying amount is greater than tax base of the asset, the resulting temporary difference is taxable (not deductible).																		
02.	(d)	The tax expense in the statement of profit or loss is made up of the current year estimate, the prior year over-provision and the movement in deferred tax. The prior year over-provision must be deducted from the current year expense, and the movement in deferred tax must be added to the current year expense, as the deferred tax liability has increased. Tax expense = Rs. 60,000,000 – Rs. 4,500,000 + Rs. 600,000 = Rs. 56,100,000																		
03.	(c)	The tax expense in the statement of profit or loss is made up of the current year estimate and the prior year under-provision. The year-end liability in the statement of financial position is made up of the current year estimate only. Tax expense = Rs. 83,000 + Rs. 5,000 under provision = Rs. 88,000																		
04.	(c)	<table><tr><td></td><td>Rs. 000</td></tr><tr><td>Deferred tax provision required (30,000 × 30%)</td><td>9,000</td></tr><tr><td>Opening balance per trial balance</td><td>12,000</td></tr><tr><td>Reduction in provision</td><td>(3,000)</td></tr></table> <table><tr><td>Tax expense:</td><td>Rs. 000</td></tr><tr><td>Current year estimate</td><td>15,000</td></tr><tr><td>Prior year overprovision</td><td>(4,000)</td></tr><tr><td>Deferred tax, as above</td><td>(3,000)</td></tr><tr><td>Charge for year</td><td>8,000</td></tr></table>		Rs. 000	Deferred tax provision required (30,000 × 30%)	9,000	Opening balance per trial balance	12,000	Reduction in provision	(3,000)	Tax expense:	Rs. 000	Current year estimate	15,000	Prior year overprovision	(4,000)	Deferred tax, as above	(3,000)	Charge for year	8,000
	Rs. 000																			
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Current year estimate	15,000																			
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Deferred tax, as above	(3,000)																			
Charge for year	8,000																			
05.	(a)	<table><tr><td></td><td>Rs.000</td></tr><tr><td>Deferred taxation increase (23,000 – 16,000)</td><td>7,000</td></tr><tr><td>Less tax on revaluation [OCI] (10,000 × 30%)</td><td>(3,000)</td></tr><tr><td>Charge to SPL</td><td>4,000</td></tr></table> <table><tr><td>Tax expense:</td><td>Rs. 000</td></tr><tr><td>Current year estimate</td><td>12,000</td></tr><tr><td>Prior year overprovision</td><td>(7,000)</td></tr><tr><td>Deferred tax, as above</td><td>4,000</td></tr><tr><td>Charge for year</td><td>9,000</td></tr></table>		Rs.000	Deferred taxation increase (23,000 – 16,000)	7,000	Less tax on revaluation [OCI] (10,000 × 30%)	(3,000)	Charge to SPL	4,000	Tax expense:	Rs. 000	Current year estimate	12,000	Prior year overprovision	(7,000)	Deferred tax, as above	4,000	Charge for year	9,000
	Rs.000																			
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Prior year overprovision	(7,000)																			
Deferred tax, as above	4,000																			
Charge for year	9,000																			

06.	(c)	A debit balance represents an under-provision of tax from the prior year. This should be added to the current year's tax expense in the statement of profit or loss. An under or over-provision only arises when the prior year tax estimate is paid so there is no adjustment required to the current year liability.																	
07.	(c)	<table><tr><td></td><td>Rs. 000</td></tr><tr><td>Charge for year</td><td>16,200</td></tr><tr><td>Under provision</td><td>2,100</td></tr><tr><td>Adjust deferred tax</td><td>(1,500)</td></tr><tr><td>Profit or loss charge</td><td>16,800</td></tr><tr><td>Deferred tax liability year end (13m × 30%)</td><td>3,900</td></tr><tr><td>Deferred tax liability opening balance</td><td>(5,400)</td></tr><tr><td>Deferred tax income</td><td>(1,500)</td></tr></table>			Rs. 000	Charge for year	16,200	Under provision	2,100	Adjust deferred tax	(1,500)	Profit or loss charge	16,800	Deferred tax liability year end (13m × 30%)	3,900	Deferred tax liability opening balance	(5,400)	Deferred tax income	(1,500)
	Rs. 000																		
Charge for year	16,200																		
Under provision	2,100																		
Adjust deferred tax	(1,500)																		
Profit or loss charge	16,800																		
Deferred tax liability year end (13m × 30%)	3,900																		
Deferred tax liability opening balance	(5,400)																		
Deferred tax income	(1,500)																		
08.	(c)	<table><tr><td></td><td>Rs. 000</td></tr><tr><td>Prior year under provision</td><td>700</td></tr><tr><td>Current provision</td><td>4,500</td></tr><tr><td>Movement of deferred tax (8.4 – 5.6)</td><td>(2,800)</td></tr><tr><td>Deferred tax on revaluation surplus</td><td>(1,200)</td></tr><tr><td>Tax charge for the year in profit or loss</td><td>1,200</td></tr></table>			Rs. 000	Prior year under provision	700	Current provision	4,500	Movement of deferred tax (8.4 – 5.6)	(2,800)	Deferred tax on revaluation surplus	(1,200)	Tax charge for the year in profit or loss	1,200				
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09.	(d)	<table><tr><td>Temporary difference</td><td>Rs. 000</td></tr><tr><td>B/f</td><td>850</td></tr><tr><td>Depreciation Year to 31.12.18 (500 – 450)</td><td>50</td></tr><tr><td>Revaluation surplus</td><td>250</td></tr><tr><td></td><td>1,150</td></tr><tr><td>Deferred tax 1,150 @ 30%</td><td>345</td></tr></table>		Temporary difference	Rs. 000	B/f	850	Depreciation Year to 31.12.18 (500 – 450)	50	Revaluation surplus	250		1,150	Deferred tax 1,150 @ 30%	345				
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Revaluation surplus	250																		
	1,150																		
Deferred tax 1,150 @ 30%	345																		
10.	(c)	The amount attributed to an asset or liability for tax purposes.																	
11.	(c)	PPE 460,000 – 270,000 = Rs. 190,000 Development cost 60,000 – 0 = Rs. 60,000																	
12.	(d)	(90,000 × 30%) will go to the revaluation surplus																	

13.	(a)	Rs. 45,000. The tax charge for the year.																																	
14.	(c)	Accrued expenses which have already been deducted for tax purposes will not give rise to a temporary difference as there is no difference in accounting and tax in time of recognition of tax expense.																																	
15.	(d)	All the statements are true.																																	
16.	(d)	The tax expense in the statement of profit or loss consists of the current tax estimate and the movement on deferred tax in the year. The closing deferred tax liability is Rs. 90,000, being the temporary differences of Rs. 360,000 at the tax rate of 25%. This means that the deferred tax liability has decreased by Rs. 40,000 in the year. This decrease should be deducted from the current tax estimate of Rs. 43,000 to give a total expense of Rs. 3,000.																																	
17.	(b)	<table><tr><th></th><th>Rs. m</th></tr><tr><td>Opening balances (140 + 160)</td><td>300</td></tr><tr><td>Charge for year</td><td>270</td></tr><tr><td>Closing balances (310 + 130)</td><td>(440)</td></tr><tr><td>Tax paid</td><td>130</td></tr></table>					Rs. m	Opening balances (140 + 160)	300	Charge for year	270	Closing balances (310 + 130)	(440)	Tax paid	130																				
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18.	(b)	<table><tr><th></th><th>Rs. 000</th></tr><tr><td>Current charge</td><td>19,400</td></tr><tr><td>Overprovision</td><td>(800)</td></tr><tr><td>Deferred tax (W)</td><td>400</td></tr><tr><td></td><td>19,000</td></tr></table> Working <table><tr><td>Required provision</td><td>6,750</td></tr><tr><td>Less revaluation</td><td>(3,750)</td></tr><tr><td></td><td>3,000</td></tr><tr><td>Balance b/f</td><td>(2,600)</td></tr><tr><td>Charge to income tax</td><td>400</td></tr></table>					Rs. 000	Current charge	19,400	Overprovision	(800)	Deferred tax (W)	400		19,000	Required provision	6,750	Less revaluation	(3,750)		3,000	Balance b/f	(2,600)	Charge to income tax	400										
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19.	(d)	<table><tr><th colspan="5">Provision for warranty</th></tr><tr><td>Bank (last year)</td><td>38</td><td></td><td>b/d</td><td>49</td></tr><tr><td>Bank (current year)</td><td>16</td><td></td><td>PL (1,750 x 2%)</td><td>35</td></tr><tr><td>PL (Reversal last year)</td><td>11</td><td></td><td></td><td></td></tr><tr><td>c/d</td><td>19</td><td></td><td></td><td></td></tr><tr><td></td><td>84</td><td></td><td></td><td>84</td></tr></table>				Provision for warranty					Bank (last year)	38		b/d	49	Bank (current year)	16		PL (1,750 x 2%)	35	PL (Reversal last year)	11				c/d	19					84			84
Provision for warranty																																			
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PL (Reversal last year)	11																																		
c/d	19																																		
	84			84																															

	Rs. m
Opening deferred tax asset $49 \times 30\%$	14.7
Closing deferred tax asset $19 \times 30\%$	5.7
Deferred tax expense	9

20. (c)

Provision for warranty			
Bank (last year)	38	b/d	49
Bank (current year)	16	PL (1,750 x 2%)	35
PL (Reversal last year)	11		
c/d	19		
	84		84

	Rs. m
Profit before tax	508
Add: Warranty expense as per accounting $35 - 11$	24
Less: Warranty payments allowed in tax $38 + 16$	(54)
	478

478 million x 30% = Rs. 143.4 million

21. (b) Expenses charged in the statement of profit or loss but not allowable in tax

22. (a) & (c) Accrued expenses that have already been deducted in determining the current tax & accrued income that will never be taxable

23. (d)

Temporary difference	Rs. 000
B/f	1,275
Depreciation Year to 31.12.18 (750 - 675)	75
Revaluation surplus	375
	1,725
Deferred tax Rs. 1,725,000 @ 32%	552

24. (d) Dividend income taxable at a rate lower than the normal tax rate.

STICKY NOTES

Tax expense in profit or loss

	Rs.
Current tax expense (current year)	XX
(prior year: under/over provision)	XX/(XX)
Deferred tax expense (income)	XX
	XX

Remember that total tax expense is required to be reconciled with product of accounting profit and applicable tax rate.

Steps to Calculate Current tax expense

1.	Calculate accounting profit before tax (after all adjustments and corrections as required under IFRSs).
2.	Calculate tax profit by making appropriate adjustments to accounting profit.
3.	Apply appropriate tax rate to tax profit. Different rates may be required to be used for different types of income.
4.	Make sure any prior year adjustment is also incorporated including under/over-provision of prior years.

Steps to Calculate Deferred tax expense

1.	Calculate carrying amount of assets and liabilities (after all adjustments and corrections as required under IFRSs).
2.	Determine tax base of assets and liabilities (including those which have carrying amount of NIL).
3.	Determine the temporary difference and identify each item as either taxable or deductible.
4.	Apply tax rate to temporary differences (with certain exceptions) to determine deferred tax liability (or asset). Different rates may need to be applied to different items.
5.	Compare the total deferred tax liability (or asset) with opening balance, to calculate the total deferred tax expense (or income). It is important to note that some of the charge may relate to items outside profit or loss.

AT A GLANCE

SPOTLIGHT

STICKY NOTES

REGULATORY FRAMEWORK OF ACCOUNTING

IN THIS CHAPTER:

AT A GLANCE

SPOTLIGHT

1. Regulatory framework in Pakistan
2. Classification of companies
3. Disclosure: General requirements
4. Disclosure: Statement of financial position
5. Disclosure: Statement of profit or loss
6. Comprehensive Examples
7. Objective Based Q&A

STICKY NOTES

AT A GLANCE

In Pakistan, companies are required to prepare financial statements in accordance with approved accounting standards as notified by Securities and Exchange Commission of Pakistan (SECP), which is regulator of corporate sector and capital markets in Pakistan. The Institute of Chartered Accountants of Pakistan being the regulator of chartered accountancy profession recommends the accounting standards for notification by SECP.

Companies Act, 2017 is relevant primary legislation. The third schedule of the Act classifies companies as public interest, large sized, medium sized or small sized companies specifying the applicable accounting framework and disclosure requirements accordingly.

The disclosure requirements for listed companies and their subsidiaries are included in fourth schedule of the Act. The schedule has three main parts namely, general requirements, requirements as to statement of financial position and requirements as to profit or loss.

The disclosure requirements for other companies are included in fifth schedule of the Act. Similar to fourth schedule, the fifth schedule has three main parts namely, general requirements, requirements as to statement of financial position and requirements as to profit or loss.

Therefore, while preparing financial statements, it is important to understand disclosure requirements of law in addition to those required by IFRSs.

1. REGULATORY FRAMEWORK IN PAKISTAN

1.1 Accounting regulation in Pakistan

The objective of financial statements is to provide information about the financial position (balance sheet), financial performance (profit and loss) and cash flows of an entity that is useful to a wide range of users in making economic decisions.

1.1.1 The Securities and Exchange Commission of Pakistan

The Securities and Exchange Commission of Pakistan (SECP) was established under the Securities and Exchange Commission of Pakistan Act, 1997 and became operational in 1999.

It is the corporate and capital market regulatory authority in Pakistan. Its stated mission is “To develop a fair, efficient and transparent regulatory framework, based on international legal standards and best practices, for the protection of investors and mitigation of systemic risk aimed at fostering growth of a robust corporate sector and broad based capital market in Pakistan” (SECP website).

One of the roles of the SECP is to decide on accounting rules that must be applied by companies in Pakistan.

Companies must prepare financial statements in accordance with approved accounting standards as applicable and notified in the official gazette by the Securities and Exchange Commission of Pakistan (SECP) and in accordance with rules in the Companies Act, 2017.

1.1.2 The Institute of Chartered Accountants of Pakistan (ICAP)

ICAP regulates the Chartered Accountancy profession. It is the body responsible for recommending accounting standards for notification by the Securities and Exchange Commission of Pakistan.

1.2 Companies Act, 2017: Introduction to the third, fourth and fifth schedules

The Companies Act, 2017 contains a series of appendices called schedules which set out detailed requirements in certain areas.

1.2.1 The third schedule

This schedule lists the classification criteria of the companies on the basis of company size and whether it is commercial or non-profit. It also specifies which companies are required to follow requirements of fourth or fifth schedule of the Act.

1.2.2 The fourth schedule

This schedule sets out the disclosure requirements that must be complied with in respect of the financial statements of a listed company and its subsidiaries.

The schedule specifies that listed companies and their subsidiaries must follow International Financial Reporting Standards as notified for this purpose in the Official gazette.

1.2.3 The fifth schedule

This schedule applies to the balance sheets and profit and loss accounts of non-listed companies (including large, medium and small sized entities).

1.3 International Financial Reporting Standards

The International Accounting and Financial Reporting Standards are developed with the aim of harmonising accounting procedures throughout the world.

The first **International Accounting Standards (IASs)** were issued in 1975 by **International Accounting Standards Committee (IASC)**. The IASs were supported with interpretations for matters where there was a divergence in practice. These interpretations were issued by another body called the **Standing Interpretation Committee** and were referred to as **Standing Interpretation Committee Pronouncements** or **SICs**.

In 2001 the constitution of the **IASC** was changed leading to the replacement of the **IASC** and the **SIC** by new bodies called the **International Accounting Standards Board (IASB)** and the **International Financial Reporting Interpretations Committee (IFRIC)**.

The **IASB** adopted all **IASs** and **SICs** that were extant at the time but said that standards written from that time were to be called **International Financial Reporting Standards (IFRSs)**. Interpretations are known as **IFRICs**.

Thus **IFRSs** are made up as follows:

	Published by the IASC (up to 2001)	Published by the IASB (from 2001 to onwards)
Accounting standards	IASs	IFRSs
Interpretations	SICs	IFRICs

IFRSs cannot be applied in any country without the approval of the national regulators in that country. All jurisdictions have some kind of formal approval process which is followed before IFRSs can be applied in that jurisdiction.

1.3.1 Adoption process for IFRS in Pakistan

The adoption of an **IFRS** involves the following steps:

- As a first step the **IFRS** is considered by **ICAP's Accounting Standards Board**, which identifies any issues that may arise on adoption.
- The Board also determines how the adoption and implementation of the standard can be facilitated. It considers issues like how long any transition period should be and whether adoption of the standard would require changes in regulations.
- The Board also identifies the need for changes to regulations it refers the matter to the **Securities and Exchange Commission of Pakistan (SECP)** (and/or the **State Bank of Pakistan (SBP)** for matters affecting banks and other financial institutions). This process is managed by the **Coordination Committees of ICAP, SECP and SBP**.
- After the satisfactory resolution of issues, the **Board** and the **Council** of ICAP reconsider the matter of adoption.
- ICAP recommends the adoption to the SECP by decision of the Council. The decision to adopt the standard rests with the SECP.
- IFRSs are adopted by the SECP by notification in the Official Gazette. When notified, the standards have the authority of the law.

2. CLASSIFICATION OF COMPANIES

2.1 Classification of Companies [Section 224 & third schedule of Companies Act, 2017]

There are following four classification of companies under the Companies Act, 2017:

- a) Public interest company (PIC)
- b) Large sized company (LSC)
- c) Medium sized company (MSC)
- d) Small sized company (SSC)

The above classification determines:

- a) Applicable accounting framework (e.g. IFRSs or Accounting Standard for NPOs); and
- b) Applicable regulatory requirements (Fourth or Fifth Schedule of Companies Act).

The following points are also relevant to classification:

- a) The classification of a company shall be based on the previous year's audited financial statements.
- b) The classification of a company can be changed where it does not fall under the previous criteria for two consecutive years.
- c) The number of employees means the average number of persons employed by a company in that financial year calculated on monthly basis.

2.2 Public Interest company

S. No.	Classification criteria	Applicable accounting framework	Schedule of Companies Act, 2017
a)	Listed Company	IFRSs	Fourth Schedule
b)	Non-listed Company which is: (i) a public sector company as defined in the Act; or (ii) a public utility or similar company carrying on the business of essential public service; or (iii) holding assets in a fiduciary capacity for a broad group of outsiders, such as a bank, insurance company, securities broker/dealer, pension fund, mutual fund or investment banking entity; or (iv) all companies engaged in production and sale of sugar; or (v) having such number of members holding ordinary shares as may be notified; or (vi) holding assets exceeding such value as may be notified.		Fifth Schedule

2.3 Large sized company

S. No.	Classification criteria	Applicable accounting framework	Schedule of Companies Act, 2017
a)	Non-listed Company with: (i) paid-up capital of Rs. 200 million or more; or (ii) turnover greater than Rs. 800 million; or (iii) employees more than 750.	IFRSs	Fifth Schedule
b)	Foreign Company with turnover of Rs. 1 billion or more.		
c)	Non-listed Company licensed / formed under Section 42 / Section 45 of the Act having annual gross revenue (grants/income/subsidies/donations) including other income/revenue of Rs. 200 million and above.	IFRSs and Accounting Standard for NPOs	

2.4 Medium sized company

S. No.	Classification criteria	Applicable accounting framework	Schedule of Companies Act, 2017
a)	Non-listed Public Company with: (i) paid-up capital less than Rs.200 million; (ii) turnover upto Rs. 800 million; (iii) Employees more than 250 but less than 750.	Revised AFRS for SSEs	Fifth Schedule
b)	Private Company with: (i) paid-up capital of greater than Rs. 10 million but not exceeding Rs. 200 million; (ii) turnover greater than Rs. 150 million but not exceeding Rs.800 million; (iii) Employees more than 250 but less than 750.		
c)	A Foreign Company which has turnover less than Rs. 1 billion.		
d)	Non-listed Company licensed / formed under Section 42 or 45 of the Act which has annual gross revenue (grants/income/subsidies/donations) including other income or revenue less than Rs.200 million.	Accounting Standard for NPOs	

2.5 Small sized company

S. No.	Classification criteria	Applicable accounting framework	Schedule of Companies Act, 2017
a)	A private company having: (i) paid-up capital up to Rs. 10 million; (ii) turnover not exceeding Rs.150 million; (iii) Employees not more than 250.	Revised AFRS for SSEs	Fifth Schedule

3. DISCLOSURE: GENERAL REQUIREMENTS

3.1 Preparation of financial statements

The fourth schedule of the Companies Act, 2017 requires that all listed companies and their subsidiaries shall follow the International Financial Reporting Standards in regard to financial statements as notified by SECP. Similarly, the fifth schedule requires all other companies to follow applicable reporting framework (e.g. IFRSs or AFRS for SSE).

The disclosure requirements, as provided in fourth and fifth schedule, are in addition to the disclosure requirements prescribed in IFRSs unless specifically required otherwise.

In addition to the information expressly required to be disclosed under the Act and the schedules, there shall be added such other information as may be considered necessary to ensure that required disclosure is not misleading.

The requirements stated in this chapter relate to both schedules (i.e. fourth schedule and fifth schedule) unless specifically identified otherwise.

► *Illustrative disclosure 01: Statement of compliance*

These financial statements have been prepared in accordance with the accounting and reporting standards as applicable in Pakistan. The accounting and reporting standards as applicable in Pakistan comprise of:

- International Financial Reporting Standards (IFRS Standards), issued by the International Accounting Standards Board (IASB) as notified under the Companies Act, 2017; and
- Provisions of and directives issued under the Companies Act, 2017.

Where the provisions of and directives issued under the Companies Act, 2017 differ from IFRS Standards, the provisions of and directives issued under the Companies Act, 2017 have been followed.

3.2 General information about the company

General information about the company comprising the following is to be disclosed in financial statements:

- Geographical location and address of all business units including mills/plant (Note: the fifth schedule does not require address to be disclosed).

► *Illustrative disclosure 02: Legal Status and Nature of business*

MT Limited (the Company) is a public limited company and was incorporated in Pakistan in 1995 under the Companies Ordinance, 1984 (now the Companies Act, 2017), and is listed on the Pakistan Stock Exchange Limited. The registered office and factory of the Company is situated at Multan Road, Lahore. The Company also has regional offices located in Karachi, Lahore, Multan, Sukkur and Islamabad.

The Company is principally engaged in assembling and manufacturing of agricultural machinery and applications.

- Particulars of company's immovable fixed assets, including location and area of land (Note: This is not required in fifth schedule).

► *Illustrative disclosure 03: Property, plant and equipment (in sub-note)*

The freehold land and building on owned land of the company are as follows:

- 202,343 square meters of factory land situated at Multan Road, Lahore;
- 697 square meters of land in sector F-6/1 Islamabad;
- Corporate office floors in Corporate Centre Lahore.

► *Illustrative disclosure 04: Property, plant and equipment (in sub-note)*

Following are particulars of the Company's immovable fixed assets:

Location	Usage	Total area (in Acres)
Shahrah-e-Roomi, Lahore	Plant site and administrative offices	34.02
Herdo Sehari, Kasur	Administrative offices	34.84
Lakho Baryar, Kasur	Administrative offices	50.63

- The capacity of an industrial unit, actual production and the reasons for shortfall;

► *Illustrative disclosure 05: Production Capacity*

	Design Capacity		Production	
	2018	2017	2018	2017
Urea	Tonnes '000		Tonnes '000	
Lahore – Plant I	695	695	688	692
Faisalabad – Plant II	635	635	635	635
Peshawar – Plant III	718	718	714	703
	2,048	2,048	2,037	2,030

The shortfall in actual production are insignificant and considered normal in the industry.

► *Illustrative disclosure 06: Capacity and Production*

	2018	2017
	MWh	
Installed capacity (based on 8,760 hours)	1,086,240	1,086,240
Actual energy delivered	387,435	645,395

Under-utilisation of available capacity is due to less demand by WAPDA.

- Number of persons employed as on the date of financial statements and average number of employees during the year;

► *Illustrative disclosure 07: Number of employees*

	2018	2017
Total number of employees at end of the year	3,357	3,364
Average number of employees for the year	3,369	3,384

- Name of associated companies or related parties or undertakings along with the basis of relationship describing common directorship and percentage of shareholding.

► *Illustrative disclosure 08: Associated companies and undertakings*

Name	Percentage of shareholding	Basis of relationship	Common directorship
ABC Limited	58%	Subsidiary	Ms. S Mr. A Mr. B
XYZ Limited	25%	More than 20% shareholding	Mr. B
KLM Limited	6%	Common directors	Mr. K Mr. M

► *Illustrative disclosure 09: Associated companies and undertakings*

The names of related parties with whom the Company has entered into transactions or had agreements / arrangements in place during the year and whose names have not been disclosed elsewhere in these financial statements are as follows:

Name of the related party	Basis of relationship	Percentage of Shareholding %
Toyota Tsusho Corporation	Associated company	20%
Tomen Power (Singapore) (Private) Limited	Associated company	16%
Red Communication Arts (Private) Limited	Common directorship	-
Kohinoor Power Company Limited	Common directorship	-
Kohinoor Energy Limited Employees Gratuity Fund	Common control	0.23%

All transactions with related parties are carried out on mutually agreed terms and conditions.

3.3 Foreign associated companies / related parties

In respect of associated companies, subsidiaries, joint ventures or holding companies incorporated outside Pakistan, following shall be separately disclosed with whom the company has entered into transactions during the year;

- Name of undertaking and country of incorporation;
- Basis of association; and
- Aggregate percentage of shareholding, including shareholding through other companies or entities.

(Note: information (ii) and (iii) are not required in fifth schedule).

► *Illustrative disclosure 10: Related party disclosure (in sub-note)*

Following particulars relate to associated companies incorporated outside Pakistan with whom the company had entered into transactions during the year:

Name of undertaking	Pakistan Maroc Phosphore S.A.
Country of incorporation	Morocco
Basis of association	Joint venture of OCP Group and Fauji Group
Aggregate %age of shareholding	12.5% Equity investment by the company

► *Illustrative disclosure 11: Related party disclosure (in sub-note)*

Following particulars relate to associated companies incorporated outside Pakistan with whom the company had entered into transactions during the year:

Name of undertaking	Toyota Tsusho Corporation
Country of incorporation	Japan
Basis of association	Associated undertaking
Aggregate %age of shareholding	20%

3.4 Credit facilities (fourth schedule only)

General nature of any credit facilities available to the company, other than trade credit available in the ordinary course of business, and not availed at the date of the statement of financial position.

► *Illustrative disclosure 12: Facilities of letter of credit and letter of guarantee (in sub-note)*

Facilities of letters of credit and letters of guarantee amounting to Rs 17,395,000 thousand and Rs 239,293 thousand (2017: Rs 13,580,000 thousand and Rs 101,655 thousand) respectively are available to the company against lien on shipping / title documents, US \$ Term Deposit Receipts and charge on assets of the company.

► *Illustrative disclosure 13: Credit facilities (in sub-note)*

Of the aggregate facility of Rs. 875 million (2018: Rs. 476.85 million) for opening letters of credit and Rs. 440 million (2018: Rs. 207.05 million) for guarantees, the amount utilized as at June 30, 2019 were Rs. 4.44 million (2018: Rs. 151.4 million) and Rs. 274.43 million (2018: Rs. 207.05 million) respectively.

3.5 Utilisation of proceeds from public offering (fourth schedule only)

In financial statements issued after initial or secondary public offering(s) of securities or issuance of debt instrument(s) implementation of plans as disclosed in the prospectus/offering document with regards to utilization of proceeds raised shall be disclosed till full implementation of such plans.

► *Illustrative disclosure 14: Utilization of proceeds from Initial Public Offering (IPO)*

The Company raised the funds through IPO for expansion and modernization of its production facilities, in order to meet the expected increase in demand for tyres and tubes and to achieve higher level of automation in their existing production facilities to bring in cost efficiencies.

Out of net IPO proceeds of Rs. 1,874 million, the expenditure of Rs. 1,466 million (78%) has been incurred by 30 June 2021.

3.6 Loans/advances/investments in foreign companies

In cases where company has given loans or advances or has made investments (both short term and long term) in foreign companies or undertakings following disclosures are required to be made:

- Name of the company or undertaking along with jurisdiction where it is located;
- Name and address of beneficial owner of investee company, if any;
- Amount of loan/investment (both in local and foreign currency);
- Terms and conditions and period for which loans or advances or investments has been made;
- Amount of return received;
- Details of all litigations against the Investee company in the foreign jurisdictions;
- Any default/breach relating to foreign loan or investment; and
- Gain or loss in case of disposals of foreign investments.

(Note: The information (ii) to (viii) is not required in fifth schedule).

► *Illustrative disclosure 15: Investment in foreign companies (in sub-note)*

Following particulars relate to investment made in the foreign company:

Particulars	Pakistan Maroc Phoshore S.A., Morocco
Name and jurisdiction of associated company	Pakistan Maroc Phosphore S.A., Morocco
Name and address of beneficial owners	Fauji Fertilizer Company Limited located at 156, The Mall Rawalpindi Cantt, Pakistan Fauji Foundation located at 68 Tipu Road, Chaklala, Rawalpindi Cantt, Pakistan Fauji Fertilizer Bin Qasim Limited located at FFBL Tower Plot No C1/C2, Sector B, Jinnah Boulevard Phase II DHA Islamabad, Pakistan Office Cherifien Des Phosphates located at Hay Erraha. 2, Rue Al Abtal, Casablanca, Morocco

Amount of investment	Rs 705,925 thousand (MAD 100,000 thousand)
Terms and conditions of investment	Equity investment
Amount of return received	Dividends of Rs. 1,262,969 thousands (from 2009 to 2020)
Details of litigations	None
Details of default / breach relating to investment	None
Gain / loss on disposal of investment	Not applicable

3.7 Foreign trade debts (fourth schedule only)

In cases where company has made export sales following disclosures are required to be made in respect of outstanding trade debts:

- Name of company or undertaking in case of related party; and
- Name of defaulting parties, relationship if any, and the default amount.

► *Illustrative disclosure 16: Trade debts (in sub-note)*

Included in due from export customers is an amount of Rs. 2.021 million (2017: 1.765 million) receivable from ABC Shoe Company, Peru against export sales made by the Company. During the year, the Company made export sales amounting to Rs. 6.332 million (2017: Rs. 4.077 million) to ABC Shoe Company, Peru through bank contracts.

3.8 Sharia compliance (fourth schedule only)

Sharia complaint companies and the companies listed on Islamic index shall disclose:

- Loans/advances obtained as per Islamic mode;
- Shariah compliant bank deposits/bank balances;
- Profit earned from shariah compliant bank deposits/bank balances;
- Revenue earned from a shariah compliant business segment;
- Gain/loss or dividend earned from shariah compliant investments;
- Exchange gain earned from actual currency;
- Mark up paid on Islamic mode of financing;
- Relationship with shariah compliant banks; and
- Profits earned or interest paid on any conventional loan or advance.

► *Illustrative disclosure 17: Short term borrowing (in sub-note)*

Short term financing – under mark-up/profit arrangement	2020	2019
	Rs. 000	
Islamic finances	1,521,967	1,127,639

The facility for running musharkah available from banks amounted to Rs. 2.5 billion (2019: 2.5 billion) out of which the amount unused at the year-end was Rs 0.98 billion (2019: Rs 0.37 billion). Rates of profit ranges from three month KIBOR plus 0.05% (2019: one month KIBOR plus 0.3%) to one month KIBOR plus 0.5% (2019: three months KIBOR plus 0.2%) per annum.

The mark up on Islamic financing during the year was Rs. 98,529 thousands (2019: Rs. 263,903 thousands).

4. DISCLOSURE: STATEMENT OF FINANCIAL POSITION

4.1 Sundry requirements

Following items shall be disclosed as separate line items on the face of the financial statements;

- Revaluation surplus on property, plant and equipment;
- Long term deposits and prepayments;
- Unpaid dividend;
- Unclaimed dividend; and
- Cash and bank balances.

4.2 Fixed assets

Where any property or asset acquired with the funds of the company and is not held in the name of the company or is not in the possession and control of the company, this fact along with reasons for the property or asset not being in the name of or possession or control of the company shall be stated; and the description and value of the property or asset, the person in whose name and possession or control it is held shall be disclosed;

► *Illustrative disclosure 18: Property, plant and equipment (in sub-note)*

Land measuring 2 kanals and 2 marlas in possession of the Company, acquired in 2014 at a cost of Rs. 57,800 thousand is not in the name of the Company due to pending legal case.

► *Illustrative disclosure 19: Property, plant and equipment (in sub-note)*

Land measuring 10 kanals is neither in the name of the Company nor in possession of the Company. The Company paid Rs. 75,000 thousand in July 2017 for land to be acquired from Pakistan Railways through open auction. The auction was later challenged in Lahore High Court and legal case is still pending.

Land and building shall be distinguished between free-hold and leasehold.

Forced sale value shall be disclosed separately in case of revaluation of Property, Plant and Equipment.

In the case of sale of fixed assets, if the aggregate book value of assets exceeds five million rupees, following particulars of each asset, which has book value of five hundred thousand rupees or more, shall be disclosed,

- cost or revalued amount, as the case may be;
- the book value;
- the sale price and the mode of disposal (e.g. by tender or negotiation);
- the particulars of the purchaser;
- gain or loss; and
- relationship, if any of purchaser with Company or any of its directors.

► *Illustrative disclosure 20: Disposal of operating fixed assets*

Particulars of assets	Sold to	Cost	Book value	Sale proceeds	Gain / (loss)	Mode of disposal
		(Rupees in thousand)				
Book value greater than Rs. 500,000						
Vehicle	Employee: Mr. Ayaz	1,973	524	524	-	Company Car Scheme
Vehicle	Employee: Mr. Sikandar	2,503	1,608	1,608	-	
Vehicle	Employee: Mr. Amir	1,124	884	884	-	
Book value less than Rs. 500,000		29,952	9,366	12,948	3,582	
Year ended: June 30, 2019		35,552	12,382	15,964	3,582	
Year ended: June 30, 2018		31,532	17,128	17,128	-	

4.3 Long term loans and advances

With regards to loans and advances to directors following shall be disclosed:

- the purposes for which loans or advances were made; and
- reconciliation of the carrying amount at the beginning and end of the period, showing disbursements and repayments;

In case of any loans or advances obtained/provided, at terms other than arm's length basis, reasons thereof shall be disclosed

In respect of loans and advances to associates and related parties there shall be disclosed,

- the name of each associate and related party;
- the terms of loans and advances;
- the particulars of collateral security held, if any;
- the maximum aggregate amount outstanding at any time during the year calculated by reference to month-end balances;
- provisions for doubtful loans and advances; and
- loans and advances written off, if any.

► *Illustrative disclosure 21: Long term loans and advances – Secured*

	2018	2017
	Rs'000	Rs'000
Loans and advances – considered good, to:		
Executives	763,000	691,000
Other employees	719,000	618,000
	1,482,000	1,309,000
Less: Amount due within twelve months	368,000	343,000
	1,114,000	966,000

Reconciliation	Executive	2017
	Rs'000	Rs'000
Balance at January 1	691,000	1,269,000
Disbursement	339,000	570,000
	1,030,000	1,839,000
Repayments	(267,000)	(530,000)
Balance at December 31	763,000	1,309,000

These subsidized and interest free loans and advances are granted to employees as per the Company's policy and are repayable within one to ten years. House building loans carry mark-up at 4% per annum and are secured against the underlying assets.

The maximum amount of loans and advances to executives outstanding at the end of any month during the year was Rs 805,865 thousand (2017: Rs 772,548 thousand).

4.4 Current assets

In respect of debts/receivables from associates and related parties there shall be disclosed.

- the name of each associate and related party;
- the maximum aggregate amount outstanding at any time during the year calculated by reference to month-end balances;
- receivables, that are either past due or impaired, along with age analysis distinguishing between trade debts, loans, advances and other receivables;
- debts written off as irrecoverable, distinguishing between trade debts and other receivables;
- provisions for doubtful or bad debts distinguishing between trade debts, loans, advances and other receivables; and
- justification for reversal of provisions of doubtful debts, if any;

► *Illustrative disclosure 22: Trade debts - Unsecured*

	2018	2017
Considered good	Rs'000	Rs'000
Due from customers	2,165,093	1,561,668
Due from associated undertakings	2,021	1,765
	2,167,114	1,563,433
Considered doubtful		
Due from customers	30,362	30,527
Less: Provision for doubtful debts	(30,362)	(30,527)
	-	-
	2,167,114	1,563,433

These customers have no recent history of default.

	2018	2017
Due from associated undertaking	Rs'000	Rs'000
ABC Shoe Company, Peru	2,021	1,765

Maximum aggregate amount due from associated undertakings at the end of any month in the year was Rs. 3.319 million (2017: Rs. 1.967 million). No interest has been charged on the amounts due from associated undertakings.

In respect of loans and advances, other than those to employees as per company's human resource policy or to the suppliers of goods or services, the name of the borrower and terms of repayment if the loan or advance exceeds rupees one million, together with the particulars of collateral security, if any, shall be disclosed separately (Note: The requirements in this para relate to fourth schedule only and not required in fifth schedule).

Provision, if any, made for bad or doubtful loans and advances or for diminution in the value of or loss in respect of any asset shall be shown as a deduction from the gross amounts;

► *Illustrative disclosure 23: Loans and advances*

	2018	2017
	Rs'000	Rs'000
Current portion of long term loans and advances	368,000	343,000
Loans and advances to employees - unsecured	27,000	17,000
Advance to suppliers – considered good	82,000	150,000
Advance to subsidiary company – interest bearing	582,000	1,122,000
	1,059,000	1,632,000

Advance to subsidiary company

This represents aggregate unsecured advance to, ABCEL, subsidiary company under a revolving credit facility upto an amount of Rs 1,500,000 thousand to meet debt servicing obligations and other working capital requirements. This carries mark-up at 1 month KIBOR + 0.60%. The maximum outstanding amount at the end of any month during the year was Rs 671,261 thousand (2017: Rs 1,336,386 thousand).

4.5 Share capital and reserves

Capital and Revenue reserves shall be clearly distinguished. Any reserve required to be maintained under the Act shall be separately disclosed. Any legal or other restrictions, on the ability of the company to distribute or otherwise, shall be disclosed for all kind of reserves maintained by the company;

“Capital reserve” includes:

- share premium account;
- reserve created under any other law for the time being in force;
- reserve arising as a consequences of scheme of arrangement;
- profit prior to incorporation; and
- any other reserve not regarded free for distribution by way of dividend

“Revenue reserve” means reserve that is normally regarded as available for distribution through the profit and loss account, including general reserves and other specific reserves created out of profit and un-appropriated or accumulated profits of previous years.

► Illustrative disclosure 24: Reserves

Capital Reserves		2018	2017
		Rs'000	Rs'000
Share premium	5.1	40,000	40,000
Capital redemption reserve	5.2	120,000	120,000
		160,000	160,000

5.1 This represents premium of Rs. 5 per share received on public issue of 8,000,000 ordinary shares of Rs. 10 each in 1991.

5.2 This represents reserve set up on redemption of preference shares of Rs. 120,000 thousands in 1996.

Revenue Reserves		2018	2017
		Rs'000	Rs'000
General reserve		8,802,360	8,802,360
Unappropriated profit		11,720,153	7,374,114
		20,522,513	16,176,474

In respect of issued share capital of a company following shall be disclosed separately:

- shares allotted for consideration paid in cash;
- shares allotted for consideration other than cash, showing separately shares issued against property and others (to be specified);
- shares allotted as bonus shares; and
- treasury shares;

Shareholders agreements for voting rights, board selection, right of first refusal and block voting shall be disclosed.

► *Illustrative disclosure 25: Share Capital*

Authorised share capital				
2018	2017		2018	2017
Number of shares '000			Rs'000	
10,000	10,000	Ordinary shares of Rs. 10 each	100,000	100,000

Issued, subscribed and paid up capital				
2018	2017		2018	2017
Number of shares '000			Rs'000	
1,890	1,890	Ordinary shares of Rs. 10 each Fully paid in cash	18,900	18,900
300	300	Ordinary shares of Rs. 10 each Issued for consideration other than cash	3,000	3,000
5,370	5,370	Ordinary shares of Rs. 10 each Issued as fully paid bonus shares	53,700	53,700
7,560	7,560		75,600	75,600

Shares issued for consideration other than cash were issued against plant and machinery.

All ordinary shares rank equally with regard to the Company's residual assets. Holders of the shares are entitled to dividends from time to time and are entitled to one vote per share at the general meetings of the Company.

4.6 Non-current liabilities

Amount due to associated companies and related parties shall be disclosed separately. (**Note:** The fifth schedule states "Amount due to associated company shall be disclosed separately").

4.7 Current liabilities

Following items shall be disclosed as separate line items:

- Payable to provident fund;
- Deposits, accrued liabilities and advances;
- Loans from banking companies and other financial institutions, other than related parties;
- Loans and advances from related parties including sponsors and directors along with purpose and utilization of amounts; and
- Loans and advances shall be classified as secured and unsecured.

► *Illustrative disclosure 26: Current liabilities*

	Note	2018	2017
		Rs'000	Rs'000
Trade and other payables	9	60,599,330	38,781,144
Mark-up payable	10	300,574	190,707
Short term borrowings – secured	11	28,526,484	11,539,083
Unclaimed dividend		638,783	437,291
Current portion of long term borrowings - secured	7	7,237,742	6,831,804
Taxation		2,641,779	1,229,780
		99,944,692	59,009,809

► *Illustrative disclosure 27: Current liabilities*

	Note	2019 Rs'000	2018 Rs'000
Employee benefits	7	31,929	29,950
Short term finances - secured	8	5,354,474	5,285,780
Trade and other payables	9	53,867	84,120
Accrued finance costs	10	103,727	48,878
Unclaimed dividend		50,088	10,305
Provision for taxation – net		59,078	61,439
		5,653,163	5,520,472

In respect of security deposit payable, following shall be disclosed:

- Bifurcation of amount received as security deposits for goods/services to be delivered / provided, into amounts utilizable for company business and others;
- Amount utilized for the purpose of the business from the security deposit in accordance with requirements of written agreements, in terms of section 217 of the Act; and
- Amount kept in separate bank account;

► *Illustrative disclosure 28: Long term deposits*

	2019 Rs'000	2018 Rs'000
Long term deposits from dealers	12,731	12,691

These represent security deposits received from dealers which, by virtue of agreement, are interest free. These are repayable on cancellation of dealership contract with dealers and cannot be utilized for the purpose of the business. These have been kept in separate bank account in accordance with the requirements of the section 217 of the Companies Act, 2017.

4.8 Contingencies and commitments

In describing legal proceedings, under any court, agency or government authority, whether local or foreign, include name of the court, agency or authority in which the proceedings are pending, the date instituted, the principal parties thereto, a description of the factual basis of the proceeding and the relief sought.

► *Illustrative disclosure 29: Contingencies and Commitments*

Penalty of Rs 5.5 billion imposed by the Competition Commission of Pakistan (CCP) in 2013, for alleged unreasonable increase in urea prices, had been set aside by the Competition Appellate Tribunal with directions to the CCP to decide the case under guidelines provided by the Tribunal. No petition was filed by the CCP for review of the decision within the stipulated time, and this option has thus become time barred for the CCP. However, the CCP can file fresh case under the guidelines provided by the Tribunal, but the Company remains confident of successfully defending these unreasonable claims in future as well.

	2018 Rs'000	2017 Rs'000
Commitments in respect of:		
Capital expenditure	1,919,124	2,498,658
Purchase of stores, spares and other items	1,528,517	2,821,573
Investment in an associated company – ABC Limited	500,000	640,000
Investment in a Joint Venture XYZ Energy Limited	3,685,374	-
Contracted out services	392,100	221,390
Rentals under lease agreements:		
Premises	254,827	312,656
Vehicles	88,226	83,674

► *Illustrative disclosure 30: Contingencies*

The Company is defending a suit for Rs. 19,579 thousand, filed in previous years by an ex-vendor on account of damages and inconvenience. Previously, the case was pending before the Civil Court, Lahore. However, during the last year, it was held by the Civil Court that the damages of Rs. 15,000 thousand has been awarded in favour of vendor for the aforementioned inconvenience. In addition to that the Company is also required to pay the amount of parts already supplied by the vendor which amounts to Rs. 4,579 thousand along with mark-up @ 7% per annum till its realization. However, the Company has filed an appeal in the Honourable High Court, Lahore against the aforesaid order of Civil Court. The management and the legal advisor are confident that outcome of the case would be in the Company's favour and no payment in this regard would be required, hence no provision there against has been made in these financial statements.

4.9 Format: statement of financial position

The following illustrative format incorporates the requirements of IFRSs and fourth/fifth schedule to the Companies Act, 2017:

ABC Limited

Statement of financial position

As at 30 June 20X2

	Rs. million
Non-current assets	
Fixed assets (Property, plant and equipment)	180
Investment property	10
Intangible assets	7
Long term deposits and prepayments	5
Long term loans and advances	20
Investments / financial assets	6
	228
Current assets	
Inventories / Stock in trade	18
Trade and other receivables (disclosure for associates and related party required)	16
Loans and advances	3
Cash and bank balances	4
	41
	269
Equity	
Share capital	50
Share premium	32
Revaluation surplus on property, plant and equipment	21
Retained earnings	40
	143

	Rs. million
Non-current liabilities	
Long term borrowings	25
Due to associated companies and related parties	5
Deferred tax liability	8
Long term provisions	27
	65
Current liabilities	
Trade payables	8
Deposits, accrued liabilities and advances	5
Short term borrowings (from banks and other financial institutions)	17
Loans and advances from related parties	3
Current portion of long term borrowings	10
Unpaid dividend	2
Unclaimed dividend	-
Current tax payable	9
Short term provisions	7
	61
	269

5. DISCLOSURE: STATEMENT OF PROFIT OR LOSS

5.1 Turnover

Following items shall be disclosed as deduction from turnover as separate line items:

- trade discount; and
- sales and other taxes directly attributed to sales.

► *Illustrative disclosure 31: Turnover (revenue)*

	2018	2017
	Rs'000	Rs'000
Manufactured urea – local	74,462,673	67,095,578
Manufactured urea – export	-	5,066,304
Purchased and packaged fertilizers	32,930,082	27,031,569
	109,392,755	99,193,451
Sales tax	(3,381,261)	(5,101,021)
Trade discount	(47,023)	(3,378,316)
	(3,428,284)	(8,479,337)
	105,964,471	90,714,114

5.2 Auditors' remuneration

The aggregate amount of auditors' remuneration, showing separately fees, expenses and other remuneration for services rendered as auditors and for services rendered in any other capacity and stating the nature of such other services. In the case of joint auditors, the aforesaid information shall be shown separately for each of the joint auditors;

► *Illustrative disclosure 32: Auditors' remuneration (sub-note of admin expenses)*

Auditors' remuneration	2019	2018
	Rs'000	Rs'000
Audit fee	1,650	1,600
Fee for half yearly review, audit of consolidated financial statements, review of Code of Corporate Governance and other certifications in the capacity of external auditors	899	890
Out of pocket expenses	160	150
	2,709	2,640

5.3 Donation

In case, donation to a single party exceeds 10 per cent of company's total amount of donation or Rs. 1 million, whichever is higher, name of donee(s) shall be disclosed and where any director or his spouse has interest in the donee(s), irrespective of the amount, names of such directors along with their interest shall be disclosed;

► *Illustrative disclosure 33: Donations*

Cost of sales and Distribution cost include donations amounting to Rs 60,176 thousand (2017: Rs 64,125 thousand) and Rs 24,515 thousand (2017: Rs 25,289 thousand) respectively. These are disbursed through ABC Welfare Foundation (associated undertaking). Interest of CEO Mr. Tariq in ABC Welfare Foundation is limited to the extent of his involvement in ABC Welfare Foundation as Chairman.

5.4 Remuneration to directors, chief executives and executives

Complete particulars of the aggregate amount charged by the company shall be disclosed separately for the directors, chief executive and executives together with the number of such directors and executives such as:

- fees;
- managerial remuneration;
- commission or bonus, indicating the nature thereof;
- reimbursable expenses which are in the nature of a perquisite or benefit;
- pension, gratuities, company's contribution to provident, superannuation and other staff funds, compensation for loss of office and in connection with retirement from office;
- other perquisites and benefits in cash or in kind stating their nature and, where practicable, their approximate money values; and
- amount for any other services rendered.

"Executive" means an employee, other than the chief executive and directors, whose basic salary exceeds twelve hundred thousand rupees in a financial year.

► *Illustrative disclosure 34: Remuneration of chief executive, directors and executives*

The aggregate amounts charged in these financial statements in respect of remuneration including benefits applicable to the chief executive, directors and executives of the company are given below:

	2018		2017	
	Chief Executive	Executives	Chief Executive	Executives
	Rs'000	Rs'000	Rs'000	Rs'000
Managerial remuneration	7,915	1,353,075	8,583	1,297,932
Contribution to provident fund	542	84,995	618	81,561
Bonus and other awards	2,783	-	3,703	561
Good performance awards	-	1,458,366	-	1,394,652
Allowance and contribution to retirement benefit plans	9,030	1,186,791	11,113	1,068,165
Total	20,270	4,083,227	24,017	3,842,871
Number of person(s)	1	339	1	336

The above were provided with medical facilities; the chief executive and certain executives were also provided with some furnishing items and vehicles in accordance with the Company's policy.

Gratuity is payable to the Chief Executive in accordance with the terms of employment while contributions for executives in respect of gratuity and pension are based on actuarial valuations.

Leave encashment of Rs 4,431 thousand (2017: Nil) and Rs 57,380 thousand (2017: Rs 46,454 thousand) were paid to chief executive and executives on separation, in accordance with the Company's policy.

In addition, 18 (2017: 16) directors were paid aggregate fee of Rs 6,075 thousand (2017: Rs 4,625 thousand).

Directors are not paid any remuneration except meeting fee.

5.5 Royalty payments

In case of royalties paid to companies/entities/individuals, following shall be disclosed:

- Name and registered address; and
- Relationship with company or directors, if any.

► *Illustrative disclosure 35: Royalty payments*

Distribution costs	2018	2017
	Rs'000	Rs'000
Salaries and benefits	840,000	813,000
Freight	270,000	239,000
Trademark license fee Note	635,000	388,000
Depreciation	165,000	146,000
Miscellaneous	1,000	500
	1,911,000	1,586,500

The trademark license fee represents the royalty fee of ABC Brands S.A.R.L., Switzerland, an associated company situated in Avenue d'Ouchy 6, 1006 Lausanne, Switzerland.

5.6 Format: Statement of comprehensive income

The following illustrative format incorporates the requirements of IFRSs and fourth/fifth schedule to the Companies Act, 2017:

► *ABC Limited*

Statement of comprehensive income (single statement)

For the year ended 30 June 20X2

	Rs. m
Revenue	678
Cost of sales	(250)
Gross profit	428
Other income	12
Distribution costs	(66)
Administrative expenses	(61)
Other operating expenses	(18)
Profit from operations	295
Finance income (e.g. income from financial assets)	-
Finance costs	(24)
Profit before tax	271
Taxation	(50)
Profit for the year	221
Other comprehensive income	
Gains on revaluation (PPE & intangible assets)	24
Gains on valuation of investments (at fair value through OCI)	22
Other comprehensive income for the year (net of tax)	46
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	267

6. COMPREHENSIVE EXAMPLES

► Example 01:

Figs Pakistan Limited is a listed company engaged in the business of manufacturing and marketing of personal care and food products. Following is an extract from its trial balance for the year ended 31 December 2017:

	Debit	Credit
	Rs. in million	
Sales - Manufactured goods		56,528
Sales - Imported goods		1,078
Scrap sales		16
Dividend income		12
Return on savings account		2
Sales tax - Imported goods	53	
Sales tax - Manufactured goods	10,201	
Sales discount	2,594	
Raw material stock as on 1 January 2017	1,751	
Work in process as on 1 January 2017	73	
Finished goods (manufactured) as on 1 January 2017	1,210	
Finished goods (imported) as on 1 January 2017	44	
Purchases - Raw material	22,603	
Purchases - Imported goods	658	
Stores and spares consumed	180	
Salaries, wages and benefits	2,367	
Utilities	734	
Depreciation and amortization	1,287	
Stationery and office expenses	230	
Repairs and maintenance	315	
Advertisement and sales promotion	4,040	
Outward freight and handling	1,279	
Legal and professional charges	71	
Auditor's remuneration	13	
Donations	34	
Other operating expenses	355	
Loss on disposal of property, plant and equipment	10	
Financial charges on short term borrowings	133	
Exchange loss	22	
Financial charges on lease	11	

Additional information

- i. The position of inventories as at 31 December 2017 was as follows:

	Rs. m
Raw material	2,125
Work in process	125
Finished goods (manufactured)	1,153
Finished goods (imported)	66

- ii. The basis of allocation of various expenses among cost of sales, distribution costs and administrative expenses are as follows:

	Cost of sales	Distribution costs	Administrative expenses
	%	%	%
Salaries, wages and benefits	55	30	15
Depreciation and amortization	70	20	10
Stationery and office expenses	25	40	35
Repairs and maintenance / Utilities	85	5	10

- iii. Auditor's remuneration includes fee for non-audit assurance services and out-of-pocket expenses amounting to Rs. 4 million and Rs. 1 million respectively.
- iv. Donations include Rs. 5 million given to Dares Cancer Foundation (DCF). One of the company's directors, Mr. Peanut is a trustee of DCF.
- v. The tax charge for the current year after making all related adjustments is estimated at Rs. 1,440 million. Taxable temporary differences of Rs. 3,120 originated in the year million, over the last year. The applicable income tax rate is 35%.
- vi. 274 million ordinary shares were outstanding as on 31 December 2017.
- vii. There is no other comprehensive income for the year.

Required

Prepare the statement of profit or loss for the year ended 31 December 2017 along with the relevant notes showing required disclosures as per the Companies Act, 2017 and International Financial Reporting Standards. Comparatives are not required.

► **ANSWER:**

Statement of comprehensive income

For the year ended 31 December 2017

	Note	Rs. million
Sales	1	44,758
Cost of sales	2	(26,203)
Gross profit		18,555
Distribution cost	3	(6,431)
Admin expenses	4	(752)
Other operating expenses	5	(399)
Other operating income	6	30
Profit from operations		11,003
Finance cost	6	(166)
Profit before tax		10,837
Taxation	8	(2,532)
Profit after tax		8,305
Other comprehensive income		-
Total comprehensive income for the year		8,305

Notes to the Financial Statements

For the year ended 31 December 2017

1 – Sales	Rs. m
Manufactured goods	
Gross sales	56,528
Sales tax	(10,201)
	46,327
Imported goods	
Gross sales	1,078
Sales tax	(53)
	1,025
Sales discount	(2,594)
	44,758

2 – Cost of Sales	Rs. m
Raw material consumed (1,751 + 22,603 - 2,125)	22,229
Stores and spares consumed	180
Salaries, wages and benefits (2,367 × 55%)	1,302
Utilities (734 × 85%)	624
Depreciation and amortizations (1.287 × 70%)	901
Stationery and office expenses (230 × 25%)	58
Repairs and maintenance (315 × 85%)	268
	25,562
Opening work in process	73
Closing work in process	(125)
	25,510
Opening finished goods (manufactured)	1,210
Closing finished goods (manufactured)	(1,153)
	25,567
Finished goods (imported)	
Opening stock	44
Purchases	658
Closing stock	(66)
	636
	26,203

3 – Distribution cost		Rs. m
Advertisement and sales promotion		4,040
Outward freight and handling		1,279
Salaries, wages and benefits (2,367 × 30%)		710
Utilities (734 × 5%)		37
Depreciation and amortization (1,287 × 20%)		257
Stationery and office expenses (230 × 40%)		92
Repairs and maintenance (315 × 5%)		16
		6,431

4 – Admin expenses		Rs. m
Salaries, wages and benefits (2,367 × 15%)		355
Utilities (734 × 10%)		73
Depreciation and amortization (1,287 × 10%)		129
Stationery and office expenses (230 × 35%)		80
Repairs and maintenance (315 × 10%)		31
Legal and professional charges		71
Auditor's remuneration	4.2	13
		752

4.1 – Auditor's remuneration		Rs. m
Audit fee		8
Other assurance services		4
Out of pocket expenses		1
		13

5 – Other operating expenses		Rs. m
Sundry operating expenses		355
Donation	5.1	34
Loss on disposal of property, plant and equipment		10
		399

5.1 - Donations include Rs. 5 million given to Dates Cancer Foundation (DCF). One of the company's directors, Mr. Peanut is a trustee of DCH. Donations other than afore-mentioned were not made to any donee in which a director or his spouse had any interest at any time during the year.

6 – Other operating income		Rs. m
Income from financial assets		
Dividend income		12
Return on savings account		2
Income from non-financial assets		
Scrap sales		16
		30

7 – Finance cost		Rs. m
Finance charges on short term borrowings		133
Exchange loss		22
Finance charges on lease		11
		166

8 – Taxation		Rs. m
Current - for the year		1,440
Deferred (3,120 × 35%)		1,092
		2,532

► *Example 02:*

Banana Limited (BL) is listed on Pakistan Stock Exchange and has registered office in Karachi. BL engages in manufacturing and marketing of fertilizers. It operates a manufacturing plant at Nawabshah.

Summarized trial balance of BL as at 30 June 2018 is given below:

Description	Rs. in million
Advance from customers	576
Cash and bank balances	831
Intangible assets	444
Investment in 3 months term deposit	500
Land and building – revaluation model	2,000
Long term deposits with utility companies	10
Long term investments	1,500
Ordinary share capital	6,000
Plant and equipment – cost model	3,086
Provision for doubtful receivables	80
Revaluation surplus on land and building	468
Running finance	800
Share premium	500
Stock-in-trade	2,670
Trade and other receivables	1,470
Trade payables	1,150
Un-appropriated profit	2,885
Unclaimed dividend	52

Additional information:

- Trade and other receivables include receivables from BL's associate i.e. Strawberry Limited (SL) and BL's subsidiary i.e. Pear Limited (PL) amounting to Rs. 50 million and Rs. 20 million respectively. Provision for doubtful receivables includes provision of Rs. 10 million against receivables from SL.

- ii. Bad debts of Rs. 35 million were written off during the year. These include an amount of Rs. 8 million receivable from SL.
- iii. Authorised share capital consists of 1 billion shares of Rs. 10 each.
- iv. 80 million shares were issued as bonus shares in the previous years whereas 20 million shares were issued as a consideration for purchase of building at market price of Rs. 15 per share. Remaining shares were allotted for consideration paid in cash.
- v. Guarantees issued by BL to Cherry Bank Limited against loans granted to BL's employees amounting to Rs. 16 million.
- vi. During the year, BL produced 3 million tonnes of urea operating at 75% production capacity. The shortfall was due to lower demand of product in the market.
- vii. Following decisions were taken by the board of directors in their meeting held on 16 August 2018:
 - Cash dividend of Rs. 3 per share for the year ended 30 June 2018 was proposed.
 - Financial statements for the year ended 30 June 2018 were approved.

Required:

- a) Formulate a note on accounting policy for property, plant and equipment measured under cost model. (Assume necessary details in this respect)
- b) Prepare BL's statement of financial position as at 30 June 2018 along with the relevant notes showing possible disclosures as required under the IFRSs and the Companies Act, 2017. (Comparative figures and note on accounting policies are not required)

► **ANSWER:**

Part (a) Accounting policy: Property, plant & equipment

Property, plant and equipment are stated at cost less accumulated depreciation and any identified impairment loss.

Cost in relation to self-constructed assets includes direct cost of material, labour and applicable manufacturing overheads and borrowings cost on qualifying assets.

Depreciation is charged to profit or loss, unless it is included in the carrying amount of another asset, on straight line method whereby cost of an asset is written off over its estimated useful life at the rates given in note XX.

Residual values and the useful lives of assets are reviewed at least at each financial year-end.

Depreciation on additions is charged from the date an asset is acquired while no depreciation is charged after the asset has been disposed of or derecognised.

Part (b)

Statement of financial position

As on 30 June 2018

Non-current Assets		Note	Rs. m
Intangible assets			444
Property, plant and equipment	[2,000 + 3,086]		5086
Long term deposits			10
Long term investments			1500
			7,040

Current Assets		Note	Rs. m
Stock-in-trade			2,670
Trade and other receivable	[1,470 - 80]	2	1,390
Short term investment			500
Cash and bank balances			831
			5,391
			12,431
Share capital and reserves:			
Share capital		3	6,000
Share premium			500
Revaluation surplus			468
Retained earnings / unappropriated profits			2885
			9,853
Current liabilities			
Trade and other payables	[576 + 1,150]		1,726
Running finance			800
Unclaimed dividend			52
			2,578
			12,431

Notes to the financial statements

For the year ended 30 June 2018

1.	Legal status and nature of business		
	Banana Limited (BL) is listed on the Pakistan Stock Exchange having registered office in Karachi. BL operates its plant located at Nawabshah. BL engages in manufacturing, and marketing of fertilizers.		
2.	Trade and other receivables		Rs. m
	Gross amount		1,470
	Provision for doubtful debts		(80)
			1,390
2.1	Trade receivables from related parties:	Receivable	Provision
	Name of related party	Rs. m	Rs. m
	Strawberry Limited (Associate)	50	10
	Pearl Limited (Subsidiary)	20	-
		70	10

2.2	Trade receivables written off (related parties)		
	During the year, trade receivable from Strawberry Limited amounting to Rs. 8 million were written off.		
3.	Share capital		Rs. m
	Authorized share capital		
	1,000 million ordinary shares of Rs. 10 each		10,000
	Issued, subscribed and paid up capital		
	80 million shares allotted as bonus shares		800
	20 million shares allotted for non-cash consideration		200
	500 million shares allotted for cash		5,000
			6,000
4.	Contingencies & Commitments		
	BL has issued guarantees to Cherry Bank Limited against loans granted to BL's employees amounting to Rs. 16 million.		
5.	Production Capacity		
	During the year BL produced 3 million units operating at 75% production capacity. The shortfall was due to lower demand of product in the market.		
6.	Subsequent events		
	The Board of Directors in its meeting held on 16 August 2018 proposed cash dividend of Rs. 3 per share amounting to Rs. 1.8 billion, subject to the approval of the members in the forthcoming annual general meeting of the company.		
7.	Date of authorisation for issue		
	These financial statements were approved and authorised for issue by the Board of Directors of the Company on 16 August 2018.		

► **Example 03:**

Safeguard Limited (SL) is listed on Pakistan Stock Exchange and has registered office in Lahore. SL is engaged in the manufacture of polyester and soda ash. Production plants are located in Lahore and Karachi. Following is the SL's draft statement of financial position as on 31 December 2020:

Equity and liabilities	Rs. in million	Assets	Rs. in million
Share capital (Rs. 10 each)	5,000	Property, plant & equipment	4,520
Reserves	2,050	Loan to employees	330
Long term liabilities	1,440	Trade and other receivables	3,265
Trade and other payables	1,610	Stock-in-trade	2,250
Bank overdraft	265		
	10,365		10,365

Additional information:

- i. Authorised share capital consists of 900 million shares of Rs. 10 each.
- ii. 130 million shares were issued at premium of Rs. 5 as consideration for purchase of building and plant. Remaining shares were allotted at par for consideration paid in cash.
- iii. Reserves include revaluation surplus on property, plant and equipment of Rs. 190 million.
- iv. Long term liabilities comprise of:
 - loan from bank of Rs. 1,100 million, out of which Rs. 250 million is payable on 30 November 2021.
 - long term deposit of Rs. 340 million from dealers.
- v. Trade and other payables include unpaid dividend of Rs. 18 million.
- vi. Loan to employees include loans to directors of Rs. 140 million. All of these loans are interest free house financing for 10 years as per company's policy. 30% of the amount was disbursed during the year. Repayment will start after two years.
- vii. Bank overdraft is net of cash in hand of Rs. 30 million.
- viii. SL has two operating segments on the basis of geographical locations. Information for 2020 extracted from reports to the segment controllers is as follows:

	North	South
	---- Rs. in million ----	
Sales	1,950	1,300
Cost of goods sold	(1,640)	(840)
Gross profit	310	460
Expenses	(175)	(390)
Profit	135	70

- ix. Assets, other income and expenses of Rs. 300 million, Rs. 40 million and Rs. 74 million respectively cannot be allocated to any segment.
- x. Assets and liabilities of North and South were in the ratio of 4:3.
- xi. North's sales include sales of Rs. 50 million to South at a profit of Rs. 5 million.

Required:

Prepare the revised statement of financial position as at 31 December 2020 along with the relevant notes showing possible disclosures as required under the IFRSs and the Companies Act, 2017. (Comparative figures and note on accounting policies are not required)

► **ANSWER:**

Statement of financial Position

As on 31 December 2020

Non-current assets		Note	Rs. m
Property, plant & equipment			4,520
Long term loans and advances		2	330
			4,850

Current assets		Note	Rs. m
Stock-in-trade			2,250
Trade and other receivables			3,265
Cash in hand			30
			5,545
			10,395
Share capital and reserves			
Share Capital		3	5,000
Share premium	[130m shares x Rs. 5]		650
Revaluation surplus			190
Retained earnings	[2,050 - 650 - 190]		1,210
			7,050
Non-current liabilities			
Bank Loan	[1,100 - 250]		850
Long term deposits			340
			1,190
Current liabilities			
Current maturity of bank loan			250
Trade and other payables	[1,610 - 18]		1,592
Unpaid dividends			18
Bank overdraft	[265 + 30]		295
			2,155
			10,395

Notes to the financial statements

For the year ended 31 December 2020

1.	Legal status and nature of business			
	Safeguard Limited (SL) is listed on the Pakistan Stock Exchange having registered office in Lahore. SL operates its plant located at Lahore and Karachi. SL engages in manufacturing of polyester and soda ash.			
2.	Long term loans and advances - Secured/unsecured			Rs. m
	Directors		2.1	140
	Employees			190
				330

2.1	Reconciliation of loan to directors			Rs. m	
	Opening balance		[140 x 70%]	98	
	Add: Disbursement during the year		[140 x 30%]	42	
	Less: Repayment			-	
	Closing balance			140	
	These interest free loans are granted to directors / employees as per the company's policy and are repayable in 10 years.				
3.	Share Capital			Rs. m	
	Authorised Share Capital:				
	900 million ordinary shares of Rs. 10 each			9,000	
	Issued, subscribed and paid-up capital				
	370 million shares allotted for cash			3,700	
	130 million shares allotted for non-cash consideration			1,300	
				5,000	
4.	Operating segments				
	The company has two operating segments on the basis of geographical locations i.e. North and south segments.				
	Reportable operating Segments		North	South	Total
			Rs. m	Rs. m	Rs. m
	Revenue from external customers		1,900	1,300	3,200
	Inter-segment revenue		50	-	50
	Revenue (Internal + External)		1,950	1,300	3,250
	Profit		135	70	205
	Assets [(10,395 - 300) x 4:3 ratio]		5,769	4,326	10,095
	Liabilities [(1,190 + 2,155) x 4:3 ratio]		1,911	1,434	3,345
	Reconciliation	Total of Reportable Segments	Inter-segment	Un-allocated	Total
		Rs. m	Rs. m	Rs. m	Rs. m
	Revenue	3,250	(50)	-	3,200
	Profit	205	(5)	(34)*	166
	Assets	10,095	-	300	10,395
	Liabilities	3,345	-	-	3,345
	*Unallocated other income 40 - expenses 74 = Rs. 34 million				

7. OBJECTIVE BASED Q&A

01. Which of the following body/institution decides on accounting rules that must be applied by companies in Pakistan?
- (a) Federal Government
 - (b) Securities and Exchange Commission of Pakistan
 - (c) State Bank of Pakistan
 - (d) The Institute of Chartered Accountants of Pakistan
02. Which of the following body/institution is responsible for recommending accounting standards for notification by Securities and Exchange Commission of Pakistan?
- (a) Pakistan Institute of Corporate Governance
 - (b) Pakistan Stock Exchange
 - (c) The Institute of Chartered Accountants of Pakistan
 - (d) Pakistan Chamber of Commerce
03. Which of the following are applicable to a company listed on Pakistan Stock Exchange?
- (a) IFRSs and Fourth Schedule of Companies Act, 2017
 - (b) IFRSs and Fifth Schedule of Companies Act, 2017
 - (c) IFRSs for SMEs and Fourth Schedule of Companies Act, 2017
 - (d) IFRSs for SMEs and Fifth Schedule of Companies Act, 2017
04. Which of the following are applicable to a non-listed public interest company?
- (a) IFRSs and Fourth Schedule of Companies Act, 2017
 - (b) IFRSs and Fifth Schedule of Companies Act, 2017
 - (c) IFRSs for SMEs and Fourth Schedule of Companies Act, 2017
 - (d) IFRSs for SMEs and Fifth Schedule of Companies Act, 2017
05. Which of the following are applicable to a non-listed large size Pakistani company?
- (a) IFRSs and Fourth Schedule of Companies Act, 2017
 - (b) IFRSs and Fifth Schedule of Companies Act, 2017
 - (c) IFRSs for SMEs and Fourth Schedule of Companies Act, 2017
 - (d) IFRSs for SMEs and Fifth Schedule of Companies Act, 2017
06. How a public utility or similar company carrying on the business of essential public services shall be classified according to Companies Act, 2017?
- (a) Public Interest Company
 - (b) Large Sized Company
 - (c) Medium Sized Company
 - (d) Small Sized Company

07. A public unlisted company has paid up capital of Rs. 8 million, turnover of Rs. 90 million and 225 employees. How it shall be classified according to Companies Act, 2017?
- (a) Public Interest Company
 - (b) Large Sized Company
 - (c) Medium Sized Company
 - (d) Small Sized Company
08. A private company has paid up capital of Rs. 80 million, turnover of Rs. 700 million and 525 employees. How it shall be classified according to Companies Act, 2017?
- (a) Public Interest Company
 - (b) Large Sized Company
 - (c) Medium Sized Company
 - (d) Small Sized Company
09. A public unlisted company has paid up capital of Rs. 80 million, turnover of Rs. 1,200 million and 225 employees. How it shall be classified according to Companies Act, 2017?
- (a) Public Interest Company
 - (b) Large Sized Company
 - (c) Medium Sized Company
 - (d) Small Sized Company
10. A foreign company has paid up capital equivalent of Rs. 250 million, turnover of Rs. 900 million and 725 employees. How it shall be classified according to Companies Act, 2017?
- (a) Public Interest Company
 - (b) Large Sized Company
 - (c) Medium Sized Company
 - (d) Small Sized Company
11. In the case of sale of fixed assets, if the aggregate book value of assets exceeds Rs. 5 million, following particulars of each asset, which has book value of Rs. 500,000 or more shall be disclosed:
- (i) cost or revalued amount, as the case may be.
 - (ii) the book value.
 - (iii) the sale price and the mode of disposal (e.g. by tender or negotiation).
 - (iv) the particulars of the purchaser.
 - (v) gain or loss.
 - (vi) relationship, if any of purchaser with Company or any of its directors.
- (a) (i), (ii) and (v) only
 - (b) (i) to (iv) only
 - (c) (i) to (v) only
 - (d) (i) to (vi) all

12. With regards to loans and advances to directors a company is required to disclose the purpose for which loans or advances were made.
The above disclosure is required by:
- (a) Fourth Schedule
 - (b) Fifth Schedule
 - (c) Both (a) and (b)
 - (d) Neither (a) nor (b)
13. In respect of loans and advances, other than those to employees as per company's HR policy or to the suppliers of goods or services, the name of the borrower and terms of repayment if the loan or advance exceeds rupees one million, together with the particulars of collateral security, if any, shall be disclosed separately.
The above disclosure is required by:
- (a) Fourth Schedule
 - (b) Fifth Schedule
 - (c) Both (a) and (b)
 - (d) Neither (a) nor (b)
14. In Fourth and Fifth Schedule, an executive has been defined as an employee, other than the chief executive and directors, whose basic salary exceeds a certain amount in a financial year. What is that amount?
- (a) Rs. 600,000
 - (b) Rs. 1,200,000
 - (c) Rs. 2,000,000
 - (d) Rs. 3,000,000
15. In respect of issued share capital of a company following shall be disclosed separately:
- (i) shares allotted for consideration paid in cash.
 - (ii) shares allotted for consideration other than cash, showing separately shares issued against property and others (to be specified).
 - (iii) shares allotted as bonus shares.
 - (iv) treasury shares.
- (a) (i), (ii) and (iii) only
 - (b) (i) and (ii) only
 - (c) (i) and (iii) only
 - (d) (i) to (iv) all
16. Mercury Limited is a listed company on Pakistan Stock Exchange. The applicable accounting framework and Schedule (for disclosure requirements) of Companies Act, 2017 is:
- (a) IFRSs and Fourth Schedule
 - (b) Revised AFRS and Fourth Schedule
 - (c) IFRSs and Fifth Schedule
 - (d) Revised AFRS and Fifth Schedule

17. Neptune (Private) Limited is a large size company according to Third schedule of Companies Act, 2017. The applicable accounting framework and Schedule (for disclosure requirements) of Companies Act, 2017 is:
- (a) IFRSs and Fourth Schedule
 - (b) Revised AFRS and Fourth Schedule
 - (c) IFRSs and Fifth Schedule
 - (d) Revised AFRS and Fifth Schedule
18. Mars Limited is public unlisted company. It is subsidiary of Mercury Limited which is listed on Pakistan Stock Exchange. The applicable accounting framework and Schedule (for disclosure requirements) of Companies Act, 2017 is:
- (a) IFRSs and Fourth Schedule
 - (b) Revised AFRS and Fourth Schedule
 - (c) IFRSs and Fifth Schedule
 - (d) Revised AFRS and Fifth Schedule
19. Which schedule of Companies Act, 2017 lists the classification criteria of the companies based on company size?
- (a) First Schedule
 - (b) Third Schedule
 - (c) Fourth Schedule
 - (d) Fifth Schedule
20. Earth Limited is a non-listed company but according to Third schedule of Companies Act, 2017 it is public interest company. The applicable accounting framework and Schedule (for disclosure requirements) of Companies Act, 2017 is:
- (a) IFRSs and Fourth Schedule
 - (b) Revised AFRS and Fourth Schedule
 - (c) IFRSs and Fifth Schedule
 - (d) Revised AFRS and Fifth Schedule
21. Which of the following is NOT a characteristic of 'small sized company' under the Companies Act, 2017?
- (a) A private company
 - (b) Paid-up capital upto Rs. 10 million
 - (c) Total assets upto Rs. 100 million
 - (d) Employees not more than 250
22. The applicable financial reporting framework and schedule of the Companies Act, 2017 for Large Sized Company are:
- (a) IFRS and Fourth Schedule
 - (b) IFRS and Fifth Schedule
 - (c) Revised AFRS for SSE and Fourth Schedule
 - (d) Revised AFRS for SSE and Fifth Schedule

23. Which of the following is NOT a disclosure requirement under the Fifth Schedule of the Companies Act, 2017?
- (a) Distinction between capital and revenue reserves
 - (b) General nature of any un-availed credit facilities
 - (c) Capacity of an industrial unit
 - (d) Remuneration of chief executive, directors and executives
24. A Limited, an unlisted company, is the parent of B Limited, a listed company. Which schedule of the Companies Act, 2017 would apply to the financial statements of A Limited and B Limited for disclosures?

	A Limited	B Limited
(a)	Fifth	Fourth
(b)	Fourth	Fifth
(c)	Fourth	Fourth
(d)	Fifth	Fifth

ANSWERS

01.	(b)	Securities and Exchange Commission of Pakistan
02.	(c)	The Institute of Chartered Accountants of Pakistan
03.	(a)	IFRSs and Fourth Schedule of Companies Act, 2017
04.	(b)	IFRSs and Fifth Schedule of Companies Act, 2017
05.	(b)	IFRSs and Fifth Schedule of Companies Act, 2017
06.	(a)	Public interest company
07.	(c)	If it was private company, classification would be as small sized company.
08.	(c)	Medium Sized Company
09.	(b)	It has turnover of more than Rs. 1 billion.
10.	(c)	Only turnover criteria are evaluated for foreign companies.
11.	(d)	All are required under Fourth and Fifth Schedule.
12.	(c)	This is requirement of Fourth Schedule and Fifth Schedule.
13.	(a)	This is requirement of Fourth Schedule only.
14.	(b)	Rs. 1,200,000 per annum
15.	(d)	All of the information is required to be disclosed.
16.	(a)	IFRSs and Fourth Schedule
17.	(c)	IFRSs and Fifth Schedule
18.	(a)	IFRSs and Fourth Schedule The same reporting framework is applicable to a subsidiary as is applicable to its parent entity.
19.	(b)	The Third schedule lists the classification criteria of the company on the basis of company size.
20.	(c)	IFRSs and Fifth Schedule. The Fifth schedule is applicable to non-listed companies even if it is public interest company.
21.	(c)	Total assets upto Rs. 100 million
22.	(b)	IFRS and Fifth Schedule
23.	(b)	General nature of any un-availed credit facilities
24.	(a)	A Limited: Fifth Schedule and B Limited: Fourth Schedule

STICKY NOTES

Summary of Third Schedule

Sr. #	Classification	Applicable accounting framework	Schedule of Companies Act, 2017
1a	Listed company	IFRSs	Fourth
1b	Other public interest company		Fifth
2	Large sized company	IFRSs / ASNPO	
3	Medium sized company	Revised AFRS / ASNPO	
4	Small sized company	Revised AFRS	

Key differences – Disclosure requirements of Fourth and Fifth Schedule

1.	Particulars of company's immovable fixed assets, including location and area of land is required in fourth schedule but not required in fifth schedule.
2.	In relation to foreign associated companies and related parties, fourth schedule additionally requires basis of association and aggregate percentage of shareholding that are not required by fifth schedule. Similarly, fifth schedule additionally requires disclosure of registered address that is not required by fourth schedule.
3.	The requirements of fourth schedule are more extensive in relation to loans/advances/investment in foreign companies and undertakings.
4.	The following are only required by fourth schedule: • Disclosure of general nature of any credit facilities • Utilisation of proceeds from IPO • Certain disclosure of outstanding trade debts (related to export sales) • Sharia compliance disclosures
5.	Disclosure relating to certain loans and advances exceeding Rs. one million are only required by fourth schedule.
6.	In relation to non-current liabilities, fourth schedule requires amounts due to associated companies and related parties to be disclosed while fifth schedule only requires that amount due to associated company to be disclosed separately.

AT A GLANCE

SPOTLIGHT

STICKY NOTES

CONSOLIDATION

IN THIS CHAPTER:

AT A GLANCE

SPOTLIGHT

1. Single economic entity concept and control
2. Consolidation procedures
3. Goodwill adjustments
4. Fair value adjustments
5. Mid-year acquisitions
6. Elimination of intra-group items
7. Comprehensive Examples
8. Objective Based Q&A

STICKY NOTES

AT A GLANCE

A parent entity (entity having control of another entity) is required (with certain exceptions) to prepare consolidated financial statements. The consolidated financial statements are the financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity.

An investor (parent) controls an investee (subsidiary) if and only if the investor has all of the following elements:

- (a) power over the investee, i.e. the investor has existing rights that give it the ability to direct the relevant activities (that significantly affect the investee's returns);
- (b) exposure, or rights, to variable returns from its involvement with the investee; and
- (c) the ability to use its power over the investee to affect the amount of the investor's returns.

The term "consolidation" simply means to put things together and this what we mainly do when preparing consolidated financial statements. However, we must be aware that consolidation is a well-defined process that includes several complexities and application of accounting principles including:

- (a) Recognising goodwill in the business combination
- (b) Accounting for partial ownership i.e. non-controlling interest
- (c) Elimination of intercompany transactions and balances
- (d) Ensuring uniform accounting policies

1. SINGLE ECONOMIC ENTITY CONCEPT AND CONTROL

1.1 The need of consolidated financial statements

Many large businesses actually consist of several separate legal entities controlled by one central company i.e. parent or holding entity. The entities controlled by parent entity are called subsidiaries.

It would be challenging for investors or financial analysts to gather the accounting information from the parent entity as well as the subsidiary companies to get the idea about the financial health of the entire (large) business.

Therefore, the parent entities are required to present their individual financial statements and also the consolidated financial statements in which parent and subsidiaries financial data is combined.

As the parent entity and its subsidiaries form one economic entity, investors, regulators, and customers find consolidated financial statements helpful in understanding the overall financial position and financial performance of the entire entity i.e. group.

► Example 01:

A Limited (a car manufacturer) buys 100% of B Limited (an automotive parts manufacturer).

The 100% ownership gives A Limited complete control over B Limited.

A Limited's business has changed as a result of buying B Limited.

It was a car manufacturer. Now it is a car manufacturer and a manufacturer of automotive parts.

The two parts of the business are operated by two separate legal entities (A Limited and B Limited). However, the two parts of the business are controlled by the management of A Limited.

In substance, the two separate legal entities are a single economic entity.

1.2 Definitions : the concept of group [IFRS 10: Appendix A and IAS 27.4]

"Group" means a parent and its subsidiaries.

"Parent" is an entity that controls one or more entities.

"Subsidiary" is an entity that is controlled by another entity (i.e. parent).

"Consolidated financial statements" are the financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity.

"Separate financial statements" are those presented by an entity in which the parent entity presents its investment in subsidiary at cost or in accordance with IFRS 9 (at fair value) or using the equity method.

The individual/separate financial statement of parent and subsidiary are not affected by consolidation specific adjustments. Consolidation specific adjustments are not part of individual entity double-entry accounting system. In practice, consolidation is one-time year-end procedure, often performed using specialized software.

1.3 Requirement [IFRS 10: 4 & 4B and Companies Act, 2017: Section 228]

Companies Act, 2017 requires that there shall be attached to the financial statements of a holding company having a subsidiary or subsidiaries, at the end of the financial year at which the holding company's financial statements are made out, consolidated financial statements of the group presented as those of a single enterprise and such consolidated financial statements shall comply with the disclosure requirements of the relevant Schedule and financial reporting standards notified by the Commission.

IFRS 10 also requires that an entity that is a parent shall present consolidated financial statements and must include all the subsidiaries of the parent. However, a parent need not present consolidated financial statements if it meets all the following conditions:

- (a) it is a wholly-owned subsidiary or is a partially-owned subsidiary of another entity and all its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements;
- (b) its debt or equity instruments are not traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets);
- (c) it did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market; and
- (d) its ultimate or any intermediate parent produces financial statements that are available for public use and comply with IFRSs, in which subsidiaries are consolidated or are measured at fair value through profit or loss in accordance with this IFRS.

A parent that is an investment entity shall not present consolidated financial statements if it is required to measure all of its subsidiaries at fair value through profit or loss.

1.4 Whether an investor is parent? [IFRS 10: 5 to 7, 10, B15, B56 to B58]

An investor, regardless of the nature of its involvement with an entity (the investee), shall determine whether it is a parent by assessing whether it controls the investee.

An investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.

An investor controls an investee if and only if the investor has all the following:

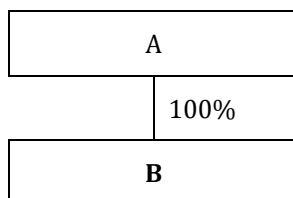
- (a) **Power over the investee:** this is when the investor has existing rights that give it the current ability to direct the relevant activities, i.e. the activities that significantly affect the investee's returns.
- (b) **Exposure, or rights, to variable returns from its involvement with the investee:** variable returns are returns that are not fixed and have the potential to vary as a result of the performance of an investee. Variable returns can be positive and/or negative. Examples of returns include dividends, capital gain from investment in investee, remuneration from providing services to investee, residual interest in the assets of investee on liquidation, tax benefits, economies of scale, cost savings and gaining access to proprietary knowledge, etc.
- (c) **The ability to use its power to affect the amount of returns:** it shall determine whether it is a principal or an agent.

In practice, the vast majority of cases involve a company achieving control of another through buying a controlling interest in its shares.

Furthermore, in the vast majority of cases obtaining a controlling interest means buying shares which give the holder more than 50% of the voting rights in the other company.

► Example 02:

A owns 100% of B's voting share capital.



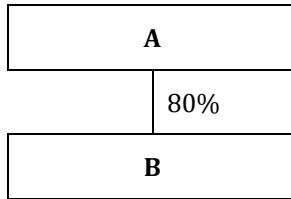
This 100% holding is described as a controlling interest and gives A complete control of B.

B would be described as a wholly owned subsidiary.

A company does not have to own all of the shares in another company in order to control it.

► *Example 03:*

A owns 80% of B's voting share capital.



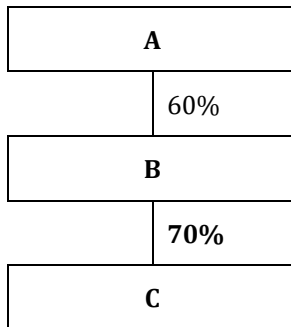
This 80% holding is described as a controlling interest and gives A complete control of B.

B would be described as a partly owned subsidiary.

Other parties own the remaining 20% of the shares. They have an ownership interest in B but do not have control. This is described as a non-controlling interest.

Non-controlling interest (NCI) is defined by IFRS 10 as: "the equity in a subsidiary not attributable, directly or indirectly, to a parent."

Control is assumed to exist when the parent owns directly, or indirectly through other subsidiaries, more than half of the voting power of the entity, unless in exceptional circumstances it can be clearly demonstrated that such control does not exist.

► *Example 04:*

A owns a controlling interest in B. B owns a controlling interest in C.

Therefore, A controls C indirectly through its ownership of B. C is described as being a sub-subsidiary of A.

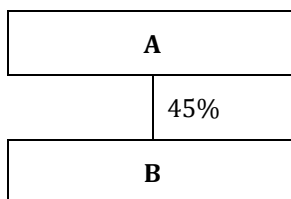
Consolidation of sub-subsidiaries is not part of this syllabus

In certain circumstances, a company might control another company even if it owns shares which give it less than half of the voting rights. Such a company is said to have *de facto* control over the other company. (*De facto* is a Latin phrase which translates as of fact. It is used to mean in reality or to refer to a position held in fact if not by legal right).

► *Example 05:*

A owns 45% of B's voting share capital.

The other shares are held by a large number of unrelated investors none of whom individually own more than 1% of B.



This 45% holding probably gives A complete control of B.

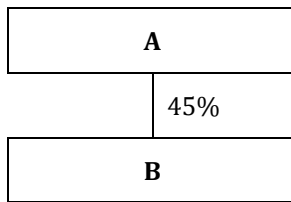
It would be unlikely that a sufficient number of the other shareholders would vote together to stop A directing the company B as it wishes.

A company might control another company even if it owns shares which give it less than half of the voting rights because it has an agreement with other shareholders which allow it to exercise control.

► *Example 06:*

A owns 45% of B's voting share capital.

A further 10% is held by A's bank who have agreed to use their vote as directed by A.



This 45% holding together with its power to use the votes attached to the bank's shares gives A complete control of B.

It is important to understand that control is different from ownership. A 60% ownership means 60% share in profit and net assets of investee but control either exists or does not exist, it is not expressed in percentage.

1.5 Acquisition method of consolidation [IFRS 3: 4, 5 & Appendix A]

IFRS 3 defines a “**business combination**” as a transaction or other event in which an acquirer obtains control of one or more businesses. It also requires that an entity shall account for each business combination by applying the acquisition method.

Applying the acquisition method requires:

- identifying the acquirer;
- determining the acquisition date (the date on which acquirer obtains the control);
- recognising and measuring the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree; and
- recognising and measuring goodwill or a gain from a bargain purchase.

1.6 Uniform accounting policies [IFRS 10: B87]

If a member of the group uses accounting policies other than those adopted in the consolidated financial statements for like transactions and events in similar circumstances, appropriate adjustments are made to that group member's financial statements in preparing the consolidated financial statements to ensure conformity with the group's accounting policies.

1.7 Common reporting date [IFRS 10: B92 & B93]

The financial statements of the parent and its subsidiaries used in the preparation of the consolidated financial statements shall have the same reporting date (period-end).

When period-end is different, the subsidiary prepares, for consolidation purposes, additional financial information as of the same date as the financial statements of the parent to enable the consolidation, unless it is impracticable to do so.

If it is impracticable to do so, subsidiary's most recent financial statements may be used with adjustments of significant transactions and events.

In any case, the difference between reporting dates shall be no more than three months, and the length of the reporting periods and any difference between the dates of the financial statements shall be the same from period to period.

2. CONSOLIDATION PROCEDURES

2.1 Accounting requirement [IFRS 10: 19, 20 & B86]

A parent shall prepare consolidated financial statements using uniform accounting policies for like transactions and other events in similar circumstances.

Consolidation of an investee shall begin from the date the investor obtains control of the investee and cease when the investor loses control of the investee.

Consolidated financial statements:

- combine like items of assets, liabilities, income, expenses and cash flows of the parent with those of its subsidiaries.
- offset (eliminate) the carrying amount of the parent's investment in each subsidiary and the parent's portion of equity of each subsidiary (the difference is goodwill or gain on bargain purchase).
- eliminate in full intragroup assets and liabilities, equity, income, expenses and cash flows relating to transactions between entities of the group (profits or losses resulting from intragroup transactions that are recognised in assets, such as inventory and fixed assets, are eliminated in full).

It is important to note the following features:

- Subsidiary's full amounts are included even if it is partially owned subsidiary. The amounts related to non-controlling interest (NCI) are then presented separately.
- The share capital (and share premium) in the consolidated statement of financial position is always just the share capital (and share premium) of the parent. That of the subsidiary disappears in the consolidation process (offset against investment to calculate goodwill and attributed to NCI).
- In statement of comprehensive income, income/expense for the current period only is to be included as opposed to SFP where adjustments may relate to longer periods.
- In case of mid-year acquisition, subsidiary's income and expenses of post-acquisition period are included only. It is often assumed that income and expenses were incurred evenly unless there is information to contrary.

► **Example 07:**

Consolidating figures	Parent		Subsidiary		Consolidated
	Rs. 000		Rs. 000		Rs. 000
Property, plant & equipment	1,000	+	500	=	1,500
Inventory	500	+	800	=	1,300
Sales	2,000	+	1,000	=	3,000

2.2 Pre-acquisition and post-acquisition reserves

It is important to distinguish the profits and gains that existed at the date of acquisition and those that have been earned after acquiring the control of the subsidiary.

Pre-acquisition reserves	The subsidiary's reserves at the date of acquisition including the effects of any acquisition date adjustments (e.g. fair value adjustment). This amount is used for calculating goodwill.
Post-acquisition reserves	Any change in subsidiary's reserves after the date of acquisition has been earned by the group and therefore This amount is allocated to: - Non-controlling interest - Group Reserves (Retained Earnings) on the basis of respective ownership%.
Total reserves = Pre acquisition reserves + Post acquisition reserves	

2.3 Major workings

There are three major calculations to perform in preparing a consolidated statement of financial position:

- Calculation of goodwill
- Calculation of consolidated retained earnings
- Calculation of non-controlling interest

In order to calculate the above figures (all of which will be explained in the following pages) information about the net assets of the subsidiary at the date of acquisition and at the end of reporting period is needed.

Since,

Net assets = Equity = Share capital + Reserves

Net assets at acquisition = Equity at acquisition = Share capital + Pre-acquisition reserves

Net assets at SFP date = Equity at SFP date = Share capital + Total reserves at SFP date

2.4 Non-controlling interest [IFRS 10: 22, B94 and Appendix A]

“**Non-controlling interest (NCI)**” is defined as equity in a subsidiary not attributable, directly or indirectly, to a parent.

Presentation in Statement of financial position (SFP)	A parent shall present non-controlling interests in the consolidated statement of financial position within equity, separately from the equity of the owners of the parent.
Presentation in Statement of Comprehensive Income (SCI)	An entity shall attribute the profit or loss and each component of other comprehensive income to the owners of the parent and to the non-controlling interests. The entity shall also attribute total comprehensive income to the owners of the parent and to the non-controlling interests even if this results in the non-controlling interests having a deficit balance. NCI share in profit = Subsidiary's profit after tax (after adjustments) x NCI% NCI share in OCI = Subsidiary's OCI (after adjustments) x NCI%

► Example 08:

Plan Limited (PL) bought 80% of Scan Limited (SL) several years ago. The statements of comprehensive income for the year to 31 December 20X1 are as follows:

	PL	SL
	Rs.	Rs.
Revenue	500,000	250,000
Cost of sales	(200,000)	(80,000)
Gross profit	300,000	170,000
Other income	25,000	6,000
Distribution costs	(70,000)	(60,000)
Administrative expenses	(90,000)	(50,000)
Other expenses	(30,000)	(18,000)
Finance costs	(15,000)	(8,000)
Profit before tax	120,000	40,000
Income tax expense	(45,000)	(16,000)
Profit after tax	75,000	24,000

Required: Prepare consolidated statement of comprehensive income for the year ended 31 December 20X1.

► **ANSWER:**

Consolidated statement of comprehensive income

For the year ended 31 December 20X1

		Rs.
Revenue	500,000 + 250,000	750,000
Cost of sales	200,000 + 80,000	(280,000)
Gross profit		470,000
Other income	25,000 + 6,000	31,000
Distribution costs	70,000 + 60,000	(130,000)
Administrative expenses	90,000 + 50,000	(140,000)
Other expenses	30,000 + 18,000	(48,000)
Finance cost	15,000 + 8,000	(23,000)
Profit before tax		160,000
Taxation	45,000 + 16,000	(61,000)
Profit after tax		99,000
Profit attributable to:		
Parent	(balancing)	94,200
Non-controlling interest	(24,000 x 20%)	4,800
		99,000

2.5 Goodwill and NCI at acquisition [IFRS 3: 19, 32 & Appendix A]

Measurement at acquisition [IFRS 3: 19, 32]

There are two ways of measuring the NCI at the date of acquisition and both ways might result in a different figure for NCI and resultantly goodwill.

NCI at acquisition is measured at either:

- fair value (sometimes called “full goodwill” method); or
- proportionate share in the recognised amounts of the acquiree’s identifiable net assets (sometimes called “partial goodwill” method).

The fair value of NCI may be given in question or calculated as follows:

Fair value of NCI = Subsidiary’s shares x NCI% x Market value per share at the date of acquisition

► **Example 09:**

Pasha Limited (PL) acquired 80% shares of Sajid Limited (SL) on 1 January 2022 for Rs. 980 million. SL has 50 million shares in issue and the market value of one share in SL was Rs. 24 and Rs. 26 on 1 January 2022 and 31 December 2022 respectively.

Required: Calculate fair value of NCI in SL at the date of acquisition.

► **ANSWER:**

50 million shares x 20% x Rs. 24 = Rs. 240 million

IFRS 3 defines the “**goodwill**” as an asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognised.

The goodwill is measured as the excess of:

- (a) the aggregate of (i) the consideration transferred (generally measured at fair value) and (ii) the amount of any NCI in the acquiree; over
- (b) the net assets acquired (at fair value) at the date of acquisition.

► **Example 10:**

Port Limited (PL) acquired 80% shares of Sort Limited (SL) on 1 January 2022 for Rs. 980 million. SL has 50 million shares in issue and the market value of one share in SL was Rs. 24 and Rs. 26 on 1 January 2022 and 31 December 2022 respectively.

The fair value of net assets acquired in SL on 1 January 2022 has been measured at Rs. 1,100 million.

Required: Calculate goodwill at the date of acquisition. NCI is measured at fair value.

► **ANSWER:**

Goodwill (at acquisition)		Rs. m
Investment		980
NCI (at fair value)	50m shares x 20% x Rs. 24	240
		1,220
Net assets acquired		(1,100)
		120

► **Example 11:**

Chart Limited (CL) acquired 80% shares of Smart Limited (SL) on 1 January 2022 for Rs. 980 million. SL has 50 million shares in issue.

The fair value of net assets acquired in SL on 1 January 2022 has been measured at Rs. 1,100 million.

Required: Calculate goodwill at the date of acquisition. NCI is measured at proportionate share of subsidiary's identifiable net assets.

► **ANSWER:**

Goodwill (at acquisition)		Rs. m
Investment		980
NCI (proportionate share)	Rs. 1,100 x 20%	220
		1,200
Net assets acquired		(1,100)
		100

Goodwill is not amortised but annually tested for impairment.

► **Example 12:**

Park Limited (PL) acquired 80% of Scan Limited (SL) on 1 January 20X1 for Rs. 230,000. The retained earnings of SL were 100,000 at that date. It is PL's policy to recognise non-controlling interest at the date of acquisition as a proportionate share of net assets.

The statements of financial position PL and SL as at 31 December 20X1 were as follows:

	PL	SL
	Rs.	Rs.
Assets:		
Investment in SL, at cost	230,000	-
Other assets	570,000	240,000
	800,000	240,000
Equity		
Share capital	200,000	50,000
Share premium	100,000	20,000
Retained earnings	440,000	125,000
	740,000	195,000
Current liabilities	60,000	45,000
	800,000	240,000

Required: Consolidated statement of financial position as at 31 December 20X1 for Park Limited.

► **ANSWER:**

Consolidated statement of financial position

As at 31 December 20X1

Assets		Rs.
Goodwill	W3	94,000
Other assets	570,000 + 240,000	810,000
		904,000
Equity		
Share capital		200,000
Share premium		100,000
Retained earnings	W5	460,000
Non-controlling interest	W4	39,000
Current liabilities	60,000 + 45,000	105,000
		904,000

W1: Group Structure

Scan Limited (Subsidiary)	Acquired on 1 January 20X1
Parent's ownership 80%	NCI ownership 20%

W2: Net assets of subsidiary

	At Acquisition	Post-acquisition	At reporting date
	Rs.	Rs.	Rs.
Share capital	50,000	-	50,000
Share premium	20,000	-	20,000
Retained earnings	100,000	25,000	125,000
	170,000	25,000	195,000

W3: Goodwill

	Rs.
Investment	230,000
NCI at acquisition 170,000 W2 x 20%	34,000
	264,000
Less: Net assets at acquisition W2	(170,000)
Goodwill at acquisition	94,000

W4: Non-controlling interest

	Rs.
NCI at acquisition 170,000 W2 x 20%	34,000
Share of post-acquisition reserves 25,000 W2 x 20%	5,000
	39,000

W5: Group reserves (retained earnings)

	Rs.
Parent's retained earnings	440,000
Share of post-acquisition reserves 25,000 W2 x 80%	20,000
	460,000

► **Example 13:**

Plus Limited (PL) acquired 80% of Shoe Limited (SL) several years ago for Rs. 30 million. The balance on SL's retained earnings was Rs. 5,000,000 at the date of acquisition. PL's policy is to measure non-controlling interest at the date of acquisition as a proportionate share of net assets.

The draft statements of financial position of the two companies at 31 December 20X1 are:

	PL (Rs. 000)	SL (Rs. 000)
Non-current assets:		
Property, plant and equipment	45,000	15,000
Investment in SL	30,000	-
Current assets	28,000	12,000
Total assets	103,000	27,000

	PL (Rs. 000)	SL (Rs. 000)
Equity		
Share capital	5,000	1,000
Retained earnings	76,000	10,000
	81,000	11,000
Non-current liabilities	2,000	6,000
Current liabilities	20,000	10,000
Total equity and liabilities	103,000	27,000

Required: Prepare a consolidated statement of financial position as at 31 December 20X1 for PL.

► **ANSWER:**

Consolidated statement of financial position

As at 31 December 20X1

Non-current assets		Rs. 000
Property, plant and equipment	45,000 + 15,000	60,000
Goodwill	W3	25,200
Current assets	28,000 + 12,000	40,000
		125,200
Equity		
Share capital		5,000
Retained earnings	W5	80,000
Non-controlling interest	W4	2,200
Non-current liabilities	2,000 + 6,000	8,000
Current liabilities	20,000 + 10,000	30,000
		125,200

W1: Group Structure

Shoe Limited (Subsidiary)	Acquired several years ago
Parent's ownership 80%	NCI ownership 20%

W2: Net assets of subsidiary

		At Acquisition	Post- acquisition	At reporting date
		Rs.000	Rs. 000	Rs. 000
Share capital		1,000		1,000
Retained earnings		5,000	5,000	10,000
		6,000	5,000	11,000

W3: Goodwill

	Rs. 000
Investment	30,000
NCI at acquisition 6,000 W2 x 20%	1,200
	31,200
Less: Net assets at acquisition W2	(6,000)
Goodwill at acquisition	25,200

W4: Non-controlling interest

	Rs. 000
NCI at acquisition 6,000 W2 x 20%	1,200
Share of post-acquisition reserves 5,000 W2 x 20%	1,000
	2,200

W5: Group reserves (retained earnings)

	Rs. 000
Parent's retained earnings	76,000
Share of post-acquisition reserves 5,000 W2 x 80%	4,000
	80,000

2.6 Classification Principle [IFRS 3: 15]

At the acquisition date, the acquirer shall classify or designate the identifiable assets acquired and liabilities assumed as necessary to apply other IFRSs subsequently.

► **Example 14:**

Saima Limited owns a property that has been rented to its subsidiary Maria Limited which uses it as its administrative office.

Required: Briefly discuss how the above property should be classified by Saima Limited in its separate financial statements and in its consolidated financial statements.

► **ANSWER:**

In separate financial statements, the property will be classified as investment property in accordance with IAS 40 as it has been rented to another entity. However, in consolidated financial statements, the property will be classified as property, plant and equipment in accordance with IAS 16 since group is to be considered as single economic unit and the property in that context is owner occupied property.

The recognition principle and measurement principle will be covered later with fair value adjustments.

3. GOODWILL ADJUSTMENTS

3.1 Impairment of goodwill (partial)

In case of partial goodwill (i.e. when NCI is measured at proportionate share in the recognised amounts of the acquiree's identifiable net assets), only goodwill relating to parent's investment is recognised, so the whole impairment loss is charged to group reserves only, and does not impact NCI.

Impact on SFP	Decrease in the amount of goodwill. No impact on NCI Decrease in group reserve.
Impact on SCI	Increase in operating/admin expenses if impairment relates to current year. No impact on NCI share.

► **Example 15:**

Path Limited (PL) acquired 80% of Slot Limited (SL) when the retained earnings of SL were Rs.20,000. The values for assets and liabilities in the statement of financial position for SL represent fair values. A review of goodwill at 31 December 20X1 found that goodwill had been impaired, and was now valued at Rs. 55,000.

The statements of financial position of a PL and SL at 31 December 20X1 are as follows:

	PL	SL
	(Rs.)	(Rs.)
Non-current assets:		
Property, plant and equipment	408,000	100,000
Investment in SL	142,000	-
Current assets	120,000	40,000
	670,000	140,000
Equity		
Share capital	100,000	20,000
Share premium	100,000	50,000
Retained earnings	400,000	60,000
	600,000	130,000
Bank loan	70,000	10,000
	670,000	140,000

Required: Prepare the consolidated statement of financial position as at 31 December 20X1.

► **ANSWER:**

Consolidated statement of financial position

As at 31 December 20X1

Non-current assets		Rs.
Property, plant & equipment	408,000 + 100,000	508,000
Goodwill	W3	55,000
		563,000
Current assets	120,000 + 40,000	160,000
		723,000

		Rs.
Equity		
Share capital		100,000
Share premium		100,000
Retained earnings	W5	417,000
		617,000
Non-controlling interest	W4	26,000
		643,000
Bank loan	70,000 + 10,000	80,000
		723,000

W1: Group Structure

Slot Limited (Subsidiary)	Acquired on (not mentioned in Q)
Parent's ownership 80%	NCI ownership 20%

W2: Net assets of subsidiary

	At Acquisition	Post-acquisition	At reporting date
	Rs.	Rs.	Rs.
Share capital	20,000		20,000
Share premium	50,000		50,000
Retained earnings	20,000	40,000	60,000
	90,000	40,000	130,000

W3: Goodwill

		Rs.
Investment		142,000
NCI at acquisition	90,000 x 20%	18,000
		160,000
Less: Net assets at acquisition	W2	(90,000)
Goodwill at acquisition		70,000
Less: Impairment	70,000 – 55,000	(15,000)
		55,000

W4: Non-controlling interest

		Rs.
NCI at acquisition	90,000 x 20%	18,000
Share of post-acquisition reserves	40,000 x 20%	8,000
		26,000

W5: Group reserves (retained earnings)

	Rs.
Parent's retained earnings	400,000
Share of post-acquisition reserves 40,000 x 80%	32,000
Less: Impairment of goodwill	(15,000)
	417,000

► **Example 16:**

Pool Limited (PL) acquired 80% of Sole Limited (SL) 3 years ago. Goodwill on acquisition was Rs.200,000. The annual impairment test on goodwill has shown it to have a recoverable amount of only Rs. 175,000. Thus a write down of Rs. 25,000 is required.

Extracts of the statements of comprehensive income for the year to 31 December 20X1 are as follows:

	PL	SL
	Rs.	Rs.
Revenue	800,000	420,000
Cost of sales	(300,000)	(220,000)
Gross profit	500,000	200,000
Operating expenses	(173,000)	(163,000)
Profit	327,000	37,000

Required: Prepare consolidated statement of comprehensive income for the year ended 31 December 20X1.

► **ANSWER:**

Consolidated statement of comprehensive income

For the year ended 31 December 20X1

	Rs.
Revenue 800,000 + 420,000	1,220,000
Cost of sales 300,000 + 220,000	(520,000)
Gross profit	700,000
Operating expenses 173,000 + 163,000 + 25,000 impairment	(361,000)
Profit	339,000
Profit attributable to:	
Parent (balancing)	331,600
Non-controlling interest (37,000 x 20%)	7,400
	339,000

► *Example 17:*

Badar Limited (BL) acquired 70% ordinary shares of Kashif Limited (KL) on 1 July 2021. The statements of financial position of both companies as at 30 June 2022 are as under:

	BL	KL
	Rs. m	Rs. m
Non-current assets		
Property, plant and equipment	500	600
Investment in KL	530	
Current assets	280	410
	1,310	1,010
Equity		
Ordinary Share capital (Rs. 10 each)	800	500
Retained earnings	260	280
	1,060	780
Liabilities	250	230
	1,310	1,010

The statements of comprehensive income of both companies for the year ended 30 June 2022 are as under:

	BL	KL
	Rs. m	Rs. m
Revenue	1,478	1,230
Cost of sales	(990)	(970)
Gross profit	488	260
Distribution costs	(80)	(40)
Administrative expenses	(120)	(65)
Finance costs	(10)	-
Profit before tax	278	155
Taxation	(98)	(45)
Profit after tax	180	110

Additional information: BL measures non-controlling interest at proportion of net assets of subsidiary at the date of acquisition. On 30th June 2022, goodwill was impaired by 10% of its recognised value.

Required: Prepare for BL, consolidated statement of financial position as at June 30, 2022 and consolidated statement of comprehensive income for the year then ended.

► **ANSWER:**

Consolidated statement of financial position

As at 30 June 2022

Non-current assets		Rs. million
Property, plant & equipment	500 + 600	1,100
Goodwill	W3	54.9
Current assets	280 + 410	690
		1,844.9
Equity		
Share capital		800
Retained earnings	W5	330.9
Non-controlling interest	W4	234
Liabilities	250 + 230	480
		1,844.9

W1: Group Structure

Kashif Limited (Subsidiary)	Acquired on 1 July 2021
Parent's ownership 70%	NCI ownership 30%

W2: Net assets of subsidiary

	At Acquisition	Post-acquisition	At reporting date
	Rs. m	Rs. m	Rs. m
Share capital	500		500
Retained earnings	170	110	280
	670	110	780

W3: Goodwill

		Rs. m
Investment		530
NCI at acquisition	670 W2 x 30%	201
		731
Less: Net assets at acquisition	W2	(670)
Goodwill at acquisition		61
Less: Impairment 10%		(6.1)
		54.9

W4: Non-controlling interest

		Rs. m
NCI at acquisition	670 W2 x 30%	201
Share of post-acquisition reserves	110 x 30%	33
		234

W5: Group reserves (retained earnings)

		Rs. m
Parent's retained earnings		260
Share of post-acquisition reserves	110 x 70%	77
Less: Impairment of goodwill		(6.1)
		330.9

Consolidated statement of comprehensive income

For the year ended 30 June 2022

		Rs. million
Revenue	1,478 + 1,230	2,708
Cost of sales	990 + 970	(1,960)
Gross profit		748
Distribution costs	80 + 40	(120)
Administrative expenses	120 + 65 + 6.1 impairment	(191.1)
Finance cost	10 + 0	(10)
Profit before tax		426.9
Taxation	98 + 45	(143)
Profit after tax		283.9
Profit attributable to:		
Parent	(balancing)	250.9
Non-controlling interest	110 x 30%	33
		283.9

3.2 Impairment of goodwill (full)

In case of full goodwill (i.e. when NCI is measured at fair value), the goodwill relates to parent and NCI both, and therefore, the impairment loss is allocated to group reserves & NCI, both.

Impact on SFP	Decrease in the amount of goodwill Decrease in NCI (NCI%). Decrease in group reserve (Parent%)
Impact on SCI	Increase in operating/admin expenses if impairment relates to current year Include the impact in calculation of NCI share

► *Example 18:*

Multan Limited (ML) acquired 70% ordinary shares of Nawab Limited (NL) on 1 July 2021.

The statements of financial position of both companies as at 30 June 2022 are as under:

	ML	NL
	Rs. m	Rs. m
Non-current assets		
Property, plant and equipment	500	600
Investment in NL	530	
Current assets	280	410
	1,310	1,010
Equity		
Ordinary Share capital (Rs. 10 each)	800	500
Retained earnings	260	280
	1,060	780
Liabilities	250	230
	1,310	1,010

The statements of comprehensive income of both companies for the year ended 30 June 2022 are as under:

	ML	NL
	Rs. m	Rs. m
Revenue	1,478	1,230
Cost of sales	(990)	(970)
Gross profit	488	260
Distribution costs	(80)	(40)
Administrative expenses	(120)	(65)
Finance costs	(10)	-
Profit before tax	278	155
Taxation	(98)	(45)
Profit after tax	180	110

Additional information: ML measures non-controlling interest at its fair value at the date of acquisition. Market value of one share of NL on 1st July 2021 was Rs. 15. On 30th June 2022, goodwill was impaired by 10% of its recognised value.

Required: Prepare for ML, consolidated statement of financial position as at June 30, 2022 and consolidated statement of comprehensive income for the year then ended.

► **ANSWER:**

Consolidated statement of financial position

As at 30 June 2022

Non-current assets		Rs. million
Property, plant & equipment	500 + 600	1,100
Goodwill	W3	76.5
Current assets		280 + 410
		1,866.5
Equity		
Share capital		800
Retained earnings	W5	331.05
Non-controlling interest	W4	255.45
Liabilities		250 + 230
		1,866.5

W1: Group Structure

Nawab Limited (Subsidiary)	Acquired on 1 July 2021
Parent's ownership 70%	NCI ownership 30%

W2: Net assets of subsidiary

	At Acquisition	Post-acquisition	At reporting date
	Rs. m	Rs. m	Rs. m
Share capital	500		500
Retained earnings	170	110	280
	670	110	780

W3: Goodwill

		Rs. m
Investment		530
NCI at acquisition	50m shares x 30% x Rs. 15	225
		755
Less: Net assets at acquisition	W2	(670)
Goodwill at acquisition		85
Less: Impairment		(8.5)
		76.5

W4: Non-controlling interest

		Rs. m
NCI at acquisition	50m shares x 30% x Rs. 15	225
Share of post-acquisition reserves	110 x 30%	33
Share of impairment loss	8.5 x 30%	(2.55)
		255.45

W5: Group reserves (retained earnings)

		Rs. m
Parent's retained earnings		260
Share of post-acquisition reserves	110 x 70%	77
Less: Impairment of goodwill	8.5 x 70%	(5.95)
		331.05

Consolidated statement of comprehensive income

For the year ended 30 June 2022

		Rs. million
Revenue	1,478 + 1,230	2,708
Cost of sales	990 + 970	(1,960)
Gross profit		748
Distribution costs	80 + 40	(120)
Administrative expenses	120 + 65 + 8.5 impairment	(193.5)
Finance cost	10 + 0	(10)
Profit before tax		424.5
Taxation	98 + 45	(143)
Profit after tax		281.5
Profit attributable to:		
Parent	(balancing)	251.05
Non-controlling interest	N1	30.45
		281.5

N1: NCI share in profit	Rs. million
Subsidiary profit as given	110
Impairment loss (full goodwill)	(8.5)
	101.5
NCI share	30%
	30.45

3.3 Bargain purchase (negative goodwill)

The cost of investment may be less than the value of net assets purchased, so bargain purchase situation arises. A bargain purchase is a business combination in which the calculation of goodwill leads to a negative figure.

When this happens the acquirer must then review the procedures used to measure the amounts recognised at the acquisition date for all of the following:

- the identifiable assets acquired and liabilities assumed;
- the non-controlling interest in the acquiree (if any); and
- the consideration transferred.

Any amount remaining after applying the above requirements is recognised as a gain in profit or loss on the acquisition date.

► **Example 19:**

Company A acquired 100% of Company B's share at a consideration of Rs. 100 million. The net assets at the date of acquisition were Rs. 112 million.

Company A acquired control of net assets of Rs. 112 while consideration paid is only Rs. 100 million, there turnout to be a negative goodwill, i.e. acquirer was able to negotiate a better price and was able to pay even less than the net assets acquired, thereby, a gain of Rs. 12 million arise which is known as negative goodwill or bargain purchase gain and the same is recorded in consolidated financial statements as a gain (Other Income).

Impact on SFP	Set goodwill to zero Increase group reserves (due to gain)
Impact on SCI	Increase other income (or present in separate line item) if relates to current year No impact on NCI share

► **Example 20:**

Maha Limited (ML) acquired 70% ordinary shares of Anum Limited (AL) on 1 July 2021.

The statements of financial position of both companies as at 30 June 2022 are as under:

	ML	AL
	Rs. m	Rs. m
Non-current assets		
Property, plant and equipment	500	600
Investment in AL	430	
Current assets	280	410
	1,210	1,010
Equity		
Ordinary Share capital (Rs. 10 each)	800	500
Retained earnings	260	280
	1,060	780
Liabilities	150	230
	1,210	1,010

The statements of comprehensive income of both companies for the year ended 30 June 2022 are as under:

	ML	AL
	Rs. m	Rs. m
Revenue	1,478	1,230
Cost of sales	(990)	(970)
Gross profit	488	260
Distribution costs	(80)	(40)
Administrative expenses	(120)	(65)
Finance costs	(10)	-
Profit before tax	278	155
Taxation	(98)	(45)
Profit after tax	180	110

Additional information: ML measures non-controlling interest at proportion of net assets of subsidiary at the date of acquisition.

Required: Prepare for ML, consolidated statement of financial position as at June 30, 2022 and consolidated statement of comprehensive income for the year then ended.

► **ANSWER:**

Consolidated statement of financial position

As at 30 June 2022

Non-current assets		Rs. million
Property, plant & equipment	500 + 600	1,100
Goodwill	W3	0
Current assets	280 + 410	690
		1,790
Equity		
Share capital		800
Retained earnings	W5	376
Non-controlling interest	W4	234
Liabilities	150 + 230	380
		1,790

W1: Group Structure

Anum Limited (Subsidiary)	Acquired on 1 July 2021
Parent's ownership 70%	NCI ownership 30%

W2: Net assets of subsidiary

	At Acquisition	Post-acquisition	At reporting date
	Rs. m	Rs. m	Rs. m
Share capital	500		500
Retained earnings	170	110	280
	670	110	780

W3: Goodwill

	Rs. m
Investment	430
NCI at acquisition $670 \text{ W2} \times 30\%$	201
	631
Less: Net assets at acquisition W2	(670)
Goodwill at acquisition	(39)
Transfer to PL (group reserves)	39
	0

W4: Non-controlling interest

	Rs. m
NCI at acquisition $670 \text{ W2} \times 30\%$	201
Share of post-acquisition reserves $110 \times 30\%$	33
	234

W5: Group reserves (retained earnings)

	Rs. m
Parent's retained earnings	260
Share of post-acquisition reserves $110 \times 70\%$	77
Bargain purchase (negative goodwill)	39
	376

Consolidated statement of comprehensive income

For the year ended 30 June 2022

	Rs. million
Revenue $1,478 + 1,230$	2,708
Cost of sales $990 + 970$	(1,960)
Gross profit	748
Distribution costs $80 + 40$	(120)
Administrative expenses $120 + 65$	(185)
Finance cost $10 + 0$	(10)
Bargain purchase W3	39
Profit before tax	472
Taxation $98 + 45$	(143)
Profit after tax	329
Profit attributable to:	
Parent (balancing)	296
Non-controlling interest $110 \times 30\%$	33
	329

3.4 Recording investment in subsidiary [IFRS 3: 37, 53, 39 & 58]

Consideration paid for a subsidiary must be measured at fair value. This consideration includes the cash paid and fair value of other consideration. Transaction costs of acquisition such as legal, accounting, valuation and other professional fees should be expensed as incurred.

Other considerations may include;

- Share exchange
- Deferred consideration
- Contingent consideration

Sometimes, a parent issues its own shares to (previous) shareholders of subsidiary in exchange of shares of subsidiary purchased from them. The shares issued should be recorded at market value (excess to par value in share premium account).

► **Example 21:**

Pair Limited (PL) acquired 80% of the shares of Soul Limited (SL) when the fair value of the net assets of SL was Rs. 800,000. The purchase price was Rs. 300,000 in cash plus 10,000 new shares in PL.

The new shares were to be issued 1 month after the date of acquisition. The market value of PL's shares at the date of acquisition was Rs. 40 each. One month later the market value had increased to Rs. 45.

The acquisition costs (legal and professional fee) were Rs. 80,000.

Required: Calculate cost of investment. Briefly discuss the reasons for inclusion or exclusion of relevant amounts.

► **ANSWER:**

Cost of investment	Rs.
Cash consideration	300,000
Share exchange [10,000 shares x Rs. 40]	400,000
Acquisition costs	-
	700,000

The share price at the date of acquisition is used not that at the date of issue as IFRS 3 specifically mentions that in case shares are issued as part of purchase consideration and such shares are valued at market value at the acquisition date.

The costs of making the acquisition should be written off to profit or loss.

Deferred consideration is amount payable in future and is recorded as liability at its fair value (i.e. its present value using entity's cost of capital). Interest is to be recognised by parent subsequently.

Any contingent consideration should always be included (usually as liability) as long as it can be measured reliably even if it is not probable of payment at the date of acquisition. This is indicated where relevant in an exam question. A post-acquisition change in contingent consideration is charged to profit or loss of parent.

► **Example 22:**

Company X purchased 100% of the issued capital of Company S on 1 January Year 4.

The purchase agreement required Company X to pay Rs. 300,000 in cash immediately and an additional sum of Rs. 100,000 on 31 December Year 6 if the earnings of Company S increase at an annual rate of 25% per year in each of the three years following the acquisition.

Required: How should the contingent payment be recognised in calculating the goodwill arising at the date of acquisition?

► **ANSWER:**

The contingent consideration should be included in the cost of investment (the purchase consideration) whether or not it is probable that it will have to be paid. The contingent consideration of Rs. 100,000 should be measured at fair value.

If it is fairly certain that the contingent consideration will have to be paid, an appropriate measure of fair value might be the present value of the future payment, discounted at an appropriate cost of capital. The purchase consideration is therefore Rs. 300,000 plus the present value of the contingent (deferred) consideration.

If parent entity has recorded the investment and related amounts correctly, no adjustment is needed. However, exam questions often state there has been some error and omission in recording the investment, that needs to be corrected.

Common issues and their treatment can be summarised as follows:

Transaction costs incorrectly capitalised	
Impact on SFP	Decrease the amount of investment in subsidiary (goodwill working) Decrease group reserves (charging as expense)
Impact on SCI	Increase administrative expenses if costs were incurred in the current year No impact on NCI share
Share exchange not yet recorded	
Impact on SFP	Increase investment in subsidiary (goodwill working) Increase parent's share capital and share premium
Impact on SCI	No impact
Deferred consideration and/or interest thereon not recorded yet	
Impact on SFP	Increase investment in subsidiary: measure at present value (goodwill working) Decrease group reserve (the interest expense) Increase liability (at acquisition + interest)
Impact on SCI	Increase finance cost to the extent it relates to current year No impact on NCI share
Contingent consideration and/or change therein not recorded yet	
Impact on SFP	Increase investment in subsidiary: measure at fair value (goodwill working) Increase or decrease group reserve (change in fair value) Increase liability (at acquisition ± change since then)
Impact on SCI	Increase or decrease finance cost to the extent it relates to current year No impact on NCI share

► **Example 23:**

Hamid Limited (HL) bought 60% ordinary shares of Rashid Limited (RL) on 1st January 2022.

Additional information:

- HL's total share capital (before this acquisition) is Rs. 300 million consisted of 30 million shares of Rs. 10 each.
- RL's total share capital is Rs. 100 million consisted of 10 million shares of Rs. 10 each.
- On 1st January 2022, market value of one share of HL and RL was Rs. 29 and Rs. 21 respectively.
- Appropriate discount rate is 10%.

Amounts paid or commitments made for the acquisition:

- One share in HL was given for every two shares in RL.
- Rs. 4 per share was paid immediately to previous owners of RL. Further Rs. 3 per share shall be paid three years later. Furthermore, Rs. 2 per share shall be paid two year later provided that profits of RL exceed a certain benchmark. The fair value of this conditional payment has been estimated at Rs. 5.48 million.
- Legal advisor was paid Rs. 0.5 million and a consultancy fee of Rs. 1.5 million was paid to financial consultant.

Required:

- Calculate Investment in RL at cost in the above business combination.
- Calculate fair value of NCI at the date of acquisition.

► **ANSWER:**

Part (a) Investment in RL		Rs. million
Share consideration	[10m shares x 60% x $\frac{1}{2}$ x Rs. 29]	87
Cash consideration	[10m shares x 60% x Rs. 4]	24
Deferred consideration	[10m shares x 60% x Rs. 3 x 1.10^{-3}]	13.52
Contingent consideration	[at fair value]	5.48
		130

Note 1: For share consideration Rs. 30 million (i.e. 6m shares x $\frac{1}{2}$ x Rs. 10) shall be added to share capital and Rs. 57 million (i.e. 6m shares x $\frac{1}{2}$ x Rs. 19) shall be added to share premium.

Note 2: Transaction costs (legal and consultancy fee) of Rs. 2 million shall be charged to PL.

Part (b) Fair value of NCI at the date of acquisition		Rs. million
	[10m shares x 40% x Rs. 21]	84

Some exam questions give aggregate “investment” figure which includes investment in subsidiary and other investments and need to be separated as only investment in equity of subsidiary is used for goodwill calculation.

► **Example 24:**

Maria Limited (ML) acquired 90% ordinary shares of Saima Limited (SL) on 1 July 2021.

The statements of financial position of both companies as at 30 June 2022 are as under:

	ML	SL
	Rs. m	Rs. m
Non-current assets		
Property, plant and equipment	500	600
Investments (see note (i))	430	
Current assets	280	410
	1,210	1,010
Equity		
Ordinary Share capital (Rs. 10 each)	800	500
Retained earnings	260	280
	1,060	780
Liabilities	150	230
	1,210	1,010

The statements of comprehensive income of both companies for the year ended 30 June 2022 are as under:

	ML	SL
	Rs. m	Rs. m
Revenue	1,478	1,230
Cost of sales	(990)	(970)
Gross profit	488	260
Distribution costs	(80)	(40)
Administrative expenses	(120)	(65)
Finance costs	(10)	-
Profit before tax	278	155
Taxation	(98)	(45)
Profit after tax	180	110

Notes:

- (i) The break-up of investment figure is as follows:

	Rs. million
Investment in SL (paid in cash)	135
Acquisition costs related to SL (paid in cash)	5*
Other investments measured at FVTPL	290
	430

*legal and consultancy fee

- (ii) The arrangement for acquisition of SL also included following which have not been accounted for yet:

Share exchange: One share in ML for every two shares acquired in SL. At the date of acquisition market value of one share of ML and SL was Rs. 28 and Rs. 21 respectively.

Future cash payment: Additional Rs. 4 per share shall be paid on 30 June 2024.

Conditional cash payment: Another additional Rs. 2 per share shall be paid on 30 June 2023 provided that SL continues to earn profit of Rs. 100 million or above till then. The fair value of this conditional payment was estimated to be Rs. 50 million on 1 July 2021. However, on 30th June 2022 the fair value has been estimated at Rs. 48 million only.

The appropriate discount rate is 9%.

- (iii) ML measures non-controlling interest at fair value on the date of acquisition.

Required: Prepare for ML, consolidated statement of financial position as at June 30, 2022 and consolidated statement of comprehensive income for the year then ended.

► **ANSWER:**

Maria Limited's Consolidated statement of financial position

As at 30 June 2022

Non-current assets		Rs. million
PPE	500 + 600	1,100
Investments	430 – 135 – 5	290
Goodwill	W3	389
Current assets	280 + 410	690
		2,469
Equity		
Share capital	800 + 225 W3.1	1,025
Share premium	0 + 405 W3.2	405
Retained earnings	W5	343.49
Non-controlling interest	W4	116
Liabilities	150 + 230 + [139 + 12.51] + [50 – 2]	579.51
		2,469

W1: Group Structure

Saima Limited (Subsidiary)	Acquired on 1 July 2021
Parent's ownership 90%	NCI ownership 10%

W2: Net assets of subsidiary

	At Acquisition	Post-acquisition	At reporting date
	Rs. m	Rs. m	Rs. m
Share capital	500		500
Retained earnings	170	110	280
	670	110	780

W3: Goodwill

		Rs. m
Investment	135 + 225 + 405 + 139 + 50	954
NCI at acquisition	50m shares x 10% x Rs. 21	105
		1,059
Less: Net assets at acquisition	W2	(670)
Goodwill at acquisition		389

3.1 50m shares x 90% x $\frac{1}{2}$ x Rs. 10 = Rs. 225 million

3.2 50m shares x 90% x $\frac{1}{2}$ x Rs. 18 = Rs. 405 million

3.3 50m shares x 90% x Rs. 4 x 1.09^{-3} = Rs. 139 million

W4: Non-controlling interest

		Rs. m
NCI at acquisition	50m shares x 10% x Rs. 21	105
Share of post-acquisition reserves	110 x 10%	11
		116

W5: Group reserves (retained earnings)

		Rs. m
Parent's retained earnings		260
Acquisition costs related to SL		(5)
Interest on deferred consideration	139 x 9%	(12.51)
Change in contingent consideration	50 - 48	2
Share of post-acquisition reserves	110 x 90%	99
		343.49

Maria Limited's Consolidated statement of comprehensive income

For the year ended 30 June 2022

		Rs. million
Revenue	1,478 + 1,230	2,708
Cost of sales	990 + 970	(1,960)
Gross profit		748
Distribution costs	80 + 40	(120)
Administrative expenses	120 + 65 + 5	(190)
Finance cost	10 + 0 + 12.51 - 2	(20.51)
Profit before tax		417.49
Taxation	98 + 45	(143)
Profit after tax		274.49
Profit attributable to:		
Parent	(balancing)	263.49
Non-controlling interest	110 x 10%	11
		274.49

4. FAIR VALUE ADJUSTMENTS

4.1 Recognition principle [IFRS 3: 10, 11, 13 & 23 and IAS 38: 34]

As of the acquisition date, the acquirer shall recognise, separately from goodwill, the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree.

The following guidance is relevant:

Contingent liabilities	Contrary to IAS 37, the acquirer shall recognise as of the acquisition date a contingent liability assumed in a business combination if it is a present obligation that arises from past events and its fair value can be measured reliably (even if outflow of economic benefits is not probable). It means although contingent liabilities will not be recorded in the individual financial statements of the subsidiary company, it will be accounted for when IFRS 3 is applied, i.e. during preparation of consolidated financial statements.
Intangible asset	Even an intangible asset that was not recognised in the financial statements of the subsidiary (acquiree) might be recognised (separately from goodwill) in the consolidated financial statements of parent (acquirer) entity. The acquirer recognises the acquired identifiable intangible assets, such as a brand name, a patent or a customer relationship, that the acquiree did not recognise as assets in its financial statements because it developed them internally and charged the related costs to expense.
Expected costs	The costs the acquirer expects but is not obliged to incur in the future to effect its plan to exit an activity of an acquiree or to terminate the employment of or relocate an acquiree's employees are not liabilities at the acquisition date. The implication of above for restructuring costs is that an acquirer should not recognise a liability for the cost of restructuring a subsidiary or for any other costs expected to be incurred as a result of the acquisition (including future losses). This is because a plan to restructure a subsidiary after an acquisition cannot be a liability at the acquisition date. For there to be a liability (and for a provision to be recognised) there must have been a past obligating event. This can only be the case if the subsidiary was already committed to the restructuring before the acquisition.

► Example 25:

If a company bought 100% of a beverage Corporation they would be buying a lot of assets but part (perhaps the largest part) of the purchase consideration would be to buy the beverage brand.

The company does not recognise its own brand in its own financial statements because companies are not allowed to recognise internally generated brands.

However, as far as the company buying the Corporation is concerned the brand is a purchased asset. It would be recognised in the consolidated financial statements and would be taken into account in the goodwill calculation.

4.2 Measurement principle and measurement period [IFRS 3: 18 & 45]

The acquirer shall measure the identifiable assets acquired and the liabilities assumed at their acquisition-date fair values. This directly affects goodwill calculation.

Initial accounting for goodwill may be determined on a provisional basis and must be finalised by the end of a measurement period. During the measurement period new information obtained about facts and circumstances that existed at the acquisition date might lead to the adjustment of provisional amounts or recognition of additional assets or liabilities with a corresponding change to goodwill. Any adjustment restates the figures as if the accounting for the business combination had been completed at the acquisition date.

Measurement period ends as soon as the acquirer receives the information it was seeking about facts and circumstances that existed at the acquisition date but must not exceed one year from the acquisition date.

4.3 Adjustments in consolidated financial statements

Adjustments will be required where the subsidiary's accounts themselves do not reflect fair value. Also, the assets and liabilities not included in the subsidiary's own SFP are to be included in consolidated financial statements if they meet recognition criteria.

The fair value adjustment also implies post-acquisition change in depreciation, amortisation and impairment etc.

Impact on SFP	Increase or decrease net assets of subsidiary - At acquisition (will impact goodwill) - Post-acquisition: effect of subsequent depreciation/impairment (will impact NCI and group reserves) - At SFP date: net amount Increase or decrease PPE or other asset/liability: net amount
Impact on SCI	Increase or decrease relevant expenses to the extent it relates to the current year Include the impact in calculation of NCI share

► **Example 26:**

Peak Limited (PL) bought 80% of Seek Limited (SL) 2 years ago. At the date of acquisition SL's retained earnings stood at Rs. 600,000.

The fair value of its net assets was not materially different from the book value except for the fact that it had a brand which was not recognised in SL's accounts. This had a fair value of Rs. 100,000 at this date and an estimated useful life of 20 years.

The statements of financial position PL and SL as at 31 December 20X1 were as follows:

	PL	SL
	Rs.	Rs.
Property, Plant and Equipment	1,800,000	1,000,000
Investment in SL	1,000,000	-
Current assets	400,000	300,000
	3,200,000	1,300,000
Share capital	100,000	100,000
Retained earnings	2,900,000	1,000,000
Current liabilities	200,000	200,000
	3,200,000	1,300,000

Required: Prepare a consolidated statement of financial position as at 31 December 20X1.

► **ANSWER:**

Consolidated statement of financial position

As at 31 December 20X1

Non-current assets		Rs.
Property, plant & equipment	1,800,000 + 1,000,000	2,800,000
Goodwill	W3	360,000
Intangible assets: Brand	W2	90,000
		3,250,000
Current assets	400,000 + 300,000	700,000
		3,950,000

Equity		Rs.
Share capital		100,000
Retained earnings	W5	3,212,000
Non-controlling interest	W4	238,000
Current liabilities	200,000 + 200,000	400,000
		3,950,000

W1: Group Structure

Seek Limited (Subsidiary)	Acquired two years ago
Parent's ownership 80%	NCI ownership 20%

W2: Net assets of subsidiary

		At Acquisition	Post-acquisition	At reporting date
		Rs.	Rs.	Rs.
Share capital		100,000		100,000
Retained earnings		600,000	400,000	1,000,000
FV adj (brand)	100,000 / 20 x 2 years	100,000	(10,000)	90,000
		800,000	390,000	1,190,000

W3: Goodwill

		Rs.
Investment		1,000,000
NCI at acquisition	800,000 x 20%	160,000
		1,160,000
Less: Net assets at acquisition	W2	(800,000)
Goodwill at acquisition		360,000

W4: Non-controlling interest

		Rs.
NCI at acquisition	800,000 x 20%	160,000
Share of post-acquisition reserves	390,000 x 20%	78,000
		238,000

W5: Group reserves (retained earnings)

		Rs.
Parent's retained earnings		2,900,000
Share of post-acquisition reserves	390,000 x 80%	312,000
		3,212,000

► **Example 27:**

Pack Limited (PL) bought 80% of Sack Limited (SL) 2 years ago. At the date of acquisition SL's retained earnings stood at Rs. 600,000.

The fair value of SL's net assets were Rs. 1,000,000. This was Rs. 300,000 above the book value of the net assets at this date. The revaluation was due to an asset that had a remaining useful economic life of 10 years as at the date of acquisition.

The statements of financial position PL and SL as at 31 December 20X1 were as follows:

	PL	SL
	Rs.	Rs.
Property, Plant and Equipment	1,800,000	1,000,000
Investment in SL	1,000,000	-
Current assets	400,000	300,000
	3,200,000	1,300,000
Share capital	100,000	100,000
Retained earnings	2,900,000	1,000,000
Current liabilities	200,000	200,000
	3,200,000	1,300,000

Required: Prepare a consolidated statement of financial position as at 31 December 20X1.

► **ANSWER:**

Consolidated statement of financial position

As at 31 December 20X1

Non-current assets		Rs.
Property, plant & equipment	1,800,000 + 1,000,000 + 240,000	3,040,000
Goodwill	W3	200,000
		3,240,000
Current assets	400,000 + 300,000	700,000
		3,940,000
Equity		
Share capital		100,000
Retained earnings	W5	3,172,000
Non-controlling interest	W4	268,000
Current liabilities	200,000 + 200,000	400,000
		3,940,000

W1: Group Structure

Sack Limited (Subsidiary)	Acquired two years ago
Parent's ownership 80%	NCI ownership 20%

W2: Net assets of subsidiary

	At Acquisition	Post-acquisition	At reporting date
	Rs.	Rs.	Rs.
Share capital	100,000		100,000
Retained earnings	600,000	400,000	1,000,000
FV adj (PPE) 300,000 / 10 x 2 years	300,000	(60,000)	240,000
	1,000,000	340,000	1,340,000

W3: Goodwill

	Rs.
Investment	1,000,000
NCI at acquisition 1,000,000 x 20%	200,000
	1,200,000
Less: Net assets at acquisition W2	(1,000,000)
Goodwill at acquisition	200,000

W4: Non-controlling interest

	Rs.
NCI at acquisition 1,000,000 x 20%	200,000
Share of post-acquisition reserves 340,000 x 20%	68,000
	268,000

W5: Group reserves (retained earnings)

	Rs.
Parent's retained earnings	2,900,000
Share of post-acquisition reserves 340,000 x 80%	272,000
	3,172,000

► **Example 28:**

On 1 January 2012, Hello acquired 60% of the ordinary share capital of Solong for Rs.110,000. At that date Solong had a retained earnings balance of Rs.60,000. The following statements of financial position have been prepared as at 31 December 2015.

	Hello	Solong
Assets	Rs.	Rs.
Property, plant and equipment	225,000	175,000
Investments in Solong	110,000	
Current assets	271,000	157,000
	606,000	332,000

	Hello	Solong
Equity and liabilities		
Share capital	100,000	100,000
Retained earnings	275,000	90,000
	375,000	190,000
Current liabilities	231,000	142,000
	606,000	332,000

The fair value of Solong's net assets at the date of acquisition was determined to be Rs.170,000.

The difference between the book value and the fair value of the net assets at the date of acquisition was due to an item of plant which had a useful life of 10 years from the date of acquisition.

Required: Prepare the consolidated statement of financial position of Hello and its subsidiary as at 31 December 2015.

► **ANSWER:**

Consolidated statement of financial position

As at 31 December 2015

Non-current assets		Rs.
Property, plant & equipment	225,000 + 175,000 + 6,000	406,000
Goodwill	W3	8,000
		414,000
Current assets	271,000 + 157,000	428,000
		842,000
Equity		
Share capital		100,000
Retained earnings	W5	290,600
Non-controlling interest	W4	78,400
Current liabilities	231,000 + 142,000	373,000
		842,000

W1: Group Structure

Solong (Subsidiary)	Acquired on 1 January 2012
Parent's ownership 60%	NCI ownership 40%

W2: Net assets of subsidiary

		At Acquisition	Post-acquisition	At reporting date
		Rs.	Rs.	Rs.
Share capital		100,000		100,000
Retained earnings		60,000	30,000	90,000
FV adj (plant)	10,000 / 10 x 4 years	10,000*	(4,000)	6,000
		170,000	26,000	196,000

*balancing figure (difference of fair value Rs. 170,000 and book value of Rs. 160,000 i.e. Share capital of Rs. 100,000 and retained earnings of Rs. 60,000).

W3: Goodwill

	Rs.
Investment	110,000
NCI at acquisition $170,000 \times 40\%$	68,000
	178,000
Less: Net assets at acquisition W2	(170,000)
Goodwill at acquisition	8,000

W4: Non-controlling interest

	Rs.
NCI at acquisition $170,000 \times 40\%$	68,000
Share of post-acquisition reserves $26,000 \times 40\%$	10,400
	78,400

W5: Group reserves (retained earnings)

	Rs.
Parent's retained earnings	275,000
Share of post-acquisition reserves $26,000 \times 60\%$	15,600
	290,600

► **Example 29:**

Pipe Limited (PL) acquired 80% of Ship Limited (SL) 3 years ago. At the date of acquisition SL had an office equipment with a fair value of Rs. 120,000 in excess of its book value. This asset had a useful life of 10 years at the date of acquisition.

Extracts of the statements of comprehensive income for the year to 31 December 20X1 are as follows:

	PL	SL
	Rs.	Rs.
Revenue	800,000	420,000
Cost of sales	(300,000)	(220,000)
Gross profit	500,000	200,000
Operating expenses	(173,000)	(163,000)
Profit	327,000	37,000

Required: Prepare consolidated statement of comprehensive income for the year ended 31 December 20X1.

► **ANSWER:**

This means that the group has to recognise extra depreciation of Rs. 36,000 (i.e. Rs. 120,000 / 10 years x 3 years) by the end of this period. One year's worth of this (Rs. 12,000) is recognised in current year.

Consolidated statement of comprehensive income

For the year ended 31 December 20X1

		Rs.
Revenue	800,000 + 420,000	1,220,000
Cost of sales	300,000 + 220,000	(520,000)
Gross profit		700,000
Operating expenses	173,000 + 163,000 + 12,000 depreciation	(348,000)
Profit		352,000
Profit attributable to:		
Parent	(balancing)	347,000
Non-controlling interest	N1	5,000
		352,000

N1: NCI share in profit		Rs.
Subsidiary profit as given		37,000
Additional Depreciation		(12,000)
		25,000
	NCI share	20%
		5,000

► **Example 30:**

The summarized draft statement of financial positions of the companies in a group at 31 December 2018 were:

	BL	FL
	Rs.	Rs.
Property, plant and equipment	86,000	24,500
Investment in FL (at cost)	27,000	-
Current assets	20,000	10,000
	133,000	34,500
Share capital	100,000	20,000
Retained earnings	22,000	6,500
Current liabilities	11,000	8,000
	133,000	34,500

Additional information is as follows:

- (a) BL acquired 80% ordinary shares in FL on 1 January 2018, when FL had accumulated profits of Rs.6,000.
- (b) The subsidiary has not incorporated the fair values in its separate books and fair value adjustments identified by the parent company at the date of acquisition are as follows:

Particulars	Carrying value at acquisition date (Rs.)	Fair value at acquisition date (Rs.)	Exists on Reporting date
Land	10,000	12,000	Yes
Inventory	6,000	4,500	No

The group has a policy of measuring non-controlling interest at proportionate share of net assets at the date of acquisition. The 20% of goodwill has impaired to date.

Required: Prepare the consolidated statement of financial position at 31 December 2018.

► **ANSWER:**

Consolidated statement of financial position

As at 31 December 2018

Non-current assets		Rs.
Property, plant & equipment	86,000 + 24,500 + 2,000	112,500
Goodwill	W3	4,640
Current assets	20,000 + 10,000 – 1,500 + 1,500	30,000
		147,140
Equity		
Share capital		100,000
Retained earnings	W5	22,440
Non-controlling interest	W4	5,700
Current liabilities	11,000 + 8,000	19,000
		147,140

W1: Group Structure

FL (Subsidiary)	Acquired on 1 January 2018
Parent's ownership 80%	NCI ownership 20%

W2: Net assets of subsidiary

	At Acquisition	Post-acquisition	At reporting date
	Rs.	Rs.	Rs.
Share capital	20,000		20,000
Retained earnings	6,000	500	6,500
FV adjustment (land) 12,000 – 10,000	2,000	-	2,000
FV adjustment (inventories) 4,500 – 6,000	(1,500)	1,500	-
	26,500	2,000	28,500

W3: Goodwill

		Rs.
Investment		27,000
NCI at acquisition	Rs. 26,500 x 20%	5,300
		32,300
Less: Net assets at acquisition	W2	(26,500)
Goodwill at acquisition		5,800
Less: Impairment 20%	5,800 x 20%	(1,160)
		4,640

W4: Non-controlling interest

		Rs.
NCI at acquisition	Rs. 26,500 x 20%	5,300
Share of post-acquisition reserves	Rs. 2,000 x 20%	400
		5,700

W5: Group reserves (retained earnings)

		Rs.
Parent's retained earnings		22,000
Share of post-acquisition reserves	Rs. 2,000 x 80%	1,600
Impairment of goodwill	W3	(1,160)
		22,440

► **Example 31:**

Ruby Limited (RL) acquired 80% ordinary shares of Adeel Limited (AL) on 1 July 2021.

The statements of financial position of both companies as at 30 June 2022 are as under:

	RL	AL
	Rs. m	Rs. m
Non-current assets		
Property, plant and equipment	500	600
Investment in AL	530	
Current assets	280	410
	1,310	1,010
Equity		
Ordinary Share capital (Rs. 10 each)	800	500
Retained earnings	260	280
	1,060	780
Liabilities	250	230
	1,310	1,010

The statements of comprehensive income of both companies for the year ended 30 June 2022 are as under:

	RL	AL
	Rs. m	Rs. m
Revenue	1,478	1,230
Cost of sales	(990)	(970)
Gross profit	488	260
Distribution costs	(80)	(40)
Administrative expenses	(120)	(65)
Finance costs	(10)	-
Profit before tax	278	155
Taxation	(98)	(45)
Profit after tax	180	110

Additional information:

- (i) RL measures non-controlling interest at fair value at the date of acquisition that was calculated at Rs. 225 million. Goodwill has not been impaired.
- (ii) At the date of acquisition, all the assets of AL had fair value equal to their carrying amount except as follows:

	Book value	Fair value	Remarks
	Rs. million		
Land	90	70	Land is not impaired as value in use was estimated to be Rs. 120 million. RL and AL use cost model for all PPE.
Brand	Nil	50	This is internally generated brand having remaining useful life of 5 years at the date of acquisition.
Inventories	20	28	75% of these inventories have been sold by the year-end.

Required: Prepare for RL, consolidated statement of financial position as at June 30, 2022 and consolidated statement of comprehensive income for the year then ended.

► **ANSWER:**

Consolidated statement of financial position

As at 30 June 2022

Non-current assets		Rs. million
Property, plant & equipment	500 + 600 - 20	1,080
Intangible assets (Brand)	50 - 10	40
Goodwill	W3	47
Current assets	280 + 410 + 8 - 6	692
		1,859
Equity		
Share capital	800	800
Retained earnings	W5	335.2
Non-controlling interest	W4	243.8
Liabilities	250 + 230	480
		1,859

W1: Group Structure

Adeel Limited (Subsidiary)	Acquired on 1 July 2021
Parent's ownership 80%	NCI ownership 20%

W2: Net assets of subsidiary

		At Acquisition	Post-acquisition	At reporting date
		Rs. m	Rs. m	Rs. m
Share capital		500		500
Retained earnings		170	110	280
FV adjustment (land)	Land	(20)	-	(20)
FV adjustment (brand)	50 – 50/5 years	50	(10)	40
FV adjustment (inventories)	8 - 6	8	(6)	2
		708	94	802

W3: Goodwill

		Rs. m
Investment		530
NCI at acquisition	(at fair value)	225
		755
Less: Net assets at acquisition	W2	(708)
Goodwill at acquisition		47

W4: Non-controlling interest

		Rs. m
NCI at acquisition	(at fair value)	225
Share of post-acquisition reserves	94 x 20%	18.8
		243.8

W5: Group reserves (retained earnings)

		Rs. m
Parent's retained earnings		260
Share of post-acquisition reserves	94 x 80%	75.2
		335.2

Consolidated statement of comprehensive income**For the year ended 30 June 2022**

		Rs. million
Revenue	1,478 + 1,230	2,708
Cost of sales	990 + 970 + 6 inventories	(1,966)
Gross profit		742
Distribution costs	80 + 40 + 10 brand amortisation	(130)

		Rs. million
Administrative expenses	120 + 65	(185)
Finance cost	10 + 0	(10)
Profit before tax		417
Taxation	98 + 45	(143)
Profit after tax		274
Profit attributable to:		
Parent	(balancing)	255.2
Non-controlling interest	N1	18.8
		274

N1: NCI share in profit	Rs. million
Subsidiary profit as given	110
Inventory expense	(6)
Brand amortisation	(10)
	94
NCI Share	20%
	18.8

5. MID-YEAR ACQUISITIONS

5.1 Post-acquisition only

In case of mid-year acquisition, subsidiary's income and expenses of post-acquisition period are included only.

► *Example 32:*

Sana Limited (SL) acquired 75% ordinary shares of Amna Limited (AL) on 1 October 2021.

The statements of financial position of both companies as at 30 June 2022 are as under:

	SL	AL
	Rs. m	Rs. m
Non-current assets		
Property, plant and equipment	500	600
Investment in AL	530	
Current assets	280	410
	1,310	1,010
Equity		
Ordinary Share capital (Rs. 10 each)	800	500
Retained earnings	260	280
	1,060	780
Liabilities	250	230
	1,310	1,010

The statements of comprehensive income of both companies for the year ended 30 June 2022 are as under:

	SL		AL	
	Jul-Sep	Oct-Jun	Jul-Sep	Oct-Jun
	Rs. m		Rs. m	Rs. m
Revenue	370	1,108	330	900
Cost of sales	(250)	(740)	(245)	(725)
Gross profit	120	368	85	175
Distribution costs	(18)	(62)	(8)	(32)
Administrative expenses	(40)	(90)	(15)	(50)
Profit before tax	62	216	62	93
Taxation	(25)	(73)	(11)	(34)
Profit after tax	37	143	51	59

Non-controlling interest is measured at fair value at the date of acquisition that was determined at Rs. 225 million.

Required: Prepare for SL, consolidated statement of financial position as at June 30, 2022 and consolidated statement of comprehensive income for the year then ended.

► **ANSWER:**

Consolidated statement of financial position

As at 30 June 2022

Non-current assets		Rs. million
Property, plant & equipment	500 + 600	1,100
Goodwill	W3	34
Current assets	280 + 410	690
		1,824
Equity		
Share capital	800	800
Retained earnings	W5	304.25
Non-controlling interest	W4	239.75
Liabilities	250 + 230	480
		1,824

W1: Group Structure

Amna Limited (Subsidiary)	Acquired on 1 October 2021 (9 months)
Parent's ownership 75%	NCI ownership 25%

W2: Net assets of subsidiary

	At Acquisition	Post-acquisition	At reporting date
	Rs. m	Rs. m	Rs. m
Share capital	500		500
Retained earnings	221	59*	280
	721	59	780

*Post acquisition profit for the year

W3: Goodwill

		Rs. m
Investment		530
NCI at acquisition	(at fair value)	225
		755
Less: Net assets at acquisition	W2	(721)
Goodwill at acquisition		34

W4: Non-controlling interest

		Rs. m
NCI at acquisition	(at fair value)	225
Share of post-acquisition reserves	59 x 25%	14.75
		239.75

W5: Group reserves (retained earnings)

		Rs. m
Parent's retained earnings		260
Share of post-acquisition reserves	59 x 75%	44.25
		304.25

Consolidated statement of comprehensive income**For the year ended 30 June 2022**

		Rs. million
Revenue	370 + 1,108 + 900	2,378
Cost of sales	250 + 740 + 725	(1,715)
Gross profit		663
Distribution costs	18 + 62 + 32	(112)
Administrative expenses	40 + 90 + 50	(180)
Profit before tax		371
Taxation	25 + 73 + 34	(132)
Profit after tax		239
Profit attributable to:		
Parent	(balancing)	224.25
Non-controlling interest	59 x 25%	14.75
		239

5.2 Assumption of evenly incurred income and expenses

It is often assumed that income, expenses and profits have incurred evenly throughout the period unless there is information to contrary.

► **Example 33:**

Pear Limited (PL) bought 70% of Sail Limited (SL) on 31st March this year. SL's profit for the year was Rs. 12,000. The statements of financial position PL and SL as at 31 December 20X1 were as follows:

	PL	SL
	Rs.	Rs.
Property, plant and equipment	100,000	20,000
Investment in SL	50,000	-
Current assets	30,000	12,000
	180,000	32,000
Share capital	10,000	1,000

	PL	SL
	Rs.	Rs.
Retained earnings	160,000	30,000
Current liabilities	10,000	1,000
	180,000	32,000

Required: Prepare the consolidated statement of financial position as at 31 December 20X1.

► **ANSWER:**

Consolidated statement of financial position

As at 31 December 20X1

Non-current assets		Rs.
Property, plant & equipment	100,000 + 20,000	120,000
Goodwill	W3	34,600
		154,600
Current assets	30,000 + 12,000	42,000
		196,600
Equity		
Share capital		10,000
Retained earnings	W5	166,300
Non-controlling interest	W4	9,300
Current liabilities	10,000 + 1,000	11,000
		196,600

W1: Group Structure

Sail Limited (Subsidiary)	Acquired on 31 st March (9 months)
Parent's ownership 70%	NCI ownership 30%

W2: Net assets of subsidiary

		At Acquisition	Post-acquisition	At reporting date
		Rs.	Rs.	Rs.
Share capital		1,000		1,000
Retained earnings	Post 12,000 x 9/12	21,000	9,000	30,000
		22,000	9,000	31,000

W3: Goodwill

		Rs.
Investment		50,000
NCI at acquisition	22,000 x 30%	6,600
		56,600
Less: Net assets at acquisition	W2	(22,000)
Goodwill at acquisition		34,600

W4: Non-controlling interest

		Rs.
NCI at acquisition	22,000 x 30%	6,600
Share of post-acquisition reserves	9,000 x 30%	2,700
		9,300

W5: Group reserves (retained earnings)

		Rs.
Parent's retained earnings		160,000
Share of post-acquisition reserves	9,000 x 70%	6,300
		166,300

► **Example 34:**

Poet Limited (PL) acquired 80% of Scar Limited (SL) on 1 October 20X1. Year end is 31 December. The statements of comprehensive income for the year to 31 December 20X1 are as follows.

	PL	SL
	Rs.	Rs.
Revenue	400,000	260,000
Cost of sales	(200,000)	(60,000)
Gross profit	200,000	200,000
Other income	20,000	-
Distribution costs	(50,000)	(30,000)
Administrative expenses	(90,000)	(95,000)
Profit before tax	80,000	75,000
Income tax expense	(30,000)	(15,000)
Profit after tax	50,000	60,000

Required: A consolidated statement of comprehensive income for the year ended 31 December 20X1.

► **ANSWER:**

The acquisition date was 1 October. This means that only 3/12 of the subsidiary's profit for the year is post-acquisition profit.

Consolidated statement of comprehensive income

For the year ended 31 December 20X1

		Rs.
Revenue	400,000 + 260,000 x 3/12	465,000
Cost of sales	200,000 + 60,000 x 3/12	(215,000)
Gross profit		250,000
Other income	20,000 + 0	20,000
Distribution costs	50,000 + 30,000 x 3/12	(57,500)
Administrative expenses	90,000 + 95,000 x 3/12	(113,750)
Profit before tax		98,750
Taxation	30,000 + 15,000 x 3/12	(33,750)
Profit after tax		65,000
Profit attributable to:		

		Rs.
Parent	(balancing)	62,000
Non-controlling interest	$60,000 \times 3/12 \times 20\%$	3,000
		65,000

► *Example 35:*

Fahad Limited (FL) acquired 75% ordinary shares of Aashir Limited (AL) on 1 October 2021.

The statements of financial position of both companies as at 30 June 2022 are as under:

	FL	AL
	Rs. m	Rs. m
Non-current assets		
Property, plant and equipment	500	600
Investment in AL	530	
Current assets	280	410
	1,310	1,010
Equity		
Ordinary Share capital (Rs. 10 each)	800	500
Retained earnings	260	280
	1,060	780
Liabilities	250	230
	1,310	1,010

The statements of comprehensive income of both companies for the year ended 30 June 2022 are as under:

	FL	AL
	Rs. m	Rs. m
Revenue	1,478	1,230
Cost of sales	(990)	(970)
Gross profit	488	260
Distribution costs	(80)	(40)
Administrative expenses	(130)	(65)
Profit before tax	278	155
Taxation	(98)	(45)
Profit after tax	180	110

Profits of both companies accrued evenly throughout the year.

Non-controlling interest is measured at fair value at the date of acquisition that was determined at Rs. 225 million.

Required: Prepare for FL, consolidated statement of financial position as at June 30, 2022 and consolidated statement of comprehensive income for the year then ended.

► **ANSWER:**

Consolidated statement of financial position

As at 30 June 2022

Non-current assets		Rs. million
Property, plant & equipment	500 + 600	1,100
Goodwill	W3	57.5
Current assets	280 + 410	690
		1,847.5
Equity		
Share capital	800	800
Retained earnings	W5	321.87
Non-controlling interest	W4	245.63
Liabilities	250 + 230	480
		1,847.5

W1: Group Structure

Aashir Limited (Subsidiary)	Acquired on 1 October 2021 (9 months)
Parent's ownership 75%	NCI ownership 25%

W2: Net assets of subsidiary

	At Acquisition	Post-acquisition	At reporting date
	Rs. m	Rs. m	Rs. m
Share capital	500		500
Retained earnings Post: 110 x 9/12	197.5	82.5	280
	697.5	82.5	780

W3: Goodwill

	Rs. m
Investment	530
NCI at acquisition (at fair value)	225
	755
Less: Net assets at acquisition W2	(697.5)
Goodwill at acquisition	57.5

W4: Non-controlling interest

	Rs. m
NCI at acquisition (at fair value)	225
Share of post-acquisition reserves 82.5 x 25%	20.63
	245.63

W5: Group reserves (retained earnings)

	Rs. m
Parent's retained earnings	260
Share of post-acquisition reserves $82.5 \times 75\%$	61.87
	321.87

Consolidated statement of comprehensive income

For the year ended 30 June 2022

	Rs. million
Revenue $1,478 + 1,230 \times 9/12$	2,400.5
Cost of sales $990 + 970 \times 9/12$	(1,717.5)
Gross profit	683
Distribution costs $80 + 40 \times 9/12$	(110)
Administrative expenses $130 + 65 \times 9/12$	(178.75)
Profit before tax	394.25
Taxation $98 + 45 \times 9/12$	(131.75)
Profit after tax	262.5
Profit attributable to:	
Parent (balancing)	241.87
Non-controlling interest $110 \times 9/12 \times 25\%$	20.63
	262.5

6. ELIMINATION OF INTRA-GROUP ITEMS

6.1 Intra-group trading

Parent and subsidiary may trade with each other.

The concept of group as a single economic entity requires that following transactions (in post-acquisition period) are cancelled in full:

- Intra-group sales & purchases (in cost of sales)
- Intra-group interest income & finance cost
- Intra-group other income & expenses
- Intra-group dividend (subsidiary to parent)

Impact on SFP	No impact if inventory has been sold outside group. The unrealised profit adjustment is required when inventory is still held within the group (covered later).
Impact on SCI	Decrease revenue / other income etc. Decrease cost of sales / other expense etc. There is no impact on NCI share unless there is unrealized profit involved in the transaction (covered later).

► Example 36:

Poem Limited (PL) acquired 80% of Spot Limited (SL) 3 years ago.

Other income in PL's statement of comprehensive income includes an inter-company management charge of Rs. 5,000 to SL. SL has recognised this in administrative expenses.

Extracts of the income statements for the year to 31 December 20X1 are as follows:

	PL	SL
	Rs.	Rs.
Revenue	800,000	420,000
Cost of sales	(300,000)	(220,000)
Gross profit	500,000	200,000
Administrative expenses	(100,000)	(90,000)
Distribution costs	(85,000)	(75,000)
Other income	12,000	2,000
Profit	327,000	37,000

Required: A consolidated statement of comprehensive income for the year ended 31 December 20X1.

► **ANSWER:**

Consolidated statement of comprehensive income

For the year ended 31 December 20X1

		Rs.
Revenue	800,000 + 420,000	1,220,000
Cost of sales	300,000 + 220,000	(520,000)
Gross profit		700,000
Administrative expenses	100,000 + 90,000 – 5,000	(185,000)
Distribution costs	85,000 + 75,000	(160,000)
Other income	12,000 + 2,000 – 5,000	9,000
Profit		364,000
Profit attributable to:		
Parent	(balancing)	356,600
Non-controlling interest	(37,000 x 20%)	7,400
		364,000

► **Example 37:**

Company A acquired 90% shares of Company B 2 years ago. During the year, Company B gave dividend of Rs. 90 million to Company A. Company A, in its individual financial statements has stated investment in subsidiary at cost, thereby, recognized the dividend received from subsidiary as Dividend Income in individual statement of profit and loss.

But for the sake of consolidation, this dividend income will be ignored and shall not become part of income in consolidated statement of profit and loss as from the group's perspective, this is not an income.

► **Example 38:**

Statements of comprehensive income for the year ended 31 December 2015.

	Bumpy	Smooth
	Rs. 000	Rs. 000
Revenue	304,900	195,300
Cost of sales	(144,200)	(98,550)
Gross profit	160,700	96,750
Operating costs	(76,450)	(52,100)
Operating profit	84,250	44,650
Investment income	10,500	2,600
Profit before tax	94,750	47,250
Income tax expense	(42,900)	(16,500)
Profit for the year	51,850	30,750
Other comprehensive income		

	Bumpy	Smooth
Gain on revaluation	5,000	2,500
Total comprehensive income	56,850	33,250

The following information is also available.

- Bumpy acquired 75% of the share capital of Smooth on 31 August 2015.
- Negative goodwill of Rs. 3.8 million arose on the acquisition.
- Profits of both companies are deemed to accrue evenly over the year except for the investment income of Smooth all of which was received in November 2015.
- The revaluation of asset was carried on by both companies on 1 July 2015.
- Bumpy has bought goods from Smooth throughout the year at Rs. 2 million per month. At the year-end Bumpy does not hold any inventory purchased from Smooth.

Required: Prepare the consolidated statement of comprehensive income for the year ended 31 December 2015.

► **ANSWER:**

Consolidated statement of comprehensive income

For the year ended 31 December 2015

	Rs. 000
Revenue $304,900 + 195,300 \times 4/12 - (2,000 \times 4 \text{ months})$	362,000
Cost of sales $144,200 + 98,550 \times 4/12 - (2,000 \times 4 \text{ months})$	(169,050)
Gross profit	192,950
Operating costs $76,450 + 52,100 \times 4/12$	(93,817)
Investment income $10,500 + 2,600^*$	13,100
Gain on bargain purchase	3,800
Profit before tax	116,033
Tax $42,900 + 16,500 \times 4/12$	(48,400)
Profit after tax	67,633
Other comprehensive income	
Gain on revaluation $5,000 + 0^{**}$	5,000
Total comprehensive income	72,633
Profit attributable to:	
Parent (balancing)	64,637
Non-controlling interest $[30,750 \times 4/12 + 2,600 \times 8/12] \times 25\%$	2,996
	67,633
Total comprehensive income attributable to:	
Parent (balancing)	69,637
Non-controlling interest	2,996
	72,633

*all relates to post-acquisition period **all relates to pre-acquisition period

6.2 Intra-group outstanding balances

It is possible that one entity in the group owes amount to another entity in the group.

The concept of group as a single economic entity requires that following balances are eliminated in full:

- Intra-group trade receivable & payable
- Intra-group interest receivable & payable
- Intra-group dividend receivable & payable
- Intra-group loan receivable & payable
- Intra-group other receivable & payable

The receivable balance and payable balance may not agree due to goods in transit or cash in transit. In such case, inventory or cash is recorded, as the case may be.

Impact on SFP	Decrease receivable Decrease payable Increase cash in transit OR inventory in transit
Impact on SCI	No impact (other than adjustment of unrealised profit in inventory, if any)
In case of inventory in transit, unrealised profit adjustment would be required additionally.	

► Example 39:

The following are the draft statements of financial position of Hail and its subsidiary Snow as at 31 December 2015.

	Hail	Snow
	Rs. 000	Rs. 000
Non-current assets		
Property, plant and equipment	161,000	85,000
Investments	68,000	-
Current assets		
Cash	7,700	25,200
Trade receivables	92,500	45,800
Snow current account	15,000	-
Inventory	56,200	36,200
	400,400	192,200
Shareholders' equity		
Share capital	100,000	50,000
Retained earnings	185,400	41,200
Share premium	-	5,000
Revaluation reserve	-	20,000
	285,400	116,200
Current liabilities	115,000	68,000
Hail current account	-	8,000
	400,400	192,200

Additional information:

- (i) Snow has 50,000 shares in issue. Hail acquired 45,000 of these on 1 January 2012 for a cost of Rs. 65,000,000 when the balances on Snow's reserves were:

	Rs.000
Share premium account	5,000
Revaluation reserve	–
Retained earnings	10,000

- (ii) Hail declared a dividend of Rs.3,000,000 just before the year end and Snow declared one of Rs.2,000,000 on same day. Neither company has yet recorded declaration of dividend or dividend income.

- (iii) The current account difference is due to cash in transit.

Required: Prepare the consolidated statement of financial position as at 31 December 2015 of Hail.

► **ANSWER:**

Consolidated statement of financial position

As at 31 December 2015

Non-current assets		Rs.
Property, plant & equipment	161,000 + 85,000	246,000
Goodwill	W3	6,500
Investments	68,000 – 65,000 in subsidiary	3,000
		255,500
Current assets		
Inventory	56,200 + 36,200	92,400
Receivable	92,500 + 45,800	138,300
Dividend receivable	1,800 recorded – 1,800 cancelled	-
Current account	15,000 – 15,000 cancelled	-
Cash	7,700 + 25,200 + 7,000 in transit	39,900
		270,600
		526,100
Equity		
Share capital		100,000
Share premium		-
Revaluation reserve	W5	18,000
Retained earnings	W5	210,480
Non-controlling interest	W4	11,420
Current liabilities		
Current account	8,000 – 8,000 cancelled	-
Other	115,000 + 68,000	183,000
Dividend payable	3,000 P + 2,000 S – 1,800 cancelled	3,200
		186,200
		526,100

W1: Group Structure

Snow Limited (Subsidiary)	Acquired on 1 January 2012
Parent's ownership 90% (45,000 / 50,000 shares)	NCI ownership 10%

W2: Net assets of subsidiary

	At Acquisition	Post-acquisition	At reporting date
	Rs.	Rs.	Rs.
Share capital	50,000		50,000
Share premium	5,000		5,000
Revaluation reserve	-	20,000	20,000
Retained earnings	10,000	31,200	41,200
Less: Dividend		(2,000)	(2,000)
		29,200	
	65,000	49,200	114,200

W3: Goodwill

	Rs.
Investment	65,000
NCI at acquisition $65,000 \times 10\%$	6,500
	71,500
Less: Net assets at acquisition W2	(65,000)
Goodwill at acquisition	6,500

W4: Non-controlling interest

	Rs.
NCI at acquisition $65,000 \times 10\%$	6,500
Share of post-acquisition reserves $49,200 \times 10\%$	4,920
	11,420

W5: Group reserves

	Revaluation reserve	Retained earnings
	Rs.	Rs.
Parent's balance	-	185,400
Less: Dividend declared	-	(3,000)
Add: Dividend income (from S) $2,000 \times 90\%$	-	1,800
Share of post-acquisition reserves $20,000 \text{ \& } 29,200 \times 90\%$	18,000	26,280
	18,000	210,480

► *Example 40:***Statements of financial position at 31 December 2018**

	ML	ZL
	Rs.	Rs.
Property, plant and equipment	41,000	16,000
Investment in ZL (at cost)	19,000	-
Current assets	20,000	28,000
ZL current account	10,000	-
	90,000	44,000
Share capital (Rs. 10 each)	50,000	10,000
Retained earnings	30,000	20,000
Current liabilities	10,000	5,000
ML current account	-	9,000
	90,000	44,000

Additional information is as follows:

- ML bought 750 shares in ZL on 1 January 2018 when the balance on the retained earnings of ZL was Rs.12,000.
- The current account difference has arisen as a cheque of Rs. 500 sent by ZL to ML on 30 December 2018 was not received by ML until 3 January 2019, Rs. 300 purchases by ZL from ML wrongly credited to some other creditor account and Rs. 200 charged by ML for certain expenses paid on behalf of ZL.
- No stock related to intercompany purchases exists at the reporting date.
- The ML Group has the policy of measuring non-controlling interest at fair value (FV) and FV of NCI was Rs. 6,000 at the date of acquisition.
- Goodwill of Rs. 1,000 has been impaired to date

Required: Prepare the consolidated statement of financial position at 31 December 2018.

► *ANSWER:*

Consolidated statement of financial position

As at 31 December 2018

Non-current assets		Rs.
Property, plant & equipment	41,000 + 16,000	57,000
Goodwill	W3	2,000
Current assets	20,000 + 28,000 + 500 in transit	48,500
ZL Current account	10,000 – 9,000 – 500 – 300 – 200	0
		107,500

Equity		Rs.
Share capital		50,000
Retained earnings	W5	35,100
Non-controlling interest	W4	7,700
Current liabilities	10,000 + 5,000 - 300	14,700
ML Current account	9,000 - 9,000	0
		107,500

W1: Group Structure

ZL (Subsidiary)	Acquired on 1 January 2018
Parent's ownership 75% (750 / 1,000)	NCI ownership 25%

W2: Net assets of subsidiary

	At Acquisition	Post-acquisition	At reporting date
	Rs.	Rs.	Rs.
Share capital	10,000		10,000
Retained earnings	12,000	8,000	20,000
Expenses to be recorded		(200)	(200)
	22,000	7,800	29,800

W3: Goodwill

	Rs.
Investment	19,000
NCI at acquisition (at fair value)	6,000
	25,000
Less: Net assets at acquisition W2	(22,000)
Goodwill at acquisition	3,000
Less: Impairment	(1,000)
	2,000

W4: Non-controlling interest

	Rs.
NCI at acquisition (at fair value)	6,000
Share of post-acquisition reserves 7,800 x 25%	1,950
Share of impairment loss 1,000 x 25%	(250)
	7,700

W5: Group reserves (retained earnings)

	Rs.
Parent's retained earnings	30,000
Share of post-acquisition reserves 7,800 x 75%	5,850
Share of impairment loss 1,000 x 75%	(750)
	35,100

6.3 Unrealised profit in inventory

A group entity may buy inventory from the other group-entity in post-acquisition period. To the extent, such inventory is sold outside group, the profit is realized to group and so, no adjustment is required.

However, for inventory not yet sold outside group, the unrealized profit portion included in inventory should be eliminated. The adjustment of unrealised profit (URP) in inventory is calculated using mark-up / margin information given in question.

If parent entity is seller	
Impact on SFP	Decrease inventory Decrease group reserves
Impact on SCI	Increase cost of sales No impact on NCI share
If subsidiary entity is seller	
Impact on SFP	Decrease inventory Decrease post-acquisition reserves of subsidiary (will ultimately effect NCI and group reserves)
Impact on SCI	Increase cost of sales Include the impact in calculation of NCI share

► **Example 41:**

Company A purchased 100% shares of Company B at the start of year 20X1. During the year 20X1, Company B sold Rs. 100 worth of goods to Company A, however, the cost of such goods were only Rs. 80. Company A has all such goods in its inventory at year end.

Required: How to account for this transaction?

► **ANSWER:**

Company B recorded profit of Rs. 20 (i.e. Rs. 100 – 80) and inventory of Rs. 100 is included in current assets of Company A.

However, Rs. 20 is not a profit from the group's perspective as from the group's perspective, the worth of good is only Rs. 80 and not Rs. 100.

Therefore, adjustment will have to be made in consolidated financial statements by reducing Inventory and subsidiary's post-acquisition profits (as subsidiary is 100% owned, whole impact will be on group reserves) by Rs. 20.

For presentation purposes Rs 100 would be eliminated from sales & cos only.

► *Example 42:*

Company A purchased 100% shares of Company B at the start of year 20X1.

During the year 20X1, Company A sold Rs. 100 worth of goods to Company B, however, the cost of such goods were only Rs. 80. Company B has 50% of such goods in its inventory at year end.

Required: How to account for this transaction?

► *ANSWER:*

Company A recorded profit of Rs. 20 (i.e. Rs. 100 – 80) and inventory of Rs. 50 is included in current assets of Company B.

However, from group perspective only half the profit is realised i.e. Rs. 10 (Rs. 20 x 50%). The remaining profit of Rs. 10 is unrealised from group's perspective. Also, from the group's perspective, the worth of unsold goods in inventory is Rs. 40 (Rs. 80 x 50%) and not Rs. 50 (Rs. 100 x 80%).

Therefore, adjustment will have to be made in consolidated financial statements by reducing inventory and group reserves (no impact on NCI as profit was recorded by parent entity) by Rs.10.

► *Example 43:*

Company A purchased 75% shares of Company B at the start of year 20X1.

During the year 20X1, Company B sold Rs. 100 worth of goods to Company A, however, the cost of such goods were only Rs. 80. Company A has 100% of such goods in its inventory at year end.

Required: How to account for this transaction?

► *ANSWER:*

Company B recorded profit of Rs. 20 (i.e. Rs. 100 – 80) and inventory of Rs. 100 is included in current assets of Company A.

However, Rs. 20 is not a profit from the group's perspective as from the group's perspective, the worth of good is only Rs. 80 and not Rs. 100.

Therefore, adjustment will have to be made in consolidated financial statements by reducing Inventory and subsidiary's post-acquisition profits (as subsidiary is 75% owned, Rs. 15 impact will be on group reserves and Rs. 5 impact will be on NCI) by Rs. 20.

► *Example 44:*

Company A purchased 75% shares of Company B at the start of year 20X1.

During the year 20X1, Company A sold Rs. 100 worth of goods to Company B, however, the cost of such goods were only Rs. 80. Company B has 50% of such goods in its inventory at year end.

Required: How to account for this transaction?

► *ANSWER:*

Company A recorded profit of Rs. 20 (i.e. Rs. 100 – 80) and inventory of Rs. 50 is included in current assets of Company B.

However, from group perspective only half the profit is realised i.e. Rs. 10 (Rs. 20 x 50%). The remaining profit of Rs. 10 is unrealised from group's perspective. Also, from the group's perspective, the worth of unsold goods in inventory is Rs. 40 (Rs. 80 x 50%) and not Rs. 50 (Rs. 100 x 80%).

Therefore, adjustment will have to be made in consolidated financial statements by reducing inventory and group reserves (no impact on NCI as profit was recorded by parent entity) by Rs.10.

► *Example 45:*

The summarized statements of financial position of Hairy and Spider as at 31 December 2015 were as follows.

	Hairy	Spider
	Rs.000	Rs.000
Non-current assets		
Property, plant and equipment	120,000	60,000
Investments	55,000	–
Current assets		
Cash	11,000	4,000
Short term investments	–	3,000
Trade receivables	72,600	19,100
Current account – Hairy	–	3,200
Inventory	17,000	11,000
	275,600	100,300
Equity and liabilities		
Share capital	100,000	60,000
Share premium	20,000	–
Capital reserve	23,000	16,000
Retained earnings	91,900	7,300
Trade payables	38,000	17,000
Current account – Spider	2,700	–
	275,600	100,300

The following information is relevant.

- On 31 December 2012, Hairy acquired 48,000 shares in Spider for Rs.55,000,000 cash. Spider has 60,000 shares in total.
- The inventory of Hairy includes Rs.4,000,000 goods from Spider invoiced to Hairy at cost plus 25%.
- The difference on the current account balances is due to cash in transit.
- The balance on Spider's retained earnings was Rs.2,300,000 at the date of acquisition. There has been no movement in the balance on Spider's capital reserve since the date of acquisition.

Required: Prepare the consolidated statement of financial position of Hairy and its subsidiary Spider as at 31 December 2015.

► ANSWER:

Consolidated statement of financial position**As at 31 December 2015**

Non-current assets		Rs. 000
Property, plant & equipment	120,000 + 60,000	180,000
Goodwill	W3	0
		180,000
Current assets		
Inventory	17,000 + 11,000 – 800 URP	27,200
Receivable	72,600 + 19,100	91,700
Current account	0 + 3,200 – 3,200 cancelled	0
Short term investments	0 + 3,000	3,000
Cash	11,000 + 4,000 + 500 in transit	15,500
		137,400
		317,400
Equity		
Share capital		100,000
Share premium		20,000
Capital reserve	(parent's only)	23,000
Retained earnings	W5	102,900
		245,900
Non-controlling interest	W4	16,500
		262,400
Current liabilities		
Trade payables	38,000 + 17,000	55,000
Current account	2,700 + 0 – 2,700 cancel	0
		55,000
		317,400

W1: Group Structure

Spider (Subsidiary)	Acquired on 31 Dec 2012 (3 years)
Parent's ownership 80% (48,000 / 60,000 shares)	NCI ownership 20%

W2: Net assets of subsidiary

	At Acquisition	Post-acquisition	At reporting date
	Rs. 000	Rs. 000	Rs. 000
Share capital	60,000		60,000
Share premium	-		-
Capital reserve	16,000		16,000
Retained earnings	2,300	5,000	7,300
URP Inventory 4,000 x 25/125		(800)	(800)
	78,300	4,200	82,500

W3: Goodwill

	Rs. 000
Investment	55,000
NCI at acquisition 78,300 x 20%	15,660
	70,660
Less: Net assets at acquisition W2	(78,300)
Gain (negative goodwill) at acquisition	(7,640)
Transfer to reserves	7,640
	0

W4: Non-controlling interest

	Rs. 000
NCI at acquisition 78,300 x 20%	15,660
Share of post-acquisition reserves 4,200 x 20%	840
	16,500

W5: Group reserves (retained earnings)

	Rs. 000
Parent's retained earnings	91,900
Gain (negative goodwill)	7,640
Share of post-acquisition reserves 4,200 x 80%	3,360
	102,900

► **Example 46:**

On 1 July 2012 Hale acquired 128,000 of Sowen's 160,000 shares. The following statements of financial position have been prepared as at 31 December 2015.

	Hale	Sowen
	Rs.000	Rs.000
Property, plant and equipment	152,000	129,600
Investment in Sowen	203,000	–
Inventory at cost	112,000	74,400
Receivables	104,000	84,000
Bank balance	41,000	8,000
	612,000	296,000
Share capital	100,000	160,000
Retained earnings	460,000	112,000
Payables	52,000	24,000
	612,000	296,000

The following information is available.

- At 1 July 2012 Sowen had a debit balance of Rs.11 million on retained earnings.
- Property, plant and equipment of Sowen included land at a cost of Rs.72 million. This land had a fair value of Rs.100 million at the date of acquisition.
- The inventory of Sowen includes goods purchased from Hale for Rs.16 million. Hale invoiced those goods at cost plus 25%.

Required: Prepare the consolidated statement of financial position of Hale as at 31 December 2015.

► **ANSWER:**

Consolidated statement of financial position

As at 31 December 2015

Non-current assets		Rs. 000
Property, plant & equipment	152,000 + 129,600 + 28,000 FV adj.	309,600
Goodwill	W3	61,400
		371,000
Current assets		
Inventory	11,200 + 74,400 – 3,200 URP	183,200
Receivable	104,000 + 84,000	188,000
Bank	41,000 + 8,000	49,000
		420,200
		791,200

Equity		Rs. 000
Share capital		100,000
Retained earnings	W5	555,200
		655,200
Non-controlling interest	W4	60,000
		715,200
Current liabilities (Payables)	52,000 + 24,000	76,000
		791,200

W1: Group Structure

Sowen (Subsidiary)	Acquired on 1 July 2012 (3.5 years)
Parent's ownership 80% (128,000 / 160,000)	NCI ownership 20%

W2: Net assets of subsidiary

	At Acquisition	Post-acquisition	At reporting date
	Rs. 000	Rs. 000	Rs. 000
Share capital	160,000		160,000
Retained earnings	(11,000)	123,000	112,000
FV adj: Land	28,000		28,000
	177,000	123,000	300,000

W3: Goodwill

	Rs. 000
Investment	203,000
NCI at acquisition	177,000 x 20%
	35,400
	238,400
Less: Net assets at acquisition	W2
	(177,000)
Goodwill at acquisition	61,400

W4: Non-controlling interest

	Rs. 000
NCI at acquisition	177,000 x 20%
	35,400
Share of post-acquisition reserves	123,000 x 20%
	24,600
	60,000

W5: Group reserves (retained earnings)

	Rs. 000
Parent's retained earnings	460,000
URP Inventory	160,000 x 25/125
	(3,200)
Share of post-acquisition reserves	123,000 x 80%
	98,400
	555,200

► **Example 47:**

Pile Limited (PL) bought 80% of Sofa Limited (SL) 2 years ago. At the date of acquisition SL's retained earnings stood at Rs. 16,000

During the year SL sold goods to PL for Rs. 20,000 which gave SL a profit of Rs. 8,000. PL still held 40% of these goods at the year end.

The statements of financial position PL and SL as at 31 December 20X1 were as follows:

	PL	SL
	Rs.	Rs.
Property, plant and equipment	100,000	41,000
Investment in SL	50,000	-
Current assets	110,000	50,000
	260,000	91,000
Share capital	50,000	30,000
Retained earnings	200,000	56,000
Current liabilities	10,000	5,000
	260,000	91,000

Required: Prepare a consolidated statement of financial position as at 31 December 20X1.

► **ANSWER:****Consolidated statement of financial position**

As at 31 December 20X1

Non-current assets		Rs.
Property, plant & equipment	100,000 + 41,000	141,000
Goodwill	W3	13,200
		154,200
Current assets	110,000 + 50,000 – 3,200 URP	156,800
		311,000
Equity		
Share capital		50,000
Retained earnings	W5	229,440
Non-controlling interest	W4	16,560
Current liabilities	10,000 + 5,000	15,000
		311,000

W1: Group Structure

Sofa Limited (Subsidiary)	Acquired two years ago
Parent's ownership 80%	NCI ownership 20%

W2: Net assets of subsidiary

	At Acquisition	Post-acquisition	At reporting date
	Rs.	Rs.	Rs.
Share capital	30,000		30,000
Retained earnings	16,000	40,000	56,000
URP Inventory [8,000 x 40%]		(3,200)	(3,200)
	46,000	36,800	82,800

W3: Goodwill

	Rs.
Investment	50,000
NCI at acquisition 46,000 x 20%	9,200
	59,200
Less: Net assets at acquisition W2	(46,000)
Goodwill at acquisition	13,200

W4: Non-controlling interest

	Rs.
NCI at acquisition 46,000 x 20%	9,200
Share of post-acquisition reserves 36,800 x 20%	7,360
	16,560

W5: Group reserves (retained earnings)

	Rs.
Parent's retained earnings	200,000
Share of post-acquisition reserves 36,800 x 80%	29,440
	229,440

► **Example 48:**

Bradley Ltd purchased 96 million shares in Bliss Ltd a year ago when Bliss had a credit balance of Rs. 190 million in retained earnings.

Bradley Ltd wishes to measure non-controlling interest at fair value and the fair value of the non-controlling interest at the date of acquisition was Rs. 330 million.

At the date of acquisition, the freehold land of Bliss Ltd was valued at Rs. 140 million in excess of its carrying value. The revaluation has not been recorded in the accounts of Bliss.

The statements of financial position of Bradley Ltd and Bliss Ltd as at 31 December 2016 are as follows:

	Bradley Ltd	Bliss Ltd
	----- Rs. Million -----	
Non-Current Assets		
Land and building	630	556
Machinery and equipment	570	440
Investment in Bliss Ltd.	1,320	-
	2,520	996
Current Assets		
Inventories	714	504
Trade receivables	1,050	252
Cash/bank	316	60
	2,080	816
	4,600	1,812
Ordinary Shares Rs. 10 each	3,000	1,200
Retained Earnings	1,160	424
Shareholders fund	4,160	1,624
Current Liabilities		
Trade payables	440	188
	4,600	1,812

Bliss Ltd owes Bradley Ltd Rs. 50 million for goods purchased during the year. Inventory of Bliss Ltd includes goods bought from Bradley Ltd at the price that includes a profit to Bradley Ltd of Rs. 24 million.

Required: Prepare the consolidated statement of financial position as at 31 December 2016.

► **ANSWER:**

Consolidated statement of financial position

As at 31 December 2016

Non-current assets		Rs. m
Property, plant & equipment	$630 + 556 + 570 + 440 + 140 \text{ FV Adj.}$	2,336
Goodwill	W3	120
		2,456
Current assets		
Inventory	$714 + 504 - 24 \text{ URP}$	1,194
Receivable	$1,050 + 252 - 50 \text{ cancel}$	1,252
Cash	$316 + 60$	376
		2,822
		5,278

Equity		Rs. m
Share capital		3,000
Retained earnings	W5	1,323.5
Non-controlling interest	W4	376.8
Current liabilities (payables)	440 + 188 – 50 cancel	578
		5,278

W1: Group Structure

Bliss Limited (Subsidiary)	Acquired a year ago
Parent's ownership 80% (96m / 120m)	NCI ownership 20%

W2: Net assets of subsidiary

	At Acquisition	Post-acquisition	At reporting date
	Rs. m	Rs. m	Rs. m
Share capital	1,200		1,200
Retained earnings	190	234	424
FV Adj: Land	140		140
	1,530	234	1,764

W3: Goodwill

	Rs. m
Investment	1,320
NCI at acquisition (at fair value)	330
	1,650
Less: Net assets at acquisition W2	(1,530)
Goodwill at acquisition	120

W4: Non-controlling interest

	Rs. m
NCI at acquisition (at fair value)	330
Share of post-acquisition reserves 234 x 20%	46.8
	376.8

W5: Group reserves (retained earnings)

	Rs. m
Parent's retained earnings	1,160
URP inventory (as given in question)	(24)
Share of post-acquisition reserves 234 x 80%	187.2
	1,323.2

► *Example 49:*

Haidar Limited (HL) acquired 75% of Saqib Limited (SL)'s ordinary shares on 1 April 20X1 for an agreed consideration of Rs. 25 million when Saqib Limited had retained earnings of Rs.10,200,000.

The draft statements of financial position of the two companies at 31 December are:

	HL (Rs. 000)	SL (Rs. 000)
Non-current assets:		
Property, plant and equipment	78,540	27,180
Investment in SL	25,000	-
Current assets		
Inventory	7,450	4,310
Accounts receivable	12,960	4,330
Cash and bank	-	920
Total assets	123,950	36,740
Equity		
Share capital	30,000	8,000
Share premium	20,000	2,000
Retained earnings	64,060	15,200
Bank loan		6,000
Current liabilities		
Accounts payable and accruals	5,920	4,160
Bank overdraft	2,100	-
Taxation	1,870	1,380
Total equity and liabilities	123,950	36,740

The following information is relevant:

- The fair value of SL's land at the date of acquisition was Rs. 4 million in excess of its carrying value. The fair value of SL's other net assets approximated to their carrying values.
- During the year HL sold inventory to SL for Rs. 2.4 million. The inventory had originally cost HL Rs. 2.0 million. SL held 25% of these goods at the year-end.
- The two companies agreed their current account balances as Rs. 500,000 payable by SL to HL at the year-end. Inter-company current accounts are included in accounts receivable or payable as appropriate.
- An impairment test at 31 December on the consolidated goodwill concluded that it should be written down by Rs. 625,000.

Required: Prepare the consolidated statement of financial position as at 31 December 20X1.

► **ANSWER:****Consolidated statement of financial position****As at 31 December 20X1**

Non-current assets		Rs. 000
Property, plant & equipment	78,540 + 27,180 + 4,000 FV Adj.	109,720
Goodwill	W3	6,225
		115,945
Current assets		
Inventory	7,450 + 4,310 – 100 URP	11,660
Receivable	12,960 + 4,330 – 500 cancel	16,790
Cash	0 + 920	920
		29,370
		145,315
Equity		
Share capital		30,000
Share premium		20,000
Retained earnings	W5	67,085
		117,085
Non-controlling interest	W4	7,300
		124,385
Non-current liabilities		0 + 6,000
Current liabilities		
Payables and accruals	5,920 + 4,160 – 500 cancel	9,580
Bank overdraft	2,100 + 0	2,100
Taxation	1,870 + 1,380	3,250
		14,930
		145,315

W1: Group Structure

Saqib Limited (Subsidiary)	Acquired on 1 April 20X1 (9 months)
Parent's ownership 75%	NCI ownership 25%

W2: Net assets of subsidiary

	At Acquisition	Post-acquisition	At reporting date
	Rs. 000	Rs. 000	Rs. 000
Share capital	8,000		8,000
Share premium	2,000		2,000
Retained earnings	10,200	5,000	15,200
FV Adj: Land	4,000		4,000
	24,200	5,000	29,200

W3: Goodwill

	Rs. 000
Investment	25,000
NCI at acquisition $24,200 \times 25\%$	6,050
	31,050
Less: Net assets at acquisition W2	(24,200)
Goodwill at acquisition	6,850
Less: Impairment	(625)
	6,225

W4: Non-controlling interest

	Rs. 000
NCI at acquisition $24,200 \times 25\%$	6,050
Share of post-acquisition reserves $5,000 \times 25\%$	1,250
	7,300

W5: Group reserves (retained earnings)

	Rs. 000
Parent's retained earnings	64,060
URP Inventory $2,400 - 2,000 = 400 \times 25\%$	(100)
Share of post-acquisition reserves $5,000 \times 75\%$	3,750
Less: Impairment of goodwill	(625)
	67,085

► **Example 50:**

Pore Limited (PL) acquired 80% of Sore Limited (SL) 3 years ago.

During the year SL sold goods to PL for Rs. 45,000 at a mark-up of 25% on cost. At the year-end PL still had a third of the goods in inventory.

Extracts of the statements of comprehensive income for the year to 31 December 20X1 are as follows:

	PL	SL
	Rs.	Rs.
Revenue	800,000	420,000
Cost of sales	(300,000)	(220,000)
Gross profit	500,000	200,000
Operating expenses	(173,000)	(163,000)
Profit	327,000	37,000

Required: Prepare consolidated statement of comprehensive income for the year ended 31 December 20X1.

► **ANSWER:**

This means that inventory held by PL has unrealised profit of Rs. 3,000 (i.e. Rs. 45,000 x 1/3 x 25/125) that needs to be adjusted.

Consolidated statement of comprehensive income

For the year ended 31 December 20X1

	Rs.
Revenue	800,000 + 420,000 – 45,000
Cost of sales	300,000 + 220,000 – 45,000 + 3,000
Gross profit	697,000
Operating expenses	173,000 + 163,000
Profit	361,000
Profit attributable to:	
Parent (balancing)	354,200
Non-controlling interest N1	6,800
	361,000

N1: NCI share in profit	Rs.
Subsidiary profit as given	37,000
Unrealised profit in inventory	(3,000)
	34,000
NCI share	20%
	6,800

► **Example 51:**

Pulp Limited (PL) acquired 80% of Self Limited (SL) 3 years ago.

Extracts of the statements of comprehensive income for the year to 31 December 20X1 are as follows:

	PL	SL
	Rs.(000)	Rs.(000)
Revenue	1,000	800
Cost of sales	(400)	(250)
Gross profit	600	550
Distribution costs	(120)	(75)
Administrative expenses	(80)	(20)
	400	455
Dividend from SL	80	-
Finance cost	(25)	(15)
Profit before tax	455	440
Tax	(45)	(40)
Profit after tax	410	400

Additional information:

- Goodwill on acquisition was Rs. 80,000. The recoverable amount of goodwill at the year-end was estimated to be Rs. 65,000. This was the first time that the recoverable amount of goodwill had fallen below the amount at initial recognition.
- SL sells goods to PL. The total sales in the year were Rs. 100,000. At the year-end PL retains inventory from SL which had cost Rs. 30,000 but was in PL's books at Rs. 35,000.
- The distribution costs of SL include depreciation of an asset which had been subject to a fair value increase of Rs. 100,000 on acquisition. This asset had remaining useful life of 10 years on the date of acquisition.

Required: Prepare consolidated statement of comprehensive income for the year ended 31 December 20X1.

► **ANSWER:****Consolidated statement of comprehensive income**

For the year ended 31 December 20X1

	Rs. 000
Revenue	1,000 + 800 - 100
Cost of sales	400 + 250 - 100 + 5 URP
Gross profit	1,145
Distribution costs	120 + 75 + 100/10 years
Administrative expenses	80 + 20 + 15 impairment of goodwill
	825

		Rs. 000
Dividend from SL	80 – 80 cancel	0
Finance cost	25 + 15	(40)
Profit before tax		785
Tax	45 + 40	(85)
Profit after tax		700
Profit attributable to:		
Parent	(balancing)	633
Non-controlling interest	N1	77
		700

N1: NCI share in profit		Rs.
Subsidiary profit as given		400
Unrealised profit in inventory	35 - 30	(5)
Additional depreciation	100 / 10 years	(10)
		385
	NCI share	20%
		77

► **Example 52:**

The following are the statements of profit or loss for the year ended 31 December 2015 of Harry and its subsidiary Sally.

	Harry	Sally
	Rs.000	Rs.000
Revenue	1,120	390
Cost of sales	(610)	(220)
Gross profit	510	170
Distribution costs	(50)	(40)
Administration costs	(55)	(45)
Operating profit	405	85
Investment income	20	4
Finance costs	(18)	(4)
Profit before tax	407	85
Income tax expense	(140)	(25)
Profit for the year	267	60

The following information is relevant.

- (i) Harry acquired 75% of Sally six years ago when Sally's retained earnings were Rs.9,000.
- (ii) Harry made sales to Sally totalling Rs.100,000 in the year. At the year end the statement of financial position of Sally included inventory purchased from Harry. Harry had taken a profit of Rs.3,000 on this inventory.
- (iii) Harry's investment income includes Rs.15,000 being its share of Sally's dividends.

Required: Prepare a consolidated statement of profit or loss for the year ended 31 December 2015.

► **ANSWER:**

Consolidated statement of comprehensive income

For the year ended 31 December 20X1

		Rs. 000
Revenue	1,120 + 390 – 100	1,410
Cost of sales	610 + 220 – 100 + 3 URP	(733)
Gross profit		677
Distribution costs	50 + 40	(90)
Administrative expenses	55 + 45	(100)
Operating profit		487
Investment income	20 + 4 – 15 cancel dividend from Sally	9
Finance cost	18 + 4	(22)
Profit before tax		474
Tax	140 + 25	(165)
Profit after tax		309
Profit attributable to:		
Parent	(balancing)	294
Non-controlling interest	60 x 25%	15
		309

6.4 Unrealised profit on transfer of non-current assets

One entity in a group may sell a non-current asset to another entity of the group. The entity making the sale will recognize a profit or loss on disposal. The entity buying the asset will include the asset at purchase cost in its own accounts and depreciation will be based on that amount.

As far as the group is concerned no transfer has occurred. The consolidated financial statements must reflect non-current assets at the amount they would have been stated had the transfer not been made.

This will require consolidation adjustments:

- to remove the part of unrealized profit or loss on disposal from retained earnings of seller, similar to the adjustment required in respect of unrealized profit in inventory.
- to adjust accumulated depreciation so that depreciation is based on the asset's cost to the group.

In practice, a net adjustment is effected in the retained earnings of the entity making the unrealized profit.

The amount of adjustment (for URP) can be calculated through the following methods:

- profit on disposal, less additional depreciation; or
- carrying value at reporting date with transfer, less carrying value without transfer

If parent entity is seller

Impact on SFP	Decrease PPE / other asset Decrease group reserves

Impact on SCI	Decrease other income No impact on NCI share

If subsidiary entity is seller

Impact on SFP	Decrease PPE / other asset Decrease post-acquisition reserves of subsidiary (will ultimately effect NCI and group reserves)

Impact on SCI	Decrease other income Include the impact in calculation of NCI share

► **Example 53:**

Pane Limited (PL) owns 80% of Sane Limited (SL). There was a transfer of a non-current asset within the group (from PL to SL) for Rs. 15,000 on 1 January 20X3.

The original cost to PL was Rs. 20,000 and the accumulated depreciation at the date of transfer was Rs. 8,000. Assets had a remaining useful life of 3 year on the date of transfer.

Required: Calculate and discuss the effect of the above transfer in consolidated financial statements for the year ended 31 December 20X3.

► **ANSWER:**

Method 1: Calculation of unrealised profit		Rs.
Gain on disposal	15,000 – (20,000 – 8,000)	3,000
Additional depreciation	3,000 / 3 years	(1,000)
Unrealised gain	3,000 x 2/3 years	2,000

Method 2: Calculation of unrealised profit		Rs.
Carrying value (with transfer)	15,000 – (15,000 / 3 years)	10,000
Carrying value (without transfer)	12,000 – (12,000 / 3 years)	(8,000)
Unrealised gain		2,000

In consolidated financial statements, the following adjustments are required:

- Reduce non-current assets by Rs. 2,000
- Reduce group reserves (no impact on NCI as profit was recognised by parent entity) by Rs. 2,000
- Reduce other income (in profit or loss) by Rs. 2,000.
- No impact on NCI share of profit (as reversal of profit relates to parent entity).

► **Example 54:**

Puff Limited (PL) owns 80% of Shed Limited (SL). There was a transfer of a non-current asset within the group (from SL to PL) for Rs. 15,000 on 1 January 20X3.

The original cost to SL was Rs. 20,000 and the accumulated depreciation at the date of transfer was Rs. 8,000. Assets had a remaining useful life of 3 year on the date of transfer.

Required: Calculate and discuss the effect of the above transfer in consolidated financial statements for the year ended 31 December 20X3.

► **ANSWER:**

Method 1: Calculation of unrealised profit		Rs.
Gain on disposal	15,000 – (20,000 – 8,000)	3,000
Additional depreciation	3,000 / 3 years	(1,000)
Unrealised gain	3,000 x 2/3 years	2,000

Method 2: Calculation of unrealised profit		Rs.
Carrying value (with transfer)	15,000 – (15,000 / 3 years)	10,000
Carrying value (without transfer)	12,000 – (12,000 / 3 years)	(8,000)
Unrealised gain		2,000

In consolidated financial statements, the following adjustments are required:

- Reduce non-current assets by Rs. 2,000
- Reduce subsidiary's post-acquisition profits (impact of Rs. 1,600 on group reserves and impact of Rs. 400 on NCI) by Rs. 2,000
- Reduce other income (in profit or loss) by Rs. 2,000.
- The NCI share of profit will be reduced by Rs. 400 (i.e. 20% of Rs. 2,000).

► **Example 55:**

Pact Limited (PL) owns 80% of Same Limited (SL). There was a transfer of an asset within the group for Rs. 15,000 on 1 January 20X3.

The original cost was Rs. 30,000 and the accumulated depreciation at the date of transfer was Rs. 12,000. Assets had a remaining useful life of 3 years on the date of transfer.

Required: Calculate the unrealised profit (loss) of the above transfer in consolidated financial statements for the year ended 31 December 20X4.

► **ANSWER:**

Method 1: Calculation of unrealised profit		Rs.
Loss on disposal	15,000 – (30,000 – 12,000)	3,000
Lesser depreciation	3,000 x 2/3 years	(2,000)
Unrealised loss	3,000 x 1/3 years	1,000

Method 2: Calculation of unrealised profit		Rs.
Carrying value (with transfer)	15,000 – (15,000 x 2/3 years)	5,000
Carrying value (without transfer)	18,000 – (18,000 x 2/3 years)	(6,000)
Unrealised loss		1,000

► **Example 56:**

On 31 December 2011, Hard acquired 60% of the ordinary share capital of Soft for Rs.110 million. At that date Soft had a retained earnings balance of Rs.50 million and a share premium account balance of Rs.10 million.

The following statements of financial position have been prepared as at 31 December 2015.

	Hard	Soft
	Rs.000	Rs.000
Assets		
Non-current assets		
Property, plant and equipment	225,000	175,000
Investments in Soft	110,000	
Current assets	271,000	157,000
	606,000	332,000
Equity and liabilities		
Capital and reserves		
Share capital	100,000	100,000
Share premium	15,000	10,000
Retained earnings	260,000	80,000
	375,000	190,000
Current liabilities	231,000	142,000
	606,000	332,000

At start of 2015 Hard sold a tangible asset to Soft for Rs.50 million. The asset was originally purchased at start of 2012 at a cost of Rs.100 million and had a useful economic life of five years.

Soft's depreciation policy is 25% per annum based on cost.

Required: Prepare the consolidated statement of financial position of Hard and its subsidiary as at 31 December 2015.

► **ANSWER:****Consolidated statement of financial position**

As at 31 December 2015

Non-current assets		Rs. 000
Property, plant & equipment	$225,000 + 175,000 - 17,500 \text{ URP W5.1}$	382,500
Goodwill	W3	14,000
		396,500
Current assets	$271,000 + 157,000$	428,000
		824,500

Equity		Rs. 000
Share capital		100,000
Share premium		15,000
Retained earnings	W5	260,500
		375,500
Non-controlling interest	W4	76,000
		451,500
Current liabilities	231,000 + 142,000	373,000
		824,500

W1: Group Structure

Soft (Subsidiary)	Acquired on 31 December 2011
Parent's ownership 60%	NCI ownership 40%

W2: Net assets of subsidiary

	At Acquisition	Post-acquisition	At reporting date
	Rs. 000	Rs. 000	Rs. 000
Share capital	100,000		100,000
Share premium	10,000		10,000
Retained earnings	50,000	30,000	80,000
	160,000	30,000	190,000

W3: Goodwill

		Rs. 000
Investment		110,000
NCI at acquisition	160,000 x 40%	64,000
		174,000
Less: Net assets at acquisition	W2	(160,000)
Goodwill at acquisition		14,000

W4: Non-controlling interest

		Rs. 000
NCI at acquisition	160,000 x 40%	64,000
Share of post-acquisition reserves	30,000 x 40%	12,000
		76,000

W5: Group reserves (retained earnings)

	Rs. 000
Parent's retained earnings	260,000
URP on transfer of asset W5.1	(17,500)
Share of post-acquisition reserves $30,000 \times 60\%$	18,000
	260,500

W5.1 Unrealised profit on transfer of intangible asset	Rs. 000
NBV with transfer $[50,000 - (50,000 \times 25\%)]$	37,500
NBV without transfer $[100,000 - (100,000 / 5 \text{ years} \times 4 \text{ years})]$	20,000
Unrealised profit	17,500

► **Example 57:**

On 1 April 2014, Hasan Limited (HL) acquired 90% of the equity shares in Shakeel Limited (SL). On the same day HL accepted a 10% loan note from SL for Rs.200,000 which was repayable at Rs.40,000 per annum (on 31 March each year) over the next five years. SL's retained earnings at the date of acquisition were Rs. 2,200,000.

Statements of financial position as at 31 March 2015

	HL	SL
	Rs.000	Rs.000
<u>Non-current assets</u>		
Property, plant and equipment	2,120	1,990
Intangible – software	–	1,800
Investments – equity in SL	4,110	–
Investments – 10% loan note SL	200	–
Investments – others	65	210
	6,495	4,000
<u>Current assets</u>		
Inventories	719	560
Trade receivables	524	328
SL current account	75	–
Cash	20	–
	1,338	888
Total assets	7,833	4,888

	HL	SL
	Rs.000	Rs.000
<u>Equity and liabilities:</u>		
Equity shares of Rs.1 each	2,000	1,500
Share premium	2,000	500
Retained earnings	2,900	1,955
	6,900	3,955
<u>Non-current liabilities</u>		
10% Loan note from HL	–	160
Government grant	230	40
	230	200
<u>Current liabilities</u>		
Trade payables	475	472
HL current account	–	60
Income taxes payable	228	174
Operating overdraft	–	27
	703	733
Total equity and liabilities	7,833	4,888

The following information is relevant:

- (i) Included in SL's property at the date of acquisition was a leasehold property recorded at its depreciated historical cost of Rs.400,000.
 The leasehold had been sub-let for its remaining life of only four years at an annual rental of Rs.80,000 payable in advance on 1 April each year. The directors of HL are of the opinion that the fair value of this leasehold is best reflected by the present value of its future cash flows. An appropriate cost of capital for the group is 10% per annum.
 The present value of a Rs.1 annuity received at the end of each year where interest rates are 10% can be taken as:

3 year annuity Rs. 2.50
 4 year annuity Rs. 3.20
- (ii) The software of SL represents the depreciated cost of the development of an integrated business accounting package. It was completed at a capitalized cost of Rs.2,400,000 and went on sale on 1 April 2013. SL's directors are depreciating the software on a straight-line basis over an eight-year life (i.e. Rs.300,000 per annum). However, the directors of HL are of the opinion that a five-year life would be more appropriate as sales of business software rarely exceed this period.
- (iii) The inventory of HL on 31 March 2015 contains goods at a transfer price of Rs.25,000 that were supplied by SL who had marked them up with a profit of 25% on cost.
- (iv) On 31 March 2015 SL remitted to HL a cash payment of Rs. 55,000. This was not received by HL until early April. It was made up of an annual repayment of the 10% loan note of Rs.40,000 (the interest had already been paid) and Rs.15,000 of the current account balance.
- (v) The accounting policy of HL for non-controlling interests (NCI) in a subsidiary is to value NCI at a proportionate share of the net assets.
- (vi) An impairment test at 31 March 2015 on the consolidated goodwill concluded that it should be written down by Rs.120,000. No other assets were impaired.

Required: Prepare the consolidated statement of financial position of HL as at 31 March 2015.

► **ANSWER:****Consolidated statement of financial position****As at 31 March 2015**

Non-current assets		Rs. 000
Property, plant & equipment	2,120 + 1,990 – 90 W2.1	4,020
Goodwill	W3	480
Intangible assets	0 + 1,800 – 360 W2.2	1,440
Investment 10% loan notes	200 + 0 – 200 cancel	0
Investment (other)	65 + 210	275
		6,215
Current assets		
Inventory	719 + 560 – 5 URP	1,274
Receivable	524 + 328	852
Current account	75 + 0 – 75 cancel	0
Cash	20 + 0 + 55 in transit	75
		2,201
		8,416
Equity		
Share capital		2,000
Share premium		2,000
Retained earnings	W5	2,420
		6,420
Non-controlling interest	W4	350
		6,770
Non- current liabilities		
10% loan notes	0 + 160 – 160 cancel	0
Government grant	230 + 40	270
		270
Current liabilities		
Trade payable	475 + 472	947
Current account	0 + 60 – 60 cancel	0
Tax payable	228 + 174	402
Overdraft	0 + 27	27
		1,376
		8,416

W1: Group Structure

Shakeel Limited (Subsidiary)	Acquired on 1 April 2014
Parent's ownership 90%	NCI ownership 10%

W2: Net assets of subsidiary

		At Acquisition	Post-acquisition	At reporting date
		Rs. 000	Rs. 000	Rs. 000
Share capital		1,500		1,500
Share premium		500		500
Retained earnings		2,200	(245)	1,955
FV Adj: Leasehold	W2.1	(120)	30	(90)
FV Adj: Software	W2.2	(180)	(180)	(360)
URP Inventory	25 x 25/125		(5)	(5)
		3,900	(400)	3,500

W2.1: Leasehold property

		Rs. 000
Carrying value at acquisition		400
Fair value at acquisition (PV of rental receipts)	$[80 + (80 \times 2.5000)]$	(280)
Loss adjustment at acquisition		120
Less: Depreciation effect	$120 / 4 \text{ years}$	(30)
Loss adjustment at SFP date		90

W2.2: Lower useful life of software

	SL's Books	Rs. 000	Consolidation	Rs. 000
Capitalised amount	(1 April 2013)	2,400		2,400
Depreciation 2014	$2,400 / 8 \text{ years}$	(300)	$2,400 / 5 \text{ years}$	(480)
At acquisition date		2,100		1,920
Depreciation 2015	$2,400 / 8 \text{ years}$	(300)	$2,400 / 5 \text{ years}$	(480)
At SFP date		1,800		1,440

W3: Goodwill

		Rs. 000
Investment		4,110
NCI at acquisition	$3,900 \times 10\%$	390
		4,500
Less: Net assets at acquisition	W2	(3,900)
Goodwill at acquisition		600
Less: Impairment		(120)
		480

W4: Non-controlling interest

		Rs. 000
NCI at acquisition	3,900 x 10%	390
Share of post-acquisition reserves	(400) x 10%	(40)
		350

W5: Group reserves (retained earnings)

		Rs. 000
Parent's retained earnings		2,900
Share of post-acquisition reserves	(400) x 90%	(360)
Less: Impairment of goodwill		(120)
		2,420

► **Example 58:**

The draft Statement of Financial Position of Flamsteed Ltd and Halley Ltd on 30 June 2016 were as follows:

Statement of financial position as at 30 June 2016

	Flamsteed Ltd	Halley Ltd
	Rs.'000	Rs.'000
Assets:		
Non-current Assets:		
Property, plant and equipment	100,000	80,000
4,000 ordinary shares in Halley at cost	60,000	-
	160,000	80,000
Current assets:		
Inventory	6,000	16,000
Owed by Flamsteed Ltd	-	20,000
Receivables	32,000	14,000
Cash	4,000	-
	42,000	50,000
Total assets	202,000	130,000
Equity and liabilities:		
Equity (ordinary shares @ Rs. 10)	90,000	50,000
Revaluation surplus	24,000	10,000
Retained earnings	52,000	56,000
	166,000	116,000
Current Liabilities:		
Owed to Halley Ltd	16,000	-
Trade payables	20,000	14,000
	36,000	14,000
Total equity and liabilities	202,000	130,000

Additional information:

- (i) Flamsteed Ltd acquired its investment in Halley Ltd on 1 July 2015, when the retained earnings of Halley Ltd stood at Rs. 12,000,000.
- (ii) The agreed consideration was Rs. 60,000,000 at the date of acquisition and a further Rs.20,000,000 on 1 July 2017, Flamsteed Ltd.'s cost of capital is 7%.
- (iii) Halley Ltd has an internally developed brand name – TOLX – which was valued at Rs.10,000,000 at the date of acquisition. The brand has indefinite useful life.
- (iv) There have been no changes in the capital or revaluation surplus of Halley Ltd since the date its shares were purchased.
- (v) At 30 June 2016, Halley had invoiced Flamsteed Ltd for goods to the value of Rs.4,000,000 and Flamsteed Ltd had sent payment in full but this had not been received by Halley Ltd.
- (vi) There is no impairment of goodwill. It is the group's policy to value non-controlling interest at fair value. At the acquisition date, the non-controlling interest was valued at Rs. 18,000,000.

Required: Prepare an extract of consolidated Statement of Financial position of Flamsteed Ltd for the year ended 30 June 2016, showing the assets side only.

► **ANSWER:****Consolidated statement of financial position (assets only)****As at 30 June 2016**

Non-current assets		Rs. 000
Property, plant & equipment	100,000 + 80,000	180,000
Goodwill	W3	13,468
Intangible asset (brand)		10,000
		203,468
Current assets		
Inventory	6,000 + 16,000	22,000
Receivables	32,000 + 14,000	46,000
Owed by Flamsteed	20,000 – 16,000 cancel – 4,000 in transit	0
Cash	4,000 + 0 + 4,000 in transit	8,000
		76,000
		279,468

W1: Group Structure

Halley Limited (Subsidiary)	Acquired on 1 July 2015
Parent's ownership 80% (4,000 / 5,000)	NCI ownership 20%

W2: Net assets of subsidiary

	At Acquisition	Post-acquisition	At reporting date
	Rs. 000	Rs. 000	Rs. 000
Share capital	50,000		50,000
Revaluation surplus	10,000		10,000
Retained earnings	12,000	44,000	56,000
FV adjustment (Brand)	10,000		10,000
	82,000	44,000	126,000

W3: Goodwill

		Rs. 000
Investment	$60,000 + 20,000 \times 1.07^{-2}$	77,468
NCI at acquisition	(at fair value)	18,000
		95,468
Less: Net assets at acquisition	W2	82,000
Goodwill at acquisition		13,468

► **Example 59:**

Tooba Limited (TL) acquired 80% ordinary shares of Maheera Limited (ML) on 1 July 2021.

The statements of financial position of both companies as at 30 June 2022 are as under:

	TL	ML
	Rs. m	Rs. m
Non-current assets		
Property, plant and equipment	500	600
Investment in ML	530	
Current assets	280	410
	1,310	1,010
Equity		
Ordinary Share capital (Rs. 10 each)	800	500
Retained earnings	260	280
	1,060	780
Liabilities	250	230
	1,310	1,010

The statements of comprehensive income of both companies for the year ended 30 June 2022 are as under:

	TL	ML
	Rs. m	Rs. m
Revenue	1,478	1,230
Cost of sales	(990)	(970)
Gross profit	488	260
Other income	45	40
Distribution costs	(80)	(40)
Administrative expenses	(175)	(105)
Profit before tax	278	155
Taxation	(98)	(45)
Profit after tax	180	110

Additional information:

- During the year ML sold goods to TL for Rs. 75 million. These goods were priced at cost plus 25% mark-up. TL has sold 80% of these goods at further mark-up of 15% to entities outside group. By the year-end, TL has paid (and ML has received) 50% of the amount due.
- On 1st January 2022, TL transferred one of its plant to ML for Rs. 140 million. The book value of this plant on the date of transfer was Rs. 100 million and it had remaining useful life of 8 years at this date. ML had immediately paid this amount to TL.

TL measures non-controlling interest at fair value as at the date of acquisition that was measured at Rs. 225 million.

Required: Prepare for TL, consolidated statement of financial position as at June 30, 2022 and consolidated statement of comprehensive income for the year then ended.

▶ **ANSWER:****Consolidated statement of financial position**

As at 30 June 2022

Non-current assets		Rs. million
Property, plant & equipment	500 + 600 – 37.5 URP	1,062.5
Goodwill	W3	85
Current assets	280 + 410 – 37.5 cancel – 3 URP	649.5
		1,797
Equity		
Share capital	800	800
Retained earnings	W5	308.1
Non-controlling interest	W4	246.4
Liabilities	250 + 230 – 37.5 cancel	442.5
		1,797

W1: Group Structure

Maheera Limited (Subsidiary)	Acquired on 1 July 2021
Parent's ownership 80%	NCI ownership 20%

W2: Net assets of subsidiary

	At Acquisition	Post-acquisition	At reporting date
	Rs. m	Rs. m	Rs. m
Share capital	500		500
Retained earnings	170	110	280
URP Inventory [75 x 20% x 25/125]		(3)	(3)
	670	107	777

W3: Goodwill

	Rs. m
Investment	530
NCI at acquisition (at fair value)	225
	755
Less: Net assets at acquisition W2	(670)
Goodwill at acquisition	85

W4: Non-controlling interest

	Rs. m
NCI at acquisition (at fair value)	225
Share of post-acquisition reserves 107 x 20%	21.4
	246.4

W5: Group reserves (retained earnings)

	Rs. m
Parent's retained earnings	260
URP on transfer of NCA [40m - (40m/8 years x 6/12)]	(37.5)
Share of post-acquisition reserves 107 x 80%	85.6
	308.1

Consolidated statement of comprehensive income**For the year ended 30 June 2022**

	Rs. million
Revenue 1,478 + 1,230 - 75 cancel	2,633
Cost of sales 990 + 970 - 75 cancel + 3 URP	(1,888)
Gross profit	745
Other income 45 + 40 - 37.5 URP	47.5
Distribution costs 80 + 40	(120)
Administrative expenses 175 + 105	(280)
Profit before tax	392.5
Taxation 98 + 45	(143)
Profit after tax	249.5
Profit attributable to:	
Parent (balancing)	228.1
Non-controlling interest N1	21.4
	249.5

N1: NCI share in profit	Rs. million
Subsidiary profit as given	110
Unrealised profit in inventory	(3)
	107
NCI Share	20%
	21.4

► **Example 60:**

Haseeb Limited (HL) acquired 80% ordinary shares of Raheem Limited (RL) on 1 July 2021.

The statements of financial position of both companies as at 30 June 2022 are as under:

	HL	RL
	Rs. m	Rs. m
Non-current assets		
Property, plant and equipment	500	600
Investment in RL	530	
Current assets	280	410
	1,310	1,010
Equity		
Ordinary Share capital (Rs. 10 each)	800	500
Retained earnings	260	280
	1,060	780
Liabilities	250	230
	1,310	1,010

The statements of comprehensive income of both companies for the year ended 30 June 2022 are as under:

	HL	RL
	Rs. m	Rs. m
Revenue	1,478	1,230
Cost of sales	(990)	(970)
Gross profit	488	260
Other income	45	40
Distribution costs	(80)	(40)
Administrative expenses	(175)	(105)
Profit before tax	278	155
Taxation	(98)	(45)
Profit after tax	180	110

Additional information:

- During the year HL sold goods to RL for Rs. 80 million. These goods were priced at 25% margin. RL has sold half of these goods to entities outside group.
- On 1st January 2022, RL transferred one of its plant to HL for Rs. 130 million. The book value of this plant on the date of transfer was Rs. 100 million and it had remaining useful life of 8 years at this date.
- On 30 June 2022, HL books show a receivable of Rs. 25 million from RL which does not match with RL books which show a different payable balance to HL due to a cheque in transit of Rs. 7 million.

HL measures non-controlling interest at fair value as at the date of acquisition that was measured at Rs. 225 million.

Required: Prepare for HL, consolidated statement of financial position as at June 30, 2022 and consolidated statement of comprehensive income for the year then ended.

► **ANSWER:****Consolidated statement of financial position**

As at 30 June 2022

Non-current assets		Rs. million
Property, plant & equipment	500 + 600 – 28.13 URP	1,071.87
Goodwill	W3	85
Current assets	280 + 410 – 10 URP – 25 cancel + 7 in transit	662
		1,818.87
Equity		
Share capital	800	800
Retained earnings	W5	315.5
Non-controlling interest	W4	241.37
Liabilities	250 + 230 – 18 cancel	462
		1,818.87

W1: Group Structure

Raheem Limited (Subsidiary)	Acquired on 1 July 2021
Parent's ownership 80%	NCI ownership 20%

W2: Net assets of subsidiary

	At Acquisition	Post-acquisition	At reporting date
	Rs. m	Rs. m	Rs. m
Share capital	500		500
Retained earnings	170	110	280
URP NCA [30 – (30/8 x 6/12)]		(28.13)	(28.13)
	670	81.87	751.87

W3: Goodwill

	Rs. m
Investment	530
NCI at acquisition (at fair value)	225
	755
Less: Net assets at acquisition W2	(670)
Goodwill at acquisition	85

W4: Non-controlling interest

	Rs. m
NCI at acquisition (at fair value)	225
Share of post-acquisition reserves 81.87 x 20%	16.37
	241.37

W5: Group reserves (retained earnings)

	Rs. m
Parent's retained earnings	260
URP inventory 80m x 1/2 x 25%	(10)
Share of post-acquisition reserves 81.87 x 80%	65.5
	315.5

Consolidated statement of comprehensive income**For the year ended 30 June 2022**

	Rs. million
Revenue 1,478 + 1,230 – 80 cancel	2,628
Cost of sales 990 + 970 – 80 cancel + 10 URP	(1,890)
Gross profit	738
Other income 45 + 40 – 28.13 URP	56.87
Distribution costs 80 + 40	(120)
Administrative expenses 175 + 105	(280)
Profit before tax	394.87
Taxation 98 + 45	(143)
Profit after tax	251.87
Profit attributable to:	
Parent (balancing)	235.5
Non-controlling interest N1	16.37
	251.87

N1: NCI share in profit	Rs. million
Subsidiary profit as given	110
Unrealised profit NCA	(28.13)
	81.87
NCI Share	20%
	16.37

► **Example 61:**

Following is the summarised trial balance of Fatima Limited (FL) and its subsidiary, Ali Limited (AL) for the year ended December 31, 2018:

	FL	AL
	-----Rs. in million-----	
Cash and bank balances	4,920	2,700
Accounts receivable	6,240	6,580
Stocks in trade – closing	14,460	5,680
Investment in AL	10,500	-
Other investments	20,100	-
Property, plant and equipment	22,500	5,940
Cost of sales	49,200	21,000
Operating expenses	3,600	5,400
Accumulated depreciation	(5,760)	(1,260)
Ordinary share capital (Rs. 10 each)	(30,000)	(6,000)
Retained earnings – opening	(33,780)	(4,800)
Sales	(57,600)	(33,800)
Accounts payable	(2,760)	(1,440)
Gain on sale of fixed assets	(540)	-
Dividend income	(1,080)	-

Following additional information is also available:

- On January 1, 2018, FL acquired 480 million shares of AL from its major shareholder for Rs.10,500 million.
- The following inter-company sales were made during the year 2018:

	Sales	Included in buyer's closing stocks in trade	Amount receivable/ payable at year end	Gross profit% on Sales
	-----Rs. in million-----			
FL to AL	2,800	900	300	20
AL to FL	5,000	1,300	500	30

- (iii) On January 2, 2018, FL sold certain plants and machineries to AL. Details of the transaction are as follows:

	Rs. in million
Sales value	144
Less: Cost of plant and machineries	150
Accumulated depreciation	(60)
Net book value	90
Gain on sale of plant	54

- (iv) The plants and machineries were purchased two years ago and were being depreciated on straight line method over a period of five years. AL computed depreciation thereon using the same method based on the remaining useful life.
- (v) FL billed Rs. 100 million to AL for management services provided during the year 2018 and credited it to operating expenses. The invoices were paid on December 15, 2018.
- (vi) Details of cash dividend are as follows:

	Dividend		
	Date of declaration	Date of payment	%
FL	November 25, 2018	January 5, 2019	20
AL	October 15, 2018	November 20, 2018	10

AL has not recorded declaration payment of dividend yet and FL has not recorded declaration of dividend yet. However, FL has recorded receipt of payment from AL.

Required: Prepare consolidated statement of financial position and statement of comprehensive income of FL for the year ended December 31, 2018. Ignore tax and corresponding figures.

► **ANSWER:**

Consolidated statement of comprehensive income

For the year ended 31 December 2018

		Rs. million
Revenue	57,600 + 33,800 – 7,800	83,600
Cost of sales	49,200 + 21,000 – 7,800 + 180 URP + 390 URP	(62,970)
Gross profit		20,630
Gain on disposal of PPE	540 + 0 – 36 URP	504
Dividend income	1,080 + 0 – 480 from AL	600
Operating expenses	3,600 + 5,400	(9,000)
Profit after tax		12,734
Profit attributable to:		
Parent	(balancing)	11,332
Non-controlling interest	N1	1,402
		12,734

N1: NCI share in profit		Rs. million
Subsidiary profit (from TB)	33,800 – 21,000 – 5,400	7,400
Unrealised profit in inventory		(390)
		7,010
	NCI Share	20%
		1,402

Consolidated statement of financial position**As at 31 December 2018**

Non-current assets		Rs. m
Property, plant & equipment	22,500 + 5,940 – 5,760 – 1,260 – 36 URP	21,384
Goodwill	W3	1,860
Investments (other)	20,100 + 0	20,100
		43,344
Current assets		
Inventory	14,460 + 5,680 – 390 URP – 180 URP	19,570
Receivable	6,240 + 6,580 – 800 cancel	12,020
Cash	4,920 + 2,700 – 600	7,020
		38,610
		81,954
Equity		
Share capital		30,000
Retained earnings	W5	39,112
Non-controlling interest	W4	3,442
		72,554
Current liabilities		
Trade payables	2,760 + 1,440 – 800 cancel	3,400
Dividend payable	30,000 x 20% (FL)	6,000
		9,400
		81,954

W1: Group Structure

Ali Limited (Subsidiary)	Acquired on 1 January 2018
Parent's ownership 80% (480/600)	NCI ownership 20%

W2: Net assets of subsidiary

	At Acquisition	Post-acquisition	At reporting date
	Rs. m	Rs. m	Rs. m
Share capital	6,000		6,000
Retained earnings	4,800	7,400*	
Less: Dividend 6,000 x 10%		(600)	
		6,800	11,600
URP inventory 1,300 x 30%		(390)	(390)
	10,800	6,410	17,210

*Profit for the year 33,800 – 21,000 – 5,400 (from trial balance)

W3: Goodwill

	Rs. m
Investment	10,500
NCI at acquisition 10,800 x 20%	2,160
	12,660
Less: Net assets at acquisition W2	(10,800)
Goodwill at acquisition	1,860

W4: Non-controlling interest

	Rs. m
NCI at acquisition 10,800 x 20%	2,160
Share of post-acquisition reserves 6,410 x 20%	1,282
	3,442

W5: Group reserves (retained earnings)

	Rs. m
Parent's retained earnings Opening balance	33,780
Profit [57,600 – 49,200 + 540 + 1,080 – 3,600]	6,420
Dividend [30,000 x 20%]	(6,000)
	34,200
URP inventory 900 x 20% margin	(180)
URP NCA 54 – 54/3 years	(36)
Share of post-acquisition reserves 6,410 x 80%	5,128
	39,112

7. COMPREHENSIVE EXAMPLES

► Example 62:

The following summarized statements of financial position pertain to Alpha Limited (AL) and its subsidiary Delta Limited (DL) as at 30 June 2014.

	AL	DL
	----- Rs. in million -----	
Property, plant and equipment	460	200
Investment (2 million shares of DL)	340	-
Long term loan granted to DL	30	-
Current assets	595	400
	1,425	600
Share capital (Rs. 100 each)	600	250
Retained earnings	325	200
Long term borrowings	200	72
Current liabilities	300	78
	1,425	600

Following relevant information is available:

- (i) AL acquired investment in DL on 1 July 2013 when retained earnings of DL were Rs.140 million and the fair value of DL's net assets was equal to their carrying values.
- (ii) Both the companies depreciate equipment at 10%, on straight line basis. On 30 June 2014, AL sold certain equipment to DL as detailed below:

	Rs. in million
Cost	40
Accumulated depreciation	30
Sale proceeds	25

- (iii) Inter-company sales of goods are invoiced at a mark-up of 20%. The relevant details are as under:

	Rs. in million
AL's inventory includes goods purchased from DL	27
DL's inventory includes goods purchased from AL	24
Receivable from DL on 30 June 2014 as per AL's books	19
Payable to AL on 30 June 2014 as per DL's books	19

- (iv) Long term loan was granted to DL on 1 July 2013. It is repayable after five years and Carries interest at 12% per annum, payable on 30 June and 31 December, each year.
- (v) AL values non-controlling interest at the acquisition date at its fair value which was Rs.80 million.

Required: Prepare a consolidated statement of financial position as at 30 June 2014 in accordance with the requirements of International Financial Reporting Standards.

► ANSWER:

Consolidated Statement of financial Position**As at 30 June 2014**

Non-current assets		Rs. m
Property, plant and equipment	[460 + 200 - 15]	645
Goodwill	W3	30
Long term loan	[30 - 30 Cancel]	0
		675
Current assets	[595 + 400 - 4.5 - 4 - 19 cancel]	967.5
		1,642.5
Equity		
Share Capital		600
Retained earnings (group)	W5	350.4
Non-Controlling Interest	W4	91.1
		1,041.5
Non-current liabilities	[200 + 72 - 30 cancel]	242
Current liabilities	[300 + 78 - 19 cancel]	359
		1,642.5

W1 Group Structure

Delta Limited (Subsidiary)	Acquired on 1 July 2013
Parent's ownership 80% (2m / 2.5m shares)	NCI ownership 20%

W2 Net Assets of Subsidiary	At Acquisition	Post-acquisition	At SFP date
	Rs. m	Rs. m	Rs. m
Share capital	250		250
Retained earnings	140	60	200
URP Inventory [27 x 20/120]		(4.5)	(4.5)
	390	55.5	445.5

W3 Goodwill		Rs. m
Investment		340
NCI at Acquisition [at FV]		80
		420
Less: Net assets at acquisition	W2	(390)
Goodwill in SFP		30

W4 Non-Controlling Interest		Rs. m
NCI at Acquisition	[at FV]	80
Share of post-acquisition reserves	[55.5 x 20%]	11.1
		91.1

W5 Group Retained Earnings		Rs. m
Parent's reserves		325
URP NCA	[25 sale proceeds - 10 book value]	(15)
URP Inventory	[24 x 20/120]	(4)
Share of post-acquisition reserves	[55.5 x 80%]	44.4
		350.4

► **Example 63:**

On 1 July 2014, Galaxy Limited (GL) acquired controlling interest in Beta Limited (BL). The following information has been extracted from the financial statements of GL and BL for the year ended 30 June 2015.

	GL	BL
	Rs. in million	
Share capital (Rs. 100 each)	100	50
Retained earnings – 1 July 2014	40	18
Profit for the year ended 30 June 2015	20	6
Shareholders' equity/Net assets	160	74
Investment in BL (300,000 shares)	50	-
Inter-company sales (at invoice value)	25	30
Inter-company purchases remained unsold at year-end	9	5
Inter-company current account balances	7	(4)

Other relevant information is as under:

- (i) On the date of acquisition, fair value of BL's net assets was equal to their book value except for the following:
 - Fair value of a land exceeded its carrying value by Rs. 20 million.
 - The value of a plant was impaired by Rs. 10 million. The impairment was also recorded by BL on 2 July 2014
 - BL measures its property, plant and equipment using cost model.
- (ii) There is no change in share capital since 1 July 2014.
- (iii) Inter-company sales are invoiced at cost plus 20%. The difference between the current account balances is due to goods dispatched by GL on 30 June 2015 which were received by BL on 5 July 2015.
- (iv) GL values non-controlling interest at the acquisition date at its fair value which was Rs. 35 million.
- (v) As at 30 June 2015, goodwill of BL was impaired by 10%.

Required: Compute the amounts of goodwill, consolidated retained earnings and non-controlling interest as they would appear in GL's consolidated statement of financial position as at 30 June 2015.

► ANSWER:

Computation for Consolidated SFP**As at 30 June 2015**

		Rs. m
Goodwill	W3	6.3
Consolidated retained earnings	W5	66.95
Non-controlling interest	W4	40.52

W1 Group Structure

Beta Limited (Subsidiary)	Acquired on 1 July 2014
Parent's ownership 60% [300,000 / 500,000]	NCI ownership 40%

W2 Net Assets of Subsidiary	At Acquisition	Post-acquisition	At SFP date
	Rs. m	Rs. m	Rs. m
Share capital	50		50
Retained earnings	18	6	24
FV adjustment: Land	20		20
Reversal of impairment: Plant		10	10
FV adjustment: Plant	(10)		(10)
URP Inventory [9 x 20/120]		(1.5)	(1.5)
	78	14.5	92.5

W3 Goodwill	Rs. m
Investment	50
NCI at Acquisition [at FV]	35
	85
Less: Net assets at acquisition W2	(78)
Goodwill at acquisition	7
Less: Impairment @10%	(0.7)
Goodwill in SFP	6.3

W4 Non-Controlling Interest	Rs. m
NCI at Acquisition [at FV]	35
Share of post-acquisition reserves [14.5 x 40%]	5.8
Share of impairment loss [0.7 x 40%]	(0.28)
	40.52

W5 Group Retained Earnings		Rs. m
Parent's reserves	[40 + 20]	60
URP Inventory	[5 + 3 = 8 x 20/120]	(1.33)
Impairment of goodwill	[0.7 x 60%]	(0.42)
Share of post-acquisition reserves	[14.5 x 60%]	8.70
		66.95

► **Example 64:**

Following information has been extracted from the financial statements of Yasir Limited (YL) and Bilal Limited (BL) for the year ended 30 June 2016.

Assets	YL	BL	Equity & Liabilities	YL	BL
	Rs. in million			Rs. in million	
Fixed assets	250	540	Share capital(Rs.10 each)	750	500
Acc. depreciation	(70)	(70)	Retained earnings	340	258
	180	470		1090	758
Investment in BL – at cost	675		Loan from YL	-	12
Loan to BL	16		Creditors & other liabilities	75	51
Stock in trade	160	150			
Other current assets	71	50			
Cash and bank	63	151			
	1,165	821		1,165	821

Additional information:

- (i) On 1 July 2014, YL acquired 75% shares of BL at Rs.18 per share. On the acquisition date, fair value of BL's net assets was equal to its book value except for an office building whose fair value exceeded its carrying value by Rs.12 million. Both companies provide depreciation on building at 5% on straight line basis.
- (ii) Year-wise net profit of both companies are given below:

	2016	2015
	---- Rs. in million -----	
YL	219	105
BL	11	168

- (iii) The following inter-company sales were made during the year ended 30 June 2016:

	Sales	Included in buyer's closing stock in trade	Profit %
	----- Rs. in million -----		
YL to BL	120	20	30% on cost
BL To YL	80	32	15% on sale

- (iv) BL declared interim dividend of 12% in the year 2015 and final dividend of 20% for the year 2016.
- (v) The loan was granted by YL to BL on 1 July 2014 and carries interest rate of 12% payable annually. The principal is repayable in five equal annual instalments of Rs.4 million each. On 30 June 2016, BL issued a cheque of Rs.5.92 million which was received by YL on 2 July 2016. No interest has been accrued by YL.
- (vi) YL values non-controlling interest on the date of acquisition at its fair value. BL's share price was Rs. 15 on acquisition date.
- (vii) An impairment test has indicated that goodwill of BL was impaired by 10% on 30 June 2016. There was no impairment during the previous year.

Required: Prepare a consolidated statement of financial position as at 30 June 2016 in accordance with the requirements of International Financial Reporting Standards.

► **ANSWER:**

Consolidated Statement of financial Position

As at 30 June 2016

Non-current assets		Rs. m
Property, plant & equipment	[180 + 470 + 10.8]	660.8
Goodwill	W3	190.35
Loan to BL	[16 - 4 - 12]	0
		851.15
Current assets		
Stock in trade	[160 + 150 - 4.62 - 4.8]	300.58
Other current assets	[71 + 50]	121
Cash and bank	[63 + 151 + 1.92 + 4]	219.92
		641.5
		1,492.65
Equity		
Share Capital		750
Retained earnings (group)	W5	406.19
Non-Controlling Interest	W4	210.46
		1,366.65
Non-current liabilities		
Loan from YL	[12 - 12]	0
Current liabilities		
Creditors & other liabilities	[75 + 51]	126
		1,492.65

W1 Group Structure

Bilal Limited (Subsidiary)	Acquired on 1 July 2014 (two years ago)
Parent's ownership 75%	NCI ownership 25%

W2 Net Assets of Subsidiary	At Acquisition	Post-acquisition	At SFP date
	Rs. m	Rs. m	Rs. m
Share capital	500		500
Retained earnings W2.1	139	119	258
FV Adj: Building [12 x 5% x 2 years]	12	(1.2)	10.8
URP Inventory [32 x 15%]		(4.8)	(4.8)
	651	113	764

W2.1: Post Acquisition		
Profits	[11+ 168]	179
Less: Dividend	[12% x Rs. 500m]	(60)
		119

W3 Goodwill		Rs. m
Investment		675
NCI at Acquisition	[50m shares x 25% x Rs. 15]	187.5
		862.5
Less: Net assets at acquisition	W2	(651)
Goodwill at acquisition		211.5
Less: Impairment	@10%	(21.15)
Goodwill in SFP		190.35

W4 Non-Controlling Interest		Rs. m
NCI at acquisition	[50m shares x 25% x Rs. 15]	187.5
Share of post-acquisition reserves	[113 x 25%]	28.25
Share of impairment loss	[21.15 x 25%]	(5.29)
		210.46

W5 Group Retained Earnings		Rs. m
Parent's reserves		340
URP Inventory	[20 x 30/130]	(4.62)
Interest on Loan	[16 x 12%]	1.92
Share of impairment of goodwill	[21.15 x 75%]	(15.86)
Share of post-acquisition reserves	[113 x 75%]	84.75
		406.19

► **Example 65:**

The draft summarized statements of financial position of Golden Limited (GL) and its subsidiary Silver Limited (SL) as at 31 December 2016 are as follows:

	GL	SL
	----- Rs. in million -----	
Building	1,600	500
Plant & machinery	1,465	690
Investment in SL	327	-
Current assets	2,068	780
	5,460	1,970
Share capital (Rs. 10 each)	980	450
Share premium	730	150
Retained earnings	3,150	210
	4,860	810
Liabilities	600	1,160
	5,460	1,970

- (i) GL acquired 60% of the shares of SL on 1 April 2016 at following consideration:

- Issuance of 20 million ordinary shares;
- Cash amounting to Rs. 87 million, which includes consultancy charges of Rs. 10 million and legal expenses of Rs. 5 million.

The market value of each share of GL and SL on acquisition date was Rs. 12 and Rs. 11 respectively. At acquisition date, retained earnings of SL were Rs. 100 million.

- (ii) The following table sets out those items whose fair value on the acquisition date was different from their book value. These values have not been incorporated in SL's books of account.

	Book value	Fair value
	-----Rs. in million-----	
Building	250	170
Inventory	112	62
Provision for bad debts	(15)	(24)

- (iii) Upon acquisition of SL, a contract for management services was also signed under which GL would provide various management services to SL at an annual fee of Rs. 50 million from the date of acquisition. The payment would be made in two equal instalments payable in arrears on 1 April and 1 October.

- (iv) On 30 September 2016, GL acquired a plant from SL in exchange of a building which was currently not in use of GL. The details of plant and building are as follows:

	Cost	Accumulated depreciation	*Exchange price
	----- Rs. in million -----		
Building	240	130	120
Plant	200	80	120

* Equivalent to fair value

Both companies follow cost model for subsequent measurement of property, plant and equipment and charge depreciation on building and plant at 5% and 20% respectively on cost.

- (v) SL paid an interim cash dividend of 10% on 31 July 2016.

- (vi) GL values non-controlling interest at the acquisition date at its fair value.

Required: Prepare a consolidated statement of financial position as at 31 December 2016 in accordance with the requirements of International Financial Reporting Standards.

► ANSWER:

Consolidated Statement of financial Position**As at 31 December 2016**

Non-current assets		Rs. m
Building	[1,600 + 500 - 77 - 11.5]	2,011.5
Plant & machinery	[1,465 + 690 - 4]	2,151
Goodwill	W3	0
		4,162.5
Current assets	[2,068 + 780 - 50 - 9 - 12.5*]	2,776.5
		6,939
Equity		
Share Capital		980
Share premium		730
Retained earnings (group)	W5	3,239.9
		4,949.9
Non-Controlling Interest	W4	241.6
		5,191.5
Liabilities	[600 + 1,160 - 12.5*]	1,747.5
		6,939

*Management services (RA&PA) = Rs. 50m x 3/12 months = Rs. 12.5m

W1 Group Structure

Silver Limited (Subsidiary)	Acquired on 1 April 2016 (9 months)
Parent's ownership 60%	NCI ownership 40%

W2 Net Assets of Subsidiary	At Acquisition	Post-acquisition	At SFP date
	Rs. m	Rs. m	Rs. m
Share capital	450		450
Share premium	150		150
Retained earnings	100	110	210
FV Adj: Building [80 x 5% x 9/12]	(80)	3	(77)
FV Adj: Inventory [62 - 112]	(50)		(50)
FV Adj: RA (current assets) [15 - 24]	(9)		(9)
URP Plant W2.1		(4)	(4)
	561	109	670

W2.1 Unrealised profit on plant

NBV without transfer	$[120 - (200 \times 20\% \times 3/12)]$	110
NBV with transfer	$[120 - (120 \times 20\% \times 3/12)]$	114
Unrealised profit		4

W3 Goodwill

		Rs. m
Investment	$[327 - 15]$	312
NCI at Acquisition	$[45\text{m shares} \times 40\% \times \text{Rs. } 11]$	198
		510
Less: Net assets at acquisition	W2	(561)
Negative goodwill (bargain purchase)		(51)
Transfer to retained earnings		51
Goodwill in SFP		0

W4 Non-Controlling Interest

		Rs. m
NCI at acquisition	$[45\text{m shares} \times 40\% \times \text{Rs. } 11]$	198
Share of post-acquisition reserves	$[109 \times 40\%]$	43.6
		241.6

W5 Group Retained Earnings

		Rs. m
Parent's reserves		3,150
Acquisition costs		(15)
URP building	W5.1	(11.5)
+ Negative goodwill (gain)		51
Share of post-acquisition reserves	$[109 \times 60\%]$	65.4
		3,239.9

W5.1 Unrealised profit on building

NBV without transfer	$[110 - (240 \times 5\% \times 3/12)]$	107
NBV with transfer	$[120 - (120 \times 5\% \times 3/12)]$	118.5
Unrealised profit		11.5

► **Example 66:**

Following are the draft statement of financial position of Jasmine Limited (JL) and its subsidiary, Sunflower Limited (SL) as on 31 December 2017:

	JL	SL
	----- Rs. in million -----	
Property, plant and equipment	880	330
Intangible assets	40	50
Investment in SL	520	-
Loan to JL	-	120
Current assets	640	345
	2,080	845
Share capital (Rs. 10 each)	700	200
Share premium	240	-
Retained earnings	720	410
Loan from SL	96	-
Current liabilities	324	235
	2,080	845

Additional information:

- (i) JL acquired 75% shares of SL on 1 January 2017. Cost of investment in JL's books consists of:
 - 10 million JL's ordinary shares issued at Rs. 24 per share; and
 - cash payment of Rs. 280 million (including professional fee of Rs. 10 million for advice on acquisition of SL)
- (ii) On acquisition date, carrying value of SL's net assets was equal to fair value except an intangible asset (brand) whose fair value was Rs. 40 million as against carrying value of Rs. 25 million. The remaining useful life of the brand is estimated at 5 years. The recoverable amount of the brand at 31 December 2017 was estimated at Rs. 28 million.
- (iii) JL values non-controlling interest at fair value. The market price of SL's shares was Rs. 36 at the date of acquisition, which has increased to Rs. 40 as of 31 December 2017.
- (iv) JL and SL showed a net profit of Rs. 200 million and Rs. 60 million respectively for the year ended 31 December 2017.
- (v) The loan was granted on 1 July 2017 and carries mark-up of 10% per annum. A cheque of Rs. 30 million including interest was dispatched by JL on 31 December 2017 but was received by SL after the year end. No interest has been accrued by SL in its financial statements.
- (vi) On 1 May 2017 SL sold a machine to JL for Rs. 52 million at a gain of Rs. 12 million. However, no payment has yet been made by JL. The remaining useful life of the machine at the time of disposal was 2 years.
- (vii) During the year, JL made sales of Rs. 250 million to SL at 20% above cost. 60% of these goods are included in SL's closing stock.
- (viii) SL declared interim cash dividend of 10% in November 2017 which was paid on 2 January 2018. The dividend has correctly been recorded by both companies.

Required: Prepare JL's consolidated statement of financial position as at 31 December 2017.

► ANSWER:

Consolidated Statement of financial Position**As at 31 December 2017**

Non-current assets		Rs. m
Property, plant & equipment	[880 + 330 - 8]	1,202
Goodwill		W3 105
Other Intangible assets	[40 + 50 + 8]	98
Loan to JL	[120 - 24 - 96]	0
		1,405
Current assets	[640 + 345 + 30 - 52 - 25 - 15*]	923
		2,328
Equity		
Share Capital		700
Share premium		240
Retained earnings (group)	W5	708.25
Non-Controlling Interest	W4	187.75
		1,836
Loan from SL	[96 - 96]	0
Current liabilities	[324 + 235 - 52 - 15*]	492
		2,328

*Dividend (RA&PA) = Rs. 20m x 75% = Rs. 15m

W1 Group Structure

Sunflower Limited (Subsidiary)	Acquired on 1 January 2017
Parent's ownership 75%	NCI ownership 25%

W2 Net Assets of Subsidiary		At Acquisition	Post-acquisition	At SFP date
		Rs. m	Rs. m	Rs. m
Share capital		200		200
Share premium		0		0
Retained earnings	W2.2	370	40	410
FV Adj: Brand	W2.1	15	(7)	8
Unrecorded interest income	[120 x 10% x 6/12]		6	6
URP machine transfer	W2.3		(8)	(8)
		585	31	616

W2.1 FV adjustment, amortisation and impairment	NBV	Diff.	FV
At acquisition	25	15	40
Amortisation (over 5 years)	(5)	(3)	(8)
	20		32
Impairment	0	(4)	(4)
CA at year end	20	8	28

W2.2: Post Acquisition reserves		
Profits		60
Less: Dividend	[10% x Rs. 200m]	(20)
		40

W2.3: Unrealised profit on transfer of machine		
Gain on disposal		12
Less: Depreciation impact	[12 / 2 years x 8/12]	(4)
		8

W3 Goodwill		Rs. m
Investment	[520 - 10]	510
NCI at Acquisition	[20m shares x 25% x Rs. 36]	180
		690
Less: Net assets at acquisition	W2	(585)
		105

W4 Non-Controlling Interest		Rs. m
NCI at Acquisition	[20m shares x 25% x Rs. 36]	180
Share of post-acquisition reserves	[31 x 25%]	7.75
		187.75

W5 Group Retained Earnings		Rs. m
Parent's reserves		720
Acquisition costs		(10)
URP Inventory	[250 x 60% x 20/120]	(25)
Share of post-acquisition reserves	[31 x 75%]	23.25
		708.25

► **Example 67:**

The following summarised Trial Balances pertain to Rivera Limited (RL) and its subsidiary Chenab Limited (CL) for the year ended 31 December 2014:

	RL		CL	
	Debit	Credit	Debit	Credit
	----- Rs. in million -----			
Sales	-	285	-	320
Cost of sales	186	-	240	-
Selling and distribution expenses	27	-	25	-
Administration expenses	17	-	15	-
Finance charges	8	-	10	-
Tax expense	19	-	12	-
Share capital (Rs. 100 each)	-	350	-	200
Retained earnings – 1 January 2014	-	50	-	36
Property, plant and equipment	190	-	263	-
Current assets	23	-	35	-
Investment in CL (1.6 million shares)	250	-	-	-
Current liabilities	-	35	-	44
	720	720	600	600

Other relevant information is as under:

- (i) RL acquired the controlling interest in CL on 1 January 2014. On the acquisition date, fair value of CL's net assets was equal to its book value except for an office building whose fair value exceeded its carrying value by Rs. 18 million. The remaining useful life of the office building on the acquisition date was 15 years.
- (ii) Inter-company sales are invoiced at cost plus 20%. Details of inter-company transactions for the year ended 31 December 2014 are as follows:
 - RL sold goods amounting to Rs. 60 million to CL. At year-end, inventory of CL included Rs. 9.60 million in respect of such goods.
 - CL sold goods amounting to Rs. 48 million to RL. At year-end, inventory of RL included Rs. 16.80 million in respect of such goods.
- (iii) There were no inter-company balances outstanding at the year-end.
- (iv) RL values the non-controlling interest at its proportionate share of CL's identifiable net assets.
- (v) As at 31 December 2014, goodwill of CL was impaired by 10%.

Required: In accordance with the requirements of International Financial Reporting Standards, prepare:

- a) Consolidated Statement of Comprehensive Income for the year ended 31 December 2014.
- b) Consolidated Statement of Financial Position as at 31 December 2014. (06) (Ignore tax effects on the adjustments).

► **ANSWER:****Consolidated Statement of Comprehensive Income****For the year ended 31 December 2014**

	Rs. m
Revenue [285 + 320 - 60 - 48]	497
Cost of sales [186 + 240 - 60 - 48 + 1.6 + 2.8]	(322.4)
Gross profit	174.6
Selling & Distribution exp. [27 + 25]	(52)
Admin exp. [17 + 15 + 1.2 + 4.68]	(37.88)
Finance costs [8 + 10]	(18)
Profit before tax	66.72
Tax expense [19 + 12]	(31)
Profit after tax	35.72

Profit / Total comprehensive income attributable to:		
Owners of parent (balancing)		32.92
Non-controlling interest	N1	2.80
		35.72

N1: NCI share in profit		Rs. m
Subsidiary's profit (as given)		18
Depreciation (on fair value adjustment)		(1.2)
URP Inventory		(2.8)
Subsidiary's profit (after adjustments)		14
		20%
		2.80

Consolidated Statement of financial Position**As at 31 December 2014**

Non-current assets		Rs. m
Property, plant and equipment [190 + 263 + 16.8]		469.8
Goodwill	W3	42.12
		511.92
Current assets [23 + 35 - 1.6 - 2.8]		53.6
		565.52

Equity		
Share Capital		350
Retained earnings (group)	W5	82.92
Non-Controlling Interest	W4	53.60
		486.52
Current liabilities	[35 + 44]	79
		565.52

W1 Group Structure

Chenab Limited (Subsidiary)	Acquired on 1 January 2014
Parent's ownership 80% (1.6m/2m shares)	NCI ownership 20%

W2 Net Assets of Subsidiary	At Acquisition	Post-acquisition	At SFP date
	Rs. m	Rs. m	Rs. m
Share capital	200		200
Retained earnings	36	18*	54
FV Adjustment: building [18 / 15 years]	18	(1.2)	16.8
URP Inventory [16.8 x 20/120]		(2.8)	(2.8)
	254	14	268

*320 - 240 - 25 - 15 - 10 - 12 = 18

W3 Goodwill	Rs. m
Investment	250
NCI at Acquisition [254 x 20%]	50.8
	300.8
Less: Net assets at acquisition W2	(254)
Goodwill at acquisition	46.8
Impairment @10%	(4.68)
Goodwill in SFP	42.12

W4 Non-Controlling Interest	Rs. m
NCI at acquisition [254 x 20%]	50.8
Share of post-acquisition reserves [14 x 20%]	2.8
	53.60

W5 Group Retained Earnings		Rs. m
Parent's reserves on 1 Jan 2014		50
Profit for the year	[285 - 186 - 27 - 17 - 8 - 19 from TB]	28
URP Inventory	[9.6 x 20/120]	(1.6)
Impairment of goodwill		(4.68)
Share of post-acquisition reserves	[14 x 80%]	11.2
		82.92

► **Example 68:**

The summarized trial balances of Oscar Limited (OL) and United Limited (UL) as at 31 December 2015 are as follows:

	Oscar Limited (OL)		United Limited (UL)	
	Debit	Credit	Debit	Credit
	----- Rs. in million -----			
Sales		835		645
Cost of sales	525		396	
Operating expense	115		102	
Tax expense	65		48	
Share capital (Rs. 10 each)		600		250
Share premium		150		60
Retained earnings as at 1 January 2015		265		179
Current liabilities		115		105
Property, plant and equipment	390		350	
Cost of investment	500			
Stock-in-trade	125		115	
Trade receivables	140		125	
Cash and bank	105		103	
	1,965	1,965	1,239	1,239

Additional information:

- On 1 May 2015, OL acquired 80% shares of UL. UL has not recognised the value of brand in its books of account. At the date of acquisition, the fair value of brand was assessed at Rs. 45 million. The remaining useful life of the brand was estimated as 15 years.
- OL charged Rs. 2.5 million monthly to UL for management services provided from the date of acquisition and has credited it to operating expenses.
- On 1 October 2015, UL sold a machine to OL for Rs. 24 million. The machine had been purchased on 1 October 2013 for Rs. 26 million. On the date of acquisition the machine was assessed as having a useful life of ten years and that estimate has not changed. Gain on disposal was erroneously credited to sales account.

(iv) Other inter-company transactions during the year 2015 were as follows:

	Sales	Included in buyer's closing stock in trade	Profit %
	----- Rs. in million -----		
OL to UL	60	20	25% on cost
UL To OL	30	5	20% on sale%

UL settled the inter-company balance as on 31 December 2015 by issuing a cheque of Rs. 30 million. However, the cheque was received by OL on 1 January 2016.

(v) The non-controlling interest is measured at the proportionate share of UL's identifiable net assets. It may be assumed that profits of both companies had accrued evenly during the year.

Required: Prepare consolidated statement of comprehensive income for the year ended 31 December 2015 and consolidated statement of financial position as at 31 December 2015.

► **ANSWER:**

Consolidated Statement of Comprehensive Income
For the year ended 31 December 2015

	Rs. m
Revenue [835 + 645 x 8/12 - 3.2 - 60]	1,201.8
Cost of sales [525 + 396 x 8/12 - 60 + 4 + 1]	(734)
Gross profit	467.8
Operating expenses [115 + 102 x 8/12 + 2 - 20* + 20*]	(185)
Other income [3.2 gain - 3.1 unrealised]	0.1
Profit before tax	282.9
Tax [65 + 48 x 8/12]	(97)
Profit after tax	185.9

Profit attributable to:		
Owners of parent (balancing)		173.92
Non-controlling interest	N1	11.98
		185.9

N1: NCI share in profit			Rs. m
Subsidiary's profit (as given)	[Post acquisition only]	W2.2	66
Amortisation (FV Adj)			(2)
URP machine transfer			(3.1)
URP inventory			(1)
Subsidiary's profit (after adjustments)			59.9
			20%
			11.98

*Intra group management services = 2.5m x 8 months = Rs. 20m

Consolidated Statement of financial Position

As at 31 December 2015

Non-current assets		Rs. m
Property, plant and equipment	[390 + 350 - 3.1]	736.9
Brand	[45 - 2]	43
Goodwill	W3	46.4
		826.3
Current assets		
Stock in Trade	[125 + 115 - 4 - 1]	235
Trade receivables	[140 + 125 - 30]	235
Cash and bank	[105 + 103 + 30]	238
		708
		1,534.3
Equity		
Share Capital		600
Share premium		150
Retained earnings (group)	W5	438.92
Non-Controlling Interest	W4	125.38
		1,314.3
Current liabilities	[115 + 105]	220
		1,534.3

W1: Group Structure

United Limited (Subsidiary)	Acquired on 1 May 2015 (8 months ago)
Parent's ownership 80%	NCI ownership 20%

W2 Net Assets of Subsidiary		At Acquisition	Post-acquisition	At SFP date
		Rs. m	Rs. m	Rs. m
Share capital		250		250
Share premium		60		60
Retained earnings	W2.2	212	66	278
FV Adjustment: Brand	[45 / 15 x 8/12]	45	(2)	43
URP machine transfer	W2.1		(3.1)	(3.1)
URP Inventory	[5 x 20%]		(1)	(1)
		567	59.9	626.9

W2.1 Unrealised profit on transfer of machine		Rs. m
NBV with transfer	$[24 - 24/8 \times 3/12]$	23.25
NBV without transfer	$[26 - 26/10 \times 2.25]$	20.15
Unrealised profit		3.1

W2.2 Retained earnings		Rs. m
Opening balance		179
Profit for the year (first 4 months)	$645 - 396 - 102 - 48 = 99 \times 4/12$	33
		212
Post acquisition (8 months)	$645 - 396 - 102 - 48 = 99 \times 8/12$	66
Closing balance		278

W3 Goodwill		Rs. m
Investment		500
NCI at Acquisition	$[567 \times 20\%]$	113.4
		613.4
Less: Net assets at acquisition	W2	(567)
Goodwill in SFP		46.4

W4 Non-Controlling Interest		Rs. m
NCI at acquisition	$[567 \times 20\%]$	113.4
Share of post-acquisition reserves	$[59.9 \times 20\%]$	11.98
		125.38

W5 Group Retained Earnings		Rs. m
Parent's RE at 1 Jan 2015		265
Profit for the year	$[835 - 525 - 115 - 65]$	130
URP Inventory	$[20 \times 25/125]$	(4)
Share of post-acquisition reserves	$[59.9 \times 80\%]$	47.92
		438.92

► **Example 69:**

The following balances are extracted from the records of Present Limited (PL) and Future Limited (FL) for the year ended 30 June 2017:

	PL		FL	
	Debit	Credit	Debit	Credit
	----- Rs. in million -----			
Sales		2,060		1,524
Cost of sales	1,300		846	
Selling and administrative expenses	350		225	
Investment income		190		50
Gain on disposal of fixed assets - net		35		
Taxation	80		60	
Share capital (Rs. 10 each)		3,500		2,600
Retained earnings as on 30 June 2017		1,996		704

Additional information:

- (i) PL acquired 65% shares of FL on 1 September 2016 against the following consideration:

- Cash payment of Rs. 900 million.
- Issuance of shares having nominal value of Rs. 1,000 million.

The fair value of each share of PL and FL on acquisition date was Rs. 16 and Rs. 12 respectively. Retained earnings of PL and FL on the acquisition date were Rs. 1,671 million and Rs. 506.5 million respectively.

At acquisition date, fair value of FL's net assets was equal to their book value except a brand which had not been recognised by FL. The fair value of the brand is assessed at Rs. 90 million. PL estimates that benefit would be obtained from the brand for the next 10 years.

- (ii) The incomes and expenses of FL had accrued evenly during the year except investment income. The investment income is exempt from tax and had been recognised in August 2016 and received in September 2016.
- (iii) On 1 January 2017 PL sold a manufacturing plant having carrying value of Rs. 42 million to FL against cash consideration of Rs. 30 million. The plant had a remaining useful life of 6 years on the date of disposal.
- (iv) On 1 February 2017 FL delivered goods having sale price of Rs. 100 million to PL on 'sale or return basis'. 40% of these goods were returned on 1 May 2017 and the remaining were accepted by PL. 20% of the goods accepted were included in the closing inventory of PL. FL earned a profit of 33.33% on cost.
- (v) Both companies paid interim cash dividend at the rate of 5% in May 2017.
- (vi) An impairment test carried out at year end has indicated that goodwill of FL has been impaired by 10%.
- (vii) PL measures the non-controlling interest at its fair value.

Required:

- (a) Prepare consolidated statement of profit or loss for the year ended 30 June 2017.
- (b) Compute the amounts of consolidated retained earnings and non-controlling interest as would appear in the consolidated statement of financial position as at 30 June 2017.

► ANSWER:

Consolidated Statement of Comprehensive Income

		Rs. m
Revenue	$[2,060 + 1,524 \times 10/12 - 60]$	3,270
Cost of sales	$[1,300 + 846 \times 10/12 - 60 + 3]$	(1,948)
Gross profit		1,322
Selling & admin exp.	$[350 + 225 \times 10/12 + 7.5 + 39.55]$	(584.55)
Investment income	$[190 + 0 - 84.5^*]$	105.5
Gain on disposal	$[35 + 11]$	46
Profit before tax		888.95
Tax	$[80 + 60 \times 10/12]$	(130)
Profit after tax		758.95

*Intra group dividend = Rs. 2,600m x 5% = Rs. 130m x 65% =

84.5

Profit attributable to:

Owners of parent	661.84
Non-controlling interest	97.11
	758.95

N1: NCI share in profit

	Rs. m
Subsidiary's profit	$[(1,524 - 846 - 225 + 0 - 60) \times 10/12]$
Depreciation (FV Adj)	(7.5)
URP Inventory	(3)
Impairment of goodwill	(39.55)
Subsidiary's profit (after adjustments)	277.45
	35%
	97.11

Consolidated Statement of financial Position

As at 30 June 2017

		Rs. m
Retained earnings (group)	W5	2,102.84
Non-Controlling Interest	W4	1,143.61

W1: Group Structure

Future Limited (Subsidiary)	Acquired on 1 September 2016 (10 months ago)
Parent's ownership 65%	NCI ownership 35%

W2 Net Assets of Subsidiary	At Acquisition	Post-acquisition	At SFP date
	Rs. m	Rs. m	Rs. m
Share capital	2,600		2,600
Retained earnings	506.5	197.5	704
FV Adj: Brand [90 / 10 x 10/12]	90	(7.5)	82.5
URP Inventory [100 x 60% x 20% x 33.33/133.33]		(3)	(3)
	3,196.5	187	3,383.5

W3 Goodwill		Rs. m
Investment	[900 cash + 1,000 / Rs. 10 x Rs. 16]	2,500
NCI at Acquisition	[260m shares x 35% x Rs. 12]	1,092
		3,592
Less: Net assets at acquisition	W2	(3,196.5)
Goodwill at acquisition		395.5
Impairment	@10%	(39.55)
Goodwill in SFP		355.95

W4 Non-Controlling Interest		Rs. m
NCI at acquisition	[260m shares x 35% x Rs. 12]	1,092
Share of post-acquisition reserves	[187 x 35%]	65.45
Impairment of goodwill	[39.55 x 35%]	(13.84)
		1,143.61

W5 Group Retained Earnings		Rs. m
Parent's reserves		1,996
Unrealised loss on transfer of plant	W5.1	11
Impairment of goodwill	[39.55 x 65%]	(25.71)
Share of post-acquisition reserves	[187 x 65%]	121.55
		2,102.84

W5.1 Unrealised loss on transfer of plant		Rs. m
Loss on disposal	[42 - 30]	12
- Lesser depreciation	[12 / 6 years x 6/12]	(1)
Unrealised loss		11

► **Example 70:**

The following summarized trial balances pertain to Arrow Limited (AL) and its subsidiary Box Limited (BL) for the year ended 31 December 2018:

	AL		BL	
	Debit	Credit	Debit	Credit
	----- Rs. in million -----			
Sales	-	5,177	-	3,996
Cost of sales	3,255	-	2,448	-
Operating expenses	713	-	636	-
Other income	-	350	-	18
Tax expense	403	-	288	-
Share capital (Rs. 10 each)	-	3,720	-	1,600
Share premium	-	1,430	-	322
Retained earnings as at 1 January 2018	-	2,293	-	516
Current liabilities	-	713	-	651
Property, plant and equipment	5,418	-	1,934	-
Investments	1,600	-	-	-
Loan to BL's Director	10	-	-	-
Current assets	2,284	-	1,797	-
	13,683	13,683	7,103	7,103

Additional information:

- (i) AL acquired 96 million shares of BL on 1 May 2018 at following consideration:
 - Cash payment of Rs. 450 million
 - Issuance of 40 million shares of AL at Rs. 25 each
- (ii) On acquisition date, carrying values of BL's net assets were equal to fair value except the following:
 - A building whose fair values and value-in-use were Rs. 390 million and Rs. 520 million respectively as against carrying value of Rs. 480 million. The group follows cost model for subsequent measurement of property, plant and equipment. The remaining life of building on acquisition date was 20 years. Fair value of the building has increased to Rs. 440 million at 31 December 2018.
 - A brand which had not been recognized by BL. The fair value of the brand was assessed at Rs. 162 million. It is estimated that benefit would be obtained from the brand for the next 6 years.
- (iii) AL measures the non-controlling interest at fair value. On the date of acquisition, the market price of BL's shares was Rs. 14 per share.
- (iv) On 1 July 2018 AL sold an equipment to BL for Rs. 250 million at a gain of Rs. 20 million. BL has charged depreciation of Rs. 12.5 million on this equipment.
- (v) In each month of 2018, BL sold goods costing Rs. 40 million to AL at cost plus 20%. At year end, 75% of the goods purchased in December were included in stock of AL.
- (vi) BL's credit balance of Rs. 38 million in AL's books does not agree with BL's books due to Rs. 7 million charged by AL for management service on 26 December 2018. Total management fee charged by AL to BL since acquisition amounted to Rs. 16 million.

- (vii) BL declared interim cash dividend of Re. 0.50 per share in December 2018. AL has correctly recorded the dividend in its books. However, BL has not yet accounted for the dividend.
- (viii) The incomes and expenses of BL may be assumed to have accrued evenly during the year.

Required: Prepare the following:

- consolidated statement of profit or loss for the year ended 31 December 2018.
- consolidated statement of financial position as at 31 December 2018.

► **ANSWER:**

Consolidated Statement of Comprehensive Income

For the year ended 31 December 2018

		Rs. m
Revenue	[5,177 + 3,996 x 8/12 - 384*]	7,457
Cost of sales	[3,255 + 2,448 x 8/12 - 384* + 6]	(4,509)
Gross profit		2,948
Operating expenses	[713 + 636 x 8/12 - 3 + 18 + 7 - 16]	(1,143)
Other income	[350 + 18 x 8/12 - 19 - 16 - 48**]	279
Gain on bargain purchase	W3	378
Profit before tax		2,462
Tax	[403 + 288 x 8/12]	(595)
Profit after tax		1,867

Profit attributable to:	
Owners of parent	1,707
Non-controlling interest	160
	1,867

*Rs. 40m x 120% = 48m x 8 months = Rs. 384m

** Rs. 80m Dividend x 60% = Rs. 48m

N1: NCI share in profit		Rs. m
Subsidiary's profit	W2	428
Dep FV Adj: (Building)		3
Dep FV Adj: (Brand)		(18)
URP Inventory		(6)
Unrecorded management costs		(7)
Subsidiary's profit (after adjustments)		400
		40%
		160

Consolidated Statement of financial Position**As at 31 December 2018**

Non-current assets		Rs. m
Property, plant and equipment	[5,418 + 1,934 - 87 - 19]	7,246
Other investments	[1,600 - 1,450]	150
Loan to director		10
Brand		144
		7,550
Current assets	[2,284 + 1,797 - 6 - 45 - 48]	3,982
		11,532
Equity		
Share Capital		3,720
Share premium		1,430
Retained earnings (group)	W5	4,000
Non-Controlling Interest	W4	1,024
		10,174
Current liabilities	[713 + 651 + 7 - 45 + 80 - 48]	1,358
		11,532

W1 Group Structure

Box Limited (Subsidiary)	Acquired on 1 May 2018 (8 months)
Parent's ownership 60% [96m / 160m shares]	NCI ownership 40%

W2 Net Assets of Subsidiary		At Acquisition	Post-acquisition	At SFP date
		Rs. m	Rs. m	Rs. m
Share capital		1,600		1,600
Share premium		322		322
Retained earnings	[516 + 642 x 4/12]	730	428*	1,158
FV Adj. (Building)	[90 / 20 x 8/12]	(90)	3	(87)
FV Adj. (Brand)	[162 / 6 x 8/12]	162	(18)	144
URP Inventory	[48 x 75% x 20/120]		(6)	(6)
Management costs			(7)	(7)
Unrecorded dividend	[0.5 x 160m shares]		(80)	(80)
		2,724	320	3,044

$$*3,996 - 2,448 - 636 + 18 - 288 = 642 \times 8/12 = 428$$

W3 Goodwill		Rs. m
Investment	[450m cash x 40m shares x Rs. 25]	1,450
NCI at Acquisition	[160m shares x 40% x Rs. 14]	896
		2,346
Less: Net assets at acquisition	W2	(2,724)
Goodwill at acquisition		(378)
Transfer to RE (W5) and PL		378
Goodwill in SFP		0

W4 Non-Controlling Interest		Rs. m
NCI at acquisition	[160m shares x 40% x Rs. 14]	896
Share of post-acquisition reserves	[320 x 40%]	128
		1,024

W5 Group Retained Earnings		Rs. m
Parent's RE on 1 Jan 2018		2,293
Profit for the year	[5,177 - 3,255 - 713 + 350 - 403]	1,156
URP on transfer of equipment		(19)
Gain on bargain purchase	W3	378
Share of post-acquisition reserves	[320 x 60%]	192
		4,000

W5.1 Unrealised profit on transfer of equipment		Rs. m
Gain		20
Less: Extra depreciation	[20 x 10%* x 6/12]	(1)
		19
Dep = Cost x Rate x 6/12		
*Rate = Dep/Cost x 12/6	[12.5 / 250 x 12 /6]	10%

► *Example 71:*

For the purpose of this question, assume that the date today is 1 September 2024. Weekday Limited (WL) is currently in the process of finalizing its financial statements for the year ended 30 June 2024. The following matter is under consideration:

On 1 January 2024, WL acquired entire shareholding of Eta Limited (EL). The purchase agreement includes contingent consideration of Rs. 90 million, payable if EL achieves a specified target profit in the next 12 months. At the acquisition date, it was not probable that EL would meet this target. However, at 30 June 2024, EL has attained 60% of the target profit within six months, and it is now probable that the target will be achieved.

Required: Discuss how the above issue should be dealt with in the financial statements of WL for the year ended 30 June 2024. Support your answers in the context of relevant IFRSs.

► *Answer:*

Contingent consideration should be recognized at fair value at the acquisition date as part of the consideration transferred. On 1 January 2024, the fair value of the contingent consideration would be significantly lower than Rs. 90 million due to low probability of achieving the target profit. As of June 30, 2024, it is now probable that the target profit will be met. The fair value of the contingent consideration would be adjusted to reflect this increased probability. The increase in the fair value of the contingent consideration liability as of 30 June 2024 would be taken to profit or loss and would not affect goodwill/consideration transferred.

8. OBJECTIVE BASED Q&A

01. On what basis may a subsidiary be excluded from consolidation?
- (a) The activities of the subsidiary are dissimilar to the activities of the rest of the group
 - (b) The subsidiary was acquired with the intention of reselling it after a short period of time
 - (c) The subsidiary is based in a country with strict exchange controls which make it difficult for it to transfer funds to the parent
 - (d) The above three statements are not valid reasons for excluding a subsidiary from consolidation.
02. When negative goodwill arises IFRS 3 Business combinations requires that the amounts involved in computing goodwill should first be reassessed.
When the amount of the negative goodwill has been confirmed, how should it be accounted for?
- (a) Charged as an expense in profit or loss
 - (b) Capitalised and presented under non-current assets
 - (c) Credited to profit or loss
 - (d) Shown as a deduction from non-current assets
03. Which **TWO** of the following statements are correct when preparing consolidated financial statements?
- (a) A subsidiary cannot be consolidated unless it prepares financial statements to the same reporting date as the parent.
 - (b) A subsidiary with a different reporting date may prepare additional statements up to the group reporting date for consolidation purposes.
 - (c) A subsidiary's financial statements can be included in the consolidation if the gap between the parent and subsidiary reporting dates is five months or less.
 - (d) Where a subsidiary's financial statements are drawn up to a different reporting date from those of the parent, adjustments should be made for significant transactions or events occurring between the two reporting dates.
04. IFRS 10 *Consolidated financial statements* provides a definition of control and identifies three separate elements of control.
Which one of the following is **not** one of these elements of control?
- (a) Power over the investee
 - (b) The power to participate in the financial and operating policies of the investee
 - (c) Exposure to, or rights to, variable returns from its involvement with the investee
 - (d) The ability to use its power over the investee to affect the amount of the investor's returns
05. Chemist Limited (CL) owns 100% of the share capital of the following companies. The directors are unsure of whether the investments should be consolidated.
In which of the following circumstances would the investment NOT be consolidated?
- (a) CL has decided to sell its investment in Alpha Limited as it is loss-making; the directors believe its exclusion from consolidation would assist users in predicting the group's future profits
 - (b) Beta Limited is a bank and its activity is so different from the engineering activities of the rest of the group that it would be meaningless to consolidate it
 - (c) Delta Limited is located in a country where local accounting standards are compulsory, and these are not compatible with IFRS used by the rest of the group
 - (d) Gamma Limited is located in a country where a military coup has taken place and CL has lost control of the investment for the foreseeable future

06. Ahmad Hassan Limited acquired 70% of the Rs. 100 million equity share capital of Asar Limited, its only subsidiary, for Rs. 200 million on 1 January 2019 when the retained earnings of Asar Limited were Rs. 156 million.

At 31 December 2019 retained earnings are as follows.

	Rs. million
Ahmad Hassan Limited	275
Asar Limited	177

Ahmad Hassan Limited considers that goodwill on acquisition is impaired by 50%. Non-controlling interest is measured at fair value, estimated at Rs. 82.8 million.

What are group retained earnings at 31 December 2019?

- (a) Rs. 276.3 million
 (b) Rs. 289.7 million
 (c) Rs. 280.32 million
 (d) Rs. 269.2 million
07. On 1 April 2010 Golden Limited acquired 75% of Silver Limited's equity shares by means of a share exchange and an additional amount payable on 1 April 2011 that was contingent upon the post-acquisition performance of Silver Limited. At the date of acquisition Golden Limited assessed the fair value of this contingent consideration at Rs. 4.2 million but by 31 March 2011 it was clear that the amount to be paid would be only Rs. 2.7 million. How should Golden Limited account for this Rs. 1.5 million adjustments in its financial statements as at 31 March 2011?
- (a) Debit current liabilities/Credit goodwill
 (b) Debit retained earnings/Credit current liabilities
 (c) Debit goodwill/Credit current liabilities
 (d) Debit current liabilities/Credit retained earnings
08. On 31 July 2018 Parveen Limited acquired 60% of the 18 million Rs. 10 ordinary shares of Sidra Limited for a sum of Rs. 432 million. Sidra Limited had accumulated profits at 1 January 2018 of Rs. 360 million and during the year to 31 December 2018 made a profit of Rs. 108 million.
 Fair value of non-controlling interest at the date of acquisition is Rs. 200 million
 What is the goodwill that should appear in the consolidated statement of financial position at 31 December 2018?
- (a) Rs. 108 million
 (b) Rs. 29 million
 (c) Rs. 171 million
 (d) Rs. 43.2 million
09. Tanveer Limited acquired Tabeer Traders, an unincorporated entity, for Rs. 2.8 million. A fair value exercise performed on Tabeer Traders' net assets at the date of purchase showed:

	Rs. 000
Property, plant and equipment	3,000
Identifiable intangible asset	500
Inventory	300
Trade receivables less payables	200
	4,000

How would the purchase be reflected in the consolidated statement of financial position?

- (a) Record the net assets at their above values and credit profit or loss with Rs. 1.2 million
 - (b) Record the net assets at their above values and credit goodwill with Rs. 1.2 million
 - (c) Ignore the intangible asset (Rs. 500,000), recording the remaining net assets at their values shown above and crediting profit or loss with Rs. 700,000
 - (d) Record the purchase as a financial asset investment at Rs. 2.8 million
10. Which of the following definitions is not included within the definition of control per IFRS 10 *Consolidated Financial Statements*?
- (a) Having power over the investee
 - (b) Having exposure, or rights, to variable returns from its investment with the investee
 - (c) Having the majority of shares in the investee
 - (d) Having the ability to use its power over the investee to affect the amount of the investor's returns
11. Sunshine Limited acquired 80% of the share capital of Sun Flower Limited on 1 January 2011. Part of the purchase consideration was Rs. 200 million cash to be paid on 1 January 2014. The applicable cost of capital is 10%.
What will the deferred consideration liability be at 31 December 2012?
- (a) Rs. 150.262 million
 - (b) Rs. 165.288 million
 - (c) Rs. 200 million
 - (d) Rs. 181.818 million
12. Which TWO of the following situations are unlikely to represent control over an investee?
- (a) Owning 55% and being able to elect 4 of the 7 directors
 - (b) Owning 51%, but the constitution requires that decisions need the unanimous consent of shareholders
 - (c) Having currently exercisable options which would take the shareholding in the investee to 55%
 - (d) Owning 35% of the ordinary shares and 80% of the preference shares of the investee
13. Which of the following is not a condition which must be met for the parent to be exempt from producing consolidated financial statements?
- (a) The activities of the subsidiary are significantly different to the rest of the group and to consolidate them would prejudice the overall group position
 - (b) The ultimate parent produces consolidated financial statements that comply with IFRS Standards and are publicly available
 - (c) The parent's debt or equity instruments are not traded in a public market
 - (d) The parent itself is a wholly owned subsidiary or a partially owned subsidiary whose owners do not object to the parent not producing consolidated financial statements

14. Consolidated financial statements are presented on the basis that the companies within the group are treated as if they are a single economic entity.

Which TWO of the following are requirements of preparing consolidated financial statements?

- (a) All subsidiaries must adopt the accounting policies of the parent in their individual financial statements
- (b) Subsidiaries with activities which are substantially different to the activities of other members of the group should not be consolidated
- (c) All assets and liabilities of subsidiaries should be included at fair value
- (d) Unrealised profits within the group must be eliminated from the consolidated financial statements

15. High Limited has a number of relationships with other companies. In which of the following relationships is High Limited necessarily the parent?

- (i) Fall Limited has 50,000 non-voting and 100,000 voting equity shares in issue with each share receiving the same dividend. High Limited owns all of Fall Limited's non-voting shares and 40,000 of its voting shares.
 - (ii) Low Limited has 1 million equity shares in issue of which High Limited owns 40%. High Limited also owns Rs. 800,000 out of Rs. 1 million 8% convertible debentures issued by Low Limited. These debentures may be converted on the basis of 40 equity shares for each Rs. 100 of debentures, or they may be redeemed in cash at the option of the holder.
 - (iii) High Limited owns 49% of the equity shares in Middle Limited and 52% of its non-redeemable preference shares. As a result of these investments, High Limited receives variable returns from Middle Limited and has the ability to affect these returns through its power over Middle Limited.
- (a) (i) only
 - (b) (i) and (ii) only
 - (c) (ii) and (iii) only
 - (d) All three

16. On 1 March 2019, Qazi Limited acquired 70% of the share capital of Hijazi Limited at a cost of Rs. 387 million.

At that date the fair value of the net assets of Hijazi Limited were Rs. 450 million. Transaction costs incurred in making the acquisition were Rs. 0.045 million. Qazi Limited has decided to account for the business combination using the full goodwill or fair value method, by attributing some goodwill to the non-controlling interests in Hijazi Limited. It is estimated that at 1 March 2019 the fair value of the non-controlling interests in Hijazi Limited was Rs. 153 million.

What was the total amount of goodwill recognised on the acquisition of Hijazi Limited by Qazi Limited?

- (a) Rs. 90 million
- (b) Rs. Nil
- (c) Rs. 72 million
- (d) Rs. 100 million

17. Sound Limited obtained a 60% holding in the 10 million Rs. 10 shares of Cloud Limited on 1 January 2018, when the retained earnings of Cloud Limited were Rs. 850 million.
- Consideration comprised Rs. 250 million cash, Rs. 400 million payable on 1 January 2019 and one share in Sound Limited for each two shares acquired. Sound Limited has a cost of capital of 8% and the market value of its shares on 1 January 2018 was Rs. 23.
- Sound Limited measures non-controlling interest at fair value. The fair value of the non-controlling interest at 1 January 2018 was estimated to be Rs. 400 million.
- What was the goodwill arising on acquisition?
- (a) Rs. 39.37 million
 - (b) Rs. 139.37 million
 - (c) Rs. 239.37 million
 - (d) Rs. 70.37 million
18. On 1 August 2017 Magnesium Limited purchased 1.8 million of the 2.4 million Rs. 10 equity shares of Copper Limited. The acquisition was through a share exchange of two shares in Magnesium Limited for every three shares in Copper Limited. The market price of a share in Magnesium Limited at 1 August 2017 was Rs. 57.5.
- Magnesium Limited will also pay in cash on 31 July 2019 (two years after acquisition) Rs. 24.2 per acquired share of Copper Limited. Magnesium Limited's cost of capital is 10% per annum.
- What is the amount of the consideration attributable to Magnesium Limited for the acquisition of Copper Limited?
- (a) Rs. 69 million
 - (b) Rs. 112.56 million
 - (c) Rs. 105 million
 - (d) Rs. 93.5 million
19. Big Limited acquired 70% of Small Limited's 10 million Rs. 10 ordinary shares for Rs. 800 million when the retained earnings of Small Limited were Rs. 570 million and the balance in its revaluation surplus was Rs. 150 million. The non-controlling interest in Small Limited was judged to have a fair value of Rs. 220 million at the date of acquisition.
- What was the goodwill arising on acquisition?
- (a) Rs. Nil
 - (b) Rs. 20 million (negative)
 - (c) Rs. 20 million
 - (d) Rs. 200 million
20. Faiqa Limited acquired 75% of the 120,000 Rs. 10 ordinary shares in Saiqa Limited on 1 January 2014. At that date Saiqa Limited had accumulated profits of Rs. 700,000 and a share premium account balance of Rs. 200,000. Faiqa Limited paid Rs. 1,680,000 for the shares in Saiqa Limited.
- At 31 December 2017 Saiqa Limited had accumulated profits of Rs. 1,000,000 and Faiqa Limited had accumulated profits of Rs. 1,600,000.
- What are the consolidated accumulated profits as at 31 December 2017?
- (a) Rs. 1,600,000
 - (b) Rs. 1,825,000
 - (c) Rs. 1,900,000
 - (d) Rs. 1,925,000

21. A bargain purchase is a business combination in which the calculation of goodwill leads to a negative figure. When this happens, which of the following are reviewed:
- The identifiable assets acquired, and liabilities assumed
 - The non-controlling interest in the acquiree
 - The consideration transferred.
- (i) and (ii) only
 - (i) and (iii) only
 - (ii) and (iii) only
 - (i), (ii) and (iii) all
22. How should the unrealised profit be posted?
- DR Cost of sales / CR Inventories
 - DR Cost of sales / DR Non-controlling interest / CR Inventories
 - DR Inventories / CR Cost of sales
 - DR Inventories / CR Non-controlling interest / CR Cost of sales
23. Which of the following is not an intra group transaction?
- The sale of goods or rendering of services between the parent and subsidiary
 - Transfers of non-current assets between the parent and subsidiary
 - The payment of dividend by subsidiary
 - The payment of dividend by parent
24. What is accounting treatment of acquisition related costs when goodwill is being measured at acquisition?
- Added to cost of investment
 - Deducted from cost of investment
 - Charged as expense of parent entity
 - Charged as expense of subsidiary entity
25. Haris Limited acquired 80% of the equity shares of Faris Limited on 1 July 2014, paying Rs. 300 for each share acquired. This represented a premium of 20% over the market price of Faris Limited shares at that date.

Faris Limited's equity at 31 March 2015 comprised:

	Rs. million	Rs. million
Equity shares of Rs. 100 each		100
Retained earnings at 1 April 2014	80	
Profit for the year ended 31 March 2015	40	120
		220

The only fair value adjustment required to Faris Limited's net assets on consolidation was a Rs. 20 million increase in the value of its land.

Haris Limited's policy is to value non-controlling interests at fair value at the date of acquisition.

For this purpose, the market price of Faris Limited's shares at that date can be deemed to be representative of the fair value of the shares held by the non-controlling interest.

What would be the carrying amount of the non-controlling interest of Faris Limited in the consolidated statement of financial position of Haris Limited as at 31 March 2015?

- (a) Rs. 54 million
- (b) Rs. 50 million
- (c) Rs. 56 million
- (d) Rs. 58 million

26. IFRS Standards require extensive use of fair values when recording the acquisition of a subsidiary.

Which TWO of the following comments, regarding the use of fair values on the acquisition of a subsidiary, are correct?

- (a) The use of fair value to record a subsidiary's acquired assets does not comply with the historical cost principle.
- (b) The use of fair values to record the acquisition of plant always increases consolidated post-acquisition depreciation charges compared to the corresponding charge in the subsidiary's own financial statements.
- (c) Cash consideration payable one year after the date of acquisition needs to be discounted to reflect its fair value.
- (d) When acquiring a subsidiary, the fair value of liabilities and contingent liabilities must also be considered.

27. Wareesha Limited has an 80% subsidiary Irfan Limited. In the last month of the year, Wareesha Limited sold inventory to Irfan Limited for Rs. 21.6 million making a mark-up of 20% on cost. The goods are still held by Irfan Limited at the year end.

If Wareesha Limited has an inventory balance of Rs. 162 million and Irfan Limited has Rs. 108 million, what will be the inventory figure in the consolidated statement of financial position?

- (a) Rs. 270 million
- (b) Rs. 266.4 million
- (c) Rs. 265.68 million
- (d) Rs. 248.4 million

28. Aliyan Limited is a subsidiary of Shaiq Limited. At the year-end Aliyan Limited has a current account debit balance of Rs. 75 million, but Shaiq Limited has a current account credit balance of only Rs. 60 million.

Which of the following two reasons might explain the difference?

Shaiq Limited had posted a cheque for Rs. 15 million to Aliyan Limited on the last day of the year.

Aliyan Limited had despatched Rs. 15 million of inventory to Shaiq Limited on the last day of the year.

- (a) Both may be the reason
- (b) None is the reason
- (c) Only statement 1 may be the reason
- (d) Only statement 2 may be the reason

29. A holding company sold goods to its wholly owned subsidiary for Rs. 18 million representing cost plus 20%. At the year-end two-thirds of the goods were still in stock.

The unrealised profit in inventory is?

- (a) Rs. 2 million
- (b) Rs. 2.4 million
- (c) Rs. 3 million
- (d) Rs. 3.6 million

30. ABC Limited buys goods from its 75% owned subsidiary XYZ Limited. XYZ Limited earns a markup of 25% on such transactions. At the group's year end, 30 June 2011 ABC Limited had not yet taken delivery of goods, at a sales value of Rs. 10 million, which were dispatched by XYZ Limited on 29 June 2011.

What would be the impact on inventory in the consolidated statement of financial position of the ABC Limited group at 30 June 2011?

- (a) Rs. 6 million
- (b) Rs. 7.5 million
- (c) Rs. 8 million
- (d) Rs. 10 million

31. Thal Limited owns 80% of the ordinary share capital of its subsidiary Cholistan Limited. At the group's year end, 28 February 2011, Thal Limited's payables include Rs. 3.6 million in respect of inventories sold by Cholistan Limited. Cholistan Limited's receivables include Rs. 6.7 million in respect of inventories sold to Thal Limited. Two days before the year end Thal Limited sent a payment of Rs. 3.1 million to Cholistan Limited that was not recorded by the latter until two days after the year end.

What is the entry that should be made to remove the intragroup transaction from the group accounts apart from cancelling intra group balances?

- (a) Rs. 2.325 million to be added to cash
- (b) Rs. 3.1 million to be added to payables
- (c) Rs. 3.1 million to be added to inventories
- (d) Rs. 3.1 million to be added to cash

32. P Limited transferred an item of plant to S Limited on 1 January 2013 for Rs. 30 million. The plant had originally cost P Limited Rs. 30 million at 1 January 2011 and had a useful economic life of 10 years, which is unchanged.

What is the unrealised profit on the plant at 31 December 2013?

- (a) Rs. 5.250 million
- (b) Rs. 12 million
- (c) Rs. 5.4 million
- (d) Rs. 9 million

33. Python Limited acquired 75% of the share capital of Snake Limited on 1 January 2011. On this date, the net assets of Snake Limited were Rs. 80 million. The non-controlling interest was calculated using fair value, which was calculated as Rs. 40 million at the date of acquisition. At 1 January 2013 the net assets of Snake Limited were Rs. 120 million and goodwill had been impaired by Rs. 10 million.

What was the value of the non-controlling interest at 1 January 2013?

- (a) Rs. 50 million
- (b) Rs. 47.5 million
- (c) Rs. 107.5 million
- (d) Rs. 87.5 million

34. King Limited acquired 60% of Queen Limited's Rs. 100 million share capital on 1 January 2013, when Queen Limited also had retained earnings of Rs. 120 million. King Limited paid Rs. 50 million cash, and also agreed to pay a further Rs. 90 million on 1 January 2015. King Limited also gave the owners of Queen Limited 1 King Limited share for every 2 shares of Queen Limited purchased.

The fair value of King Limited's shares were Rs. 40 on 1 January 2013, and Rs. 60 on 31 December 2013. At 31 December 2013 King Limited had retained earnings of Rs. 210 million and Queen Limited had retained earnings of Rs. 110 million. King Limited has a cost of capital of 10%.

King Limited measures the non-controlling interest at fair value. The fair value of the non-controlling interest at 1 January 2013 was Rs. 25 million.

The Par value per share is Rs. 10 each.

What is the total goodwill at 1 January 2013?

- (a) Rs. 49.38 million
 - (b) Rs. 24 million
 - (c) Rs. 109.38 million
 - (d) Rs. 65 million
35. King Limited acquired 60% of Queen Limited's Rs. 100 million share capital on 1 January 2013, when Queen Limited also had retained earnings of Rs. 120 million. King Limited paid Rs. 50 million cash and agreed to pay a further Rs. 90 million on 1 January 2015. King Limited also gave the owners of Queen Limited 1 King Limited share for every 2 shares of Queen Limited purchased.

The fair value of King Limited's shares were Rs. 40 on 1 January 2013, and Rs. 60 on 31 December 2013. At 31 December 2013 King Limited had retained earnings of Rs. 210 million and Queen Limited had retained earnings of Rs. 110 million. King Limited has a cost of capital of 10%.

King Limited measures the non-controlling interest at fair value. The fair value of the non-controlling interest at 1 January 2013 was Rs. 25 million.

What is the group retained earnings at 31 December 2013?

- (a) Rs. 256.562 million
 - (b) Rs. 271.438 million
 - (c) Rs. 196.562 million
 - (d) Rs. 211.438 million
36. On 1 June 2011 Arsalan Limited acquired 80% of the equity share capital of Habib Limited. At the date of acquisition, the fair values of Habib Limited's net assets were equal to their carrying amounts with the exception of its property.

This had a fair value of Rs. 1.2 million below its carrying amount. The property had a remaining useful life of eight years.

What effect will any adjustment required in respect of the property have on group retained earnings at 30 September 2011?

- (a) Rs. 40,000
- (b) Rs. 50,000
- (c) Rs. 150,000
- (d) Rs. 120,000

37. On 1 April 2017 Riyasat Limited acquired 116 million of Farasat Limited's 145 million ordinary shares for an immediate cash payment of Rs. 210 million and issued at par one 10% Rs. 100 loan note for every 200 shares acquired.

At the date of acquisition Farasat Limited owned a recently built property that was carried at its depreciated construction cost of Rs. 62 million. The fair value of this property at the date of acquisition was Rs. 82 million and it had an estimated remaining life of 20 years.

Farasat Limited also had an internally-developed brand which was valued at the acquisition date at Rs. 25 million with a remaining life of 10 years.

The inventory of Farasat Limited at 31 March 2019 includes goods supplied by Riyasat Limited for a sale price of Rs. 56 million. Riyasat Limited adds a mark-up of 40% on cost to all sales.

What is the total amount of the consideration transferred by Riyasat Limited to acquire the investment in Farasat Limited?

- (a) Rs. 210 million
- (b) Rs. 116 million
- (c) Rs. 268 million
- (d) Rs. 326 million

38. On 1 April 2017 Riyasat Limited acquired 116 million of Farasat Limited's 145 million ordinary shares for an immediate cash payment of Rs. 210 million and issued at par one 10% Rs. 100 loan note for every 200 shares acquired.

At the date of acquisition Farasat Limited owned a recently built property that was carried at its depreciated construction cost of Rs. 62 million. The fair value of this property at the date of acquisition was Rs. 82 million and it had an estimated remaining life of 20 years.

Farasat Limited also had an internally-developed brand which was valued at the acquisition date at Rs. 25 million with a remaining life of 10 years.

The inventory of Farasat Limited at 31 March 2019 includes goods supplied by Riyasat Limited for a sale price of Rs. 56 million. Riyasat Limited adds a mark-up of 40% on cost to all sales.

What will be the amount of the adjustment to group retained earnings at 31 March 2019 in respect of the movement on the fair value adjustments?

- (a) Rs. 45 million
- (b) Rs. 7 million
- (c) Rs. 52 million
- (d) Rs. 5.6 million

39. On 1 April 2017 Riyasat Limited acquired 116 million of Farasat Limited's 145 million ordinary shares for an immediate cash payment of Rs. 210 million and issued at par one 10% Rs. 100 loan note for every 200 shares acquired.

At the date of acquisition Farasat Limited owned a recently built property that was carried at its depreciated construction cost of Rs. 62 million. The fair value of this property at the date of acquisition was Rs. 82 million and it had an estimated remaining life of 20 years.

Farasat Limited also had an internally-developed brand which was valued at the acquisition date at Rs. 25 million with a remaining life of 10 years.

The inventory of Farasat Limited at 31 March 2019 includes goods supplied by Riyasat Limited for a sale price of Rs. 56 million. Riyasat Limited adds a mark-up of 40% on cost to all sales.

What is the amount of the unrealised profit arising from intragroup trading?

- (a) Rs. 56 million
- (b) Rs. 40 million
- (c) Rs. 16 million
- (d) Rs. 24 million

40. Samreen Limited has a 75% owned subsidiary Narmeen Limited. During the year Samreen Limited sold inventory to Narmeen Limited for an invoiced price of Rs. 800,000. Narmeen Limited have since sold 75% of that inventory on to third parties.

The sale was at a mark-up of 25% on cost to Samreen Limited. Narmeen Limited is the only subsidiary of Samreen Limited.

What is the adjustment to inventory that would be included in the consolidated statement of financial position of Samreen Limited at the year-end resulting from this sale?

- (a) Rs. 40,000
- (b) Rs. 80,000
- (c) Rs. 120,000
- (d) Rs. 160,000

41. Abrish Limited acquired 80% of Shazim Limited on 1 July 2012. In the post-acquisition period Abrish Limited sold goods to Shazim Limited at a price of Rs. 12 million. These goods had cost Abrish Limited Rs. 9 million. During the year to 31 March 2013 Shazim Limited had sold Rs. 10 million (at cost to Shazim Limited) of these goods for Rs. 15 million.

How will this affect group cost of sales in the consolidated statement of comprehensive income of Abrish Limited for the year ended 31 March 2013?

- (a) Increase by Rs. 11.5 million
- (b) Increase by Rs. 9.6 million
- (c) Decrease by Rs. 11.5 million
- (d) Decrease by Rs. 9.6 million

42. On 1 July 2017, Hareem Limited acquired 60% of the equity share capital of Maneha Limited and on that date made a Rs. 10 million loan to Maneha Limited at a rate of 8% per annum.

What will be the effect on group retained earnings at the year-end date of 31 December 2017 when this intragroup transaction is cancelled?

- (a) Group retained earnings will increase by Rs. 400,000
- (b) Group retained earnings will be reduced by Rs. 240,000
- (c) Group retained earnings will be reduced by Rs. 160,000
- (d) There will be no effect on group retained earnings

43. Maaz Limited acquired 80% of Hamza Limited on 1 January 2018. At the date of acquisition Hamza Limited had a building which had a fair value Rs. 22 million and a carrying amount of Rs. 20 million. The remaining useful life was 20 years. At the year-end date of 30 June 2018, the fair value of the building was Rs. 23 million. It is group policy to use revaluation model for its building.

Hamza Limited's profit for the year to 30 June 2018 was Rs. 1.6 million which accrued evenly throughout the year.

Maaz Limited measures non-controlling interest at fair value. At 30 June 2018 it estimated that goodwill in Hamza Limited was impaired by Rs. 500,000. It is group policy to use revolution model for its buildings. What is the total comprehensive income attributable to the non-controlling interest at 30 June 2018?

- (a) Rs. 250,000
- (b) Rs. 260,000
- (c) Rs. 360,000
- (d) Rs. 400,000

44. Asim Limited acquires 80% of the share capital of Arif Limited on 1 August 2016 and is preparing its group financial statements for the year ended 31 December 2016.

How will Arif Limited's results be included in the group statement of comprehensive income?

- (a) 80% of Arif Limited's revenue and expenses for the year ended 31 December 2016
- (b) 100% of Arif Limited's revenue and expenses for the year ended 31 December 2016
- (c) 80% of Arif Limited's revenue and expenses for the period 1 August 2016 to 31 December 2016
- (d) 100% of Arif Limited's revenue and expenses for the period 1 August 2016 to 31 December 2016

45. Which of the following would result in an unrealised profit within a group scenario?

- (a) A parent sells a building originally costing Rs. 800,000 to its subsidiary for Rs. 900,000. The subsidiary still holds this asset at the date of consolidation.
- (b) A parent sells a building originally costing Rs. 800,000 to its subsidiary for Rs. 900,000. The subsidiary has sold this asset before the date of consolidation.
- (c) A parent sells goods which originally cost Rs. 14,000 to its subsidiary for Rs. 18,000. The subsidiary has sold all of these goods at the date of consolidation.
- (d) A parent sells goods which originally cost Rs. 14,000 to an associate for Rs. 18,000. The associate has sold all of these goods at the date of consolidation.

46. Jerry Limited acquired an 80% holding in Tom Limited on 1 April 2016. From 1 April 2016 to 31 December 2016 Tom Limited sold goods to Jerry Limited for Rs. 4.3m at a mark-up of 10%. Jerry Limited's inventory at 31 December 2016 included Rs. 2.2m of such inventory. The statements of comprehensive income for each entity for the year to 31 December 2016 showed the following in respect of cost of sales:

Jerry Limited Rs. 14.7m

Tom Limited Rs. 11.6m

What is the cost of sales figure to be shown in the consolidated statement of comprehensive income for the year to 31 December 2016?

- (a) Rs. 18,900,000
- (b) Rs. 20,200,000
- (c) Rs. 19,100,000
- (d) Rs. 19,300,000

47. Sun Limited acquired a 60% holding in Moon Limited on 1 January 2016. At this date Moon Limited owned a building with a fair value Rs. 200 million in excess of its carrying amount, and a remaining life of 10 years.

All depreciation is charged to operating expenses. Goodwill had been impaired by Rs. 55 million in the year to 31 December 2016. The balances on operating expenses for the year to 31 December 2017 are shown below:

Sun Limited Rs. 600 million

Moon Limited Rs. 350 million

What are consolidated operating expenses for the year to 31 December 2017?

- (a) Rs. 930 million
- (b) Rs. 970 million
- (c) Rs. 950 million
- (d) None of the above

48. A Limited acquired a 60% holding in B Limited on 1 July 2016. At this date, A Limited gave B Limited a Rs. 500 million 8% loan. The interest on the loan has been accounted for correctly in the individual financial statements.

The totals for finance costs for the year to 31 December 2016 in the individual financial statements are shown below.

A Limited Rs. 200 million

B Limited Rs. 70 million

What are consolidated finance costs for the year to 31 December 2016?

- (a) Rs. 215 million
- (b) Rs. 225 million
- (c) Rs. 230 million
- (d) Rs. 250 million

49. Abeeha Limited has owned 80% of Seema Limited for many years. In the current year ended 30 June 2013, Abeeha Limited has reported total revenues of Rs. 5.5 million, and Seema Limited of Rs. 2.1 million. Abeeha Limited has sold goods to Seema Limited during the year with a total value of Rs. 1 million, earning a margin of 20%. Half of these goods remain in year-end inventories.

What is the consolidated revenue figure for the Abeeha group for the year ended 30 June 2013?

- (a) Rs. 7.6 million
- (b) Rs. 6.6 million
- (c) Rs. 8.6 million
- (d) Rs. 5.5 million

50. On 1 January 2014, Venice Limited acquired 80% of the equity share capital of Greece Limited. Extracts of their statements of comprehensive income for the year ended 30 September 2014 are:

	Venice Limited	Greece Limited
	Rs. 000	Rs. 000
Revenue	64,600	38,000
Cost of sales	(51,200)	(26,000)

Sales from Venice Limited to Greece Limited throughout the year to 30 September 2014 had consistently been Rs. 800,000 per month. Venice Limited made a mark-up on cost of 25% on these sales.

Greece Limited had Rs. 1.5 million of these goods in inventory as at 30 September 2014.

What would be the cost of sales in Venice Limited's consolidated statement of comprehensive income for the year ended 30 September 2014?

- (a) Rs. 63,500,000
- (b) Rs. 70,700,000
- (c) Rs. 63,800,000
- (d) Rs. 77,900,000

51. Haris Limited has owned a 90% subsidiary Faris Limited for many years, but then purchased a 75% subsidiary Suria Limited half way through this year. The revenue of each company is as follows:

Haris Limited	Rs. 150 million
Faris Limited	Rs. 135 million
Suria Limited	Rs. 120 million

During the year, Faris Limited sold goods to Haris Limited for Rs. 30 million. These items were then sold outside of the group by Haris Limited just before the end of the year.

What is the consolidated revenue figure for the year?

- (a) Rs. 255 million
 - (b) Rs. 375 million
 - (c) Rs. 315 million
 - (d) Rs. 435 million
52. Halim Limited owns 55% of Namal Limited. In 2018 Namal Limited made a profit after tax of Rs. 72 million. During the year Halim Limited sold goods costing Rs. 36 million to Namal Limited at a mark-up of 40%. Two thirds of these goods had been sold outside of the group by the year end.
- Calculate the non-controlling interest to be shown in the consolidated statement of comprehensive income for 2018.
- (a) Rs. 32.4 million
 - (b) Rs. 72 million
 - (c) Rs. Nil
 - (d) Cannot be determined with this information
53. Two years ago, Burhan Limited purchased 60% of Hussain Limited and 10% of Meerab Limited. Burhan Limited is not able to exert significant influence over its investment in Meerab Limited. Revenue for the three companies for the year to 30th June 2010 was:

	Burhan Limited Rs. million	Hussain Limited Rs. million	Meerab Limited Rs. million
Revenue	180	144	108

The group revenue in the consolidated statement of comprehensive income is:

- (a) Rs. 266.4 million
- (b) Rs. 277.2 million
- (c) Rs. 324 million
- (d) Rs. 432 million

54. Hareem Limited and its subsidiary Maneha Limited have the following results for the year 2014.

	Hareem Limited Rs. million	Maneha Limited Rs. million
Revenue	900	450
Cost of sales	(450)	(234)
Gross profits	450	216

During the year, Hareem Limited sold goods to Maneha Limited for Rs. 90 million making a profit of Rs. 18 million.

None of these goods remain in inventories at the year end.

What will be shown as revenue and gross profit in the 2014 consolidated Statement of comprehensive income?

- (a) Revenue Rs. 1,260 million, Gross profit Rs. 666 million
 (b) Revenue Rs. 1,260 million, Gross profit Rs. 648 million
 (c) Revenue Rs. 1,350 million, Gross profit Rs. 756 million
 (d) Revenue Rs. 1,350 million, Gross profit Rs. 666 million
55. Bilal Limited sells inventory costing Rs. 30 million to his subsidiary Sohail Limited for Rs. 45 million. By the end of the year, Sohail Limited has just half of this inventory remaining.

If the sales of the two companies were: Rs. 150 million and Rs. 120 million respectively, and the cost of sales were Rs. 75 million and Rs. 60 million calculate the consolidated revenue and gross profit for the year.

- (a) Revenue Rs. 225 million; Gross profit Rs. 127.5 million
 (b) Revenue Rs. 270 million; Gross profit Rs. 127.5 million
 (c) Revenue Rs. 225 million; Gross profit Rs. 120 million
 (d) Revenue Rs. 270 million; Gross profit Rs. 120 million
56. Abrar Limited acquired 60% of Haq Limited on 1 March 2019. In September 2019 Abrar Limited sold Rs. 46 million worth of goods to Haq Limited. Abrar Limited applies a 30% mark-up to all its sales. 25% of these goods were still held in inventory by Haq Limited at the end of the year.

An extract from the draft statements of profit or loss of Abrar Limited and Haq Limited at 31 December 2019 is:

	Abrar Limited Rs. million	Haq Limited Rs. million
Revenue	955	421.5
Cost of sales	(407.3)	(214.6)
Gross profit	547.7	206.9

All revenue and costs arise evenly throughout the year.

What will be shown as gross profit in the consolidated statement of comprehensive income of Abrar Limited for the year ended 31 December 2019?

- (a) Rs. 548 million approximately
 (b) Rs. 717 million approximately
 (c) Rs. 720 million approximately
 (d) Rs. 754 million approximately

57. Shahzad Limited acquired 80% of Roy Limited on 1 June 2011. Sales from Roy Limited to Shahzad Limited throughout the year ended 30 September 2011 were consistently Rs. 1 million per month. Roy Limited made a mark-up on cost of 25% on these sales. At 30 September 2011 Shahzad Limited was holding Rs. 2 million inventory that had been supplied by Roy Limited in the post-acquisition period.

By how much will the unrealised profit decrease the profit attributable to the non-controlling interest for the year ended 30 September 2011?

- (a) Rs. 80,000
- (b) Rs. 160,000
- (c) Rs. 320,000
- (d) Rs. 400,000

58. Akbar Limited has owned 70% of Hamayuon Limited for many years. It also holds a Rs. 5 million 8% loan note from Hamayuon Limited. One of Hamayuon Limited's non-current assets has suffered an impairment of Rs. 50,000 during the year. There is a balance in the revaluation surplus of Hamayuon Limited of Rs. 30,000 in respect of this asset. The impairment loss has not yet been recorded.

The entity financial statements of Hamayuon Limited show a profit for the year of Rs. 1.3 million.

What is the amount attributable to the non-controlling interests in the consolidated statement of profit or loss?

- (a) Rs. 1,300,000
- (b) Rs. 1,280,000
- (c) Rs. 384,000
- (d) Rs. 390,000

59. The following figures relate to Bushra Limited and its subsidiary Ansari Limited for the year ended 31 December 2015.

	Rs. m
Bushra Limited	600
Ansari Limited	300

During the year Bushra Limited sold goods to Ansari Limited for Rs. 20 million making a profit of Rs.5 million. These goods were all sold by Ansari Limited before the year end.

What is the amount for total revenue in the consolidated statement of comprehensive income for Bushra Limited for the year ended 31 December 2015?

- (a) Rs. 900 million
- (b) Rs. 880 million
- (c) Rs. 860 million
- (d) Rs. 580 million

60. Fahad Limited Ltd acquired 80% of the ordinary shares of Mustufa Limited on 31 December 2014 when Mustufa Limited's retained earnings were Rs. 20 million. At 31st December 2015, Mustufa Limited's retained earnings stood at Rs. 25 million. Neither companies pay dividends nor have made any other reserve transfers.

Calculate the non-controlling interest in the consolidated statement of comprehensive income for the year ended 31st December 2015.

- (a) Rs. 1 million
- (b) Rs. 2 million
- (c) Rs. 3 million
- (d) Rs. 4 million

61. Which TWO of the following elements are NOT included within the definition of control?

- (a) Power to participate in the financial and operating policies of the investee
- (b) Power over the investee to affect the amount of the investor's returns
- (c) Exposure or rights to variable returns from its involvement with the investee
- (d) Holding the majority of shares in investee's share capital

62. Ansoo Limited (AL) owns a property that has been rented to its subsidiary which uses it as sales office. How should the above property be classified by AL in separate and consolidated financial statements?

Separate

Consolidated

(a) Property, plant and equipment	Property, plant and equipment
(b) Investment property	Property, plant and equipment
(c) Property, plant and equipment	Investment property
(d) Investment property	Investment property

63. Parent Limited (PL) has a 75% shareholding in Subsidiary Limited (SL) since 2021. During 2023, SL made sales of Rs. 10 million to PL at a profit of Rs. 2 million. At 31 December 2023, PL had 60% of these goods in its inventory.

What would be the impact of unrealised profit on consolidated financial statements?

- (a) Reduction in inventory, group reserves and non-controlling interest by Rs. 1.2 million, Rs. 0.9 million and Rs. 0.3 million respectively
- (b) Reduction in inventory, group reserves and non-controlling interest by Rs. 2 million, Rs. 1.5 million and Rs. 0.5 million respectively
- (c) Reduction in inventory, group reserves and non-controlling interest by Rs. 1.2 million, Rs. 0.72 million and Rs. 0.48 million respectively
- (d) Reduction in inventory and group reserves by Rs. 1.2 million each

ANSWERS

01.	(d)	None of the reason is valid.		
02.	(c)	Credited to profit or loss		
03.	(b) & (d)	Option (a) is incorrect as different reporting date is possible. Option (c) is incorrect as time gap is maximum 3 months.		
04.	(b)	This is the definition of significant influence, not control.		
05.	(d)	Consolidation is not appropriate in this case as the parent has lost control.		
06.	(c)		Rs. million	Rs. million
		Consideration		200
		NCI at fair value		82.8
		Net assets:		
		Shares	100	
		Retained earnings	156	(256)
		Goodwill		26.8
		Ahmad Hassan Limited		275
		Asar Limited: $(177 - 156) \times 70\%$		14.7
		Goodwill impairment $(26.8 / 2) \times 70\%$		(9.38)
		Group retained earnings		280.32
07.	(d)	This adjustment reduces (debits) the liability and credit it to retained earnings. The remeasurement relates to the post-acquisition period, so goodwill is not affected.		
08.	(b)		Rs. million	
		Cost of Investment	432	
		FV of NCI	200	
			632	
		Net assets acquired:		
		Share capital $[18 \times \text{Rs. } 10]$	180	
		Opening accumulated profits	360	
		Profits up to 31 July $(108 \times 7/12)$	63	
			603	
		Goodwill	29	
09.	(a)	It is the correct treatment for a bargain purchase (negative goodwill)		

10.	(c)	While having the majority of shares may be a situation which leads to control, it does not feature in the definition of control per IFRS 10 <i>Consolidated Financial Statements</i> .		
11.	(d)	At 31 December 2012 the deferred consideration needs to be discounted to present value by one year. Rs. 200 million/1.1 = Rs. 181.818 million Alternatively, discount Rs. 200 million to present value and then add interest for two years, compounded annually.		
12.	(b) & (d)	The fact that unanimous consent is required would suggest that there is no control over the investee. Preference shares carry no voting rights and therefore are excluded when considering the control held over an investee.		
13.	(a)	The activities of the subsidiary are irrelevant when making the decision as to whether to produce consolidated financial statements or not.		
14.	(c) & (d)	While the same accounting policies must be used in the consolidated financial statements, the subsidiaries do not have to operate the same policies as the parent. Having different activities is not an acceptable reason for non-consolidation		
15.	(c)	High Limited only owns 40% of Fall Limited’s voting shares so is unlikely to exercise control.		
16.	(a)		Rs. million	
		Cost of 70% shares in Hijazi Limited	387	
		Fair value of NCI	153	
			540	
		Fair value of net assets acquired	(450)	
		Total goodwill at acquisition	90	
17.	(b)	Consideration transferred:		
			Rs. million	Rs. million
		Cash		250
		Deferred consideration (400/ 1.08)		370.37
		Shares (3 million × Rs. 23)		69
				689.37
		Fair value of non-controlling interest		400
				1,089.37
		Fair value of net assets:		
		Share Capital	100	
		Retained earnings	850	(950)
		Goodwill		139.37

18.	(c)		Rs. million
		Shares ($1.8\text{m} \times 2/3 \times \text{Rs. } 57.5$)	69
		Deferred consideration ($1.8\text{m} \times \text{Rs. } 24.2 \times 1.1^{-2}$)	36
			105
19.	(d)		Rs. million
		Consideration transferred	800
		Fair value of non-controlling interest	220
			1,020
		<i>Fair value of net assets:</i>	
		Shares	100
		Retained earnings	570
		Revaluation surplus	150
			(820)
20.	(b)		Rs.
		Faiqa Limited	1,600,000
		Saiqa Limited ($1,000,000 - 700,000$) $\times 75\%$	225,000
			1,825,000
21.	(d)	All three are needed to be reviewed.	
22.	(a)	The correct answer is: DR Cost of sales / CR Inventories The unrealised profit is added to cost of sales and removed from inventories.	
23.	(d)	Payment of dividend by parent is not intra group transaction. The payment is made to shareholders of parent entity.	
24.	(c)	The acquisition related costs are not capitalised and charged as expense by parent.	
25.	(c)	Market price of Faris Limited shares at acquisition was Rs. 250 ($\text{Rs. } 300 \times 100/120$), therefore non-controlling interest (NCI) at acquisition was Rs.50 million ($1\text{million} \times 20\% \times \text{Rs. } 250$). NCI share of the post-acquisition profit is Rs. 6 million ($40\text{ million} \times 9/12 \times 20\%$). Therefore, non-controlling interest as at 31 March 2015 is Rs.56 million.	
26.	(c) & (d)	The fair value of deferred consideration is its present value. Fair values are applied to the subsidiary's assets, liabilities and contingent liabilities. While the use of fair value seems to not comply with the historical cost principle, this will effectively form part of the cost of the subsidiary to the parent, so the principle is still applied. Depreciation will not increase if the fair value of assets is lower than the current carrying amount.	

27.	(b)	The consolidated inventory of the group is Rs.162 million + Rs.108 million but this must be adjusted for the unrealised profit contained within the inventory of Irfan Limited of Rs. 3.6 million ($20/120 \times \text{Rs.}21.6$ million). = 162 million + 108 million – 3.6 million = Rs. 266.4 million														
28.	(a)	If items (cash or inventory) are despatched on the last day of the year by Aliyan Limited, the recipient will not have recorded the transaction and so the current account balances will not agree. The transaction must be entered in the books of the parent before the consolidation takes place, to ensure that the current account balances cancel each other on consolidation.														
29.	(a)	Unrealised profit = Rs. 18 million $\times 2/3 \times 20/120$ = Rs. 2 million														
30.	(c)	Inventory in transit is valued at Rs.100,000 but we must remove unrealised profit (URP). URP is calculated as Rs. 10 million/125×25 = Rs.2 million. Hence we increase inventory by Rs. 10 million but remove the URP of Rs. 2 million. The value of goods in transit to the group is Rs. 8 million.														
31.	(d)	The double entry is: Dr Cash 3.1 million, Cr Receivables Rs. 3.1 million. The remaining Rs. 3.6 million would then be cancelled from receivables and payables.														
32.	(a)	Carrying amount at the date of transfer would have been Rs. 24 million (Rs.30 million less 2 years depreciation at Rs.3 million a year). To work out the unrealised profit, the carrying amount at year end (after transfer) must be compared to the carrying amount at year end if the asset had never been transferred: Carrying amount at year end (Rs. 30 million less 1-year depreciation (Rs.30 million/8 year remaining life)) = Rs.30 million – Rs. 3.750 million = Rs.26.250 million Carrying amount if asset had never been transferred = (Rs.24 million less another Rs. 3 million depreciation) = Rs.21 million Therefore, the unrealised profit = Rs. 26.250 – Rs. 21 = Rs.5.25 million.														
33.	(b)	The NCI at 1 January is calculated by taking the NCI value at acquisition, plus the NCI share of post-acquisition net assets, deducting the NCI share of any impairment: Rs.40 million + ($25\% \times (\text{Rs.}120 \text{ million} - \text{Rs. } 80 \text{ million})$) – ($25\% \times \text{Rs.}10 \text{ million}$) = Rs.47.5 million.														
34.	(a)	<table><tr><th></th><th>Rs. million</th></tr><tr><td>Cash consideration</td><td>50</td></tr><tr><td>Deferred consideration ($\text{Rs.}90 \times (1 \div 1.10^2)$)</td><td>74.38</td></tr><tr><td>Share consideration ($100/10 \times 60\% \times 1/2 \times \text{Rs.}40$)</td><td>120</td></tr><tr><td>Non-controlling interest at acquisition</td><td>25</td></tr><tr><td>Less: Net assets at acquisition (Rs.100 + Rs.120)</td><td>(220)</td></tr><tr><td>Total goodwill</td><td>49.38</td></tr></table>		Rs. million	Cash consideration	50	Deferred consideration ($\text{Rs.}90 \times (1 \div 1.10^2)$)	74.38	Share consideration ($100/10 \times 60\% \times 1/2 \times \text{Rs.}40$)	120	Non-controlling interest at acquisition	25	Less: Net assets at acquisition (Rs.100 + Rs.120)	(220)	Total goodwill	49.38
	Rs. million															
Cash consideration	50															
Deferred consideration ($\text{Rs.}90 \times (1 \div 1.10^2)$)	74.38															
Share consideration ($100/10 \times 60\% \times 1/2 \times \text{Rs.}40$)	120															
Non-controlling interest at acquisition	25															
Less: Net assets at acquisition (Rs.100 + Rs.120)	(220)															
Total goodwill	49.38															

35.	(c)		Rs. million
		King Limited's (parent) retained earnings	210
		Queen Limited's 60% × (Rs.110 – Rs.120)	(6)
		Unwinding discount (Rs.74.38 × 10%)	(7.438)
			196.562
36.	(a)	(Rs.1.2 million / 8 × 4/12) × 80% = Rs.40,000 The adjustment will reduce depreciation over the next 8 years, so it will <i>increase</i> retained earnings.	
37.	(c)		Rs. million
		Cash	210
		Loan notes (116m × 100/200)	58
			268
38.	(d)		
			Acquisition
			Movement (2 years)
			Rs. million
		Property	20
		Brand	25
39.	(c)		(7)
		Rs.7 million × 80% = Rs.5.6 million	
40.	(a)	Rs.16 million i.e. Rs. 56 million × 40/140	
41.	(c)	The profit on the Rs.800,000 sale is Rs.160,000 (Rs.800,000 × 25/125). As 75% of the goods have been sold on to third parties, 25% remain in inventory at the year end. Unrealised profits only arise on goods remaining in inventory at the year end, so the unrealised profit is Rs.40,000 (Rs.160,000 × 25%).	
42.	(d)		Rs. million
		Decrease (cancellation of intra group)	12.0
		Increase (Rs. 2m × 25% (profit margin))	(0.5)
		Net decrease	11.5
43.	(c)	The group retained earnings will not change as a result of cancellation of intragroup cancellation of interest income and interest expense.	
43.	(c)		Rs.
		Subsidiary's post-acquisition profit (1.6m × 6/12)	800,000
		Additional depreciation on FVA ((2m/20) × 6/12)	(50,000)
		Goodwill impairment	(500,000)
		Post-acquisition gain on revaluation	
		[23m – (22m – 0.55m depreciation)]	1,550,000
			1,800,000
		NCI share 20%	360,000

44.	(d)	All of Arif Limited's revenue and expenses will be time-apportioned from the date of acquisition to the date of consolidation to reflect the period for which these were controlled by Asim Limited.		
45.	(a)	The asset has not been sold outside of the group and therefore there is an unrealised profit to adjust for on consolidation.		
46.	(d)	Cost of sales = Rs. 14.7m + Rs. 8.7m (9/12 × Rs. 11.6m) – Rs. 4.3m (intra-group sale) + Rs. 0.2m (Unrealised Profit) = Rs. 19.3m The unrealised profit is Rs. 2.2m × 10/110 = Rs. 0.2m		
47.	(b)	Operating expenses = Rs. 600 million + Rs. 350 million + Rs. 20 million (FV depreciation) = Rs. 970 million The only adjustments to the statement of comprehensive income should be the current year income or expenses. Therefore, the prior year fair value depreciation and goodwill impairment are ignored.		
48.	(b)	The finance costs for the subsidiary must be time apportioned for six months, as A has only owned them for that period of time. Also, the intra-group interest must be split out. The intra-group interest would not have existed in the first half of the year, as the loan was only given to B in July. The intra-group interest for the second 6 months would have been Rs. 20 million (Rs.500× 8% × 6/12). Without this, B's finance costs would have been Rs. 50 million for the year. Splitting this evenly across the year would mean that Rs. 25 million was incurred in each six-month period. Therefore, the total finance costs would be Rs. 20 million + Rs. 25 million = Rs. 225 million.		
49.	(b)	Consolidated revenue: Abeeha Limited Rs. 5.5m + Seema Limited Rs. 2.1m – Rs. 1m intra-group= Rs. 6.6 million All intra-group sales and cost of sales are removed from the group accounts.		
50.	(c)		Rs. 000	
		Venice Limited	51,200	
		Greece Limited (26,000 × 9/12)	19,500	
		Intra-group purchases (800 × 9 months)	(7,200)	
		Unrealised profit in inventory (1,500 × 25/125)	300	
			63,800	
51.	(c)	Rs. 150+135 – 30 + (120 x 6/12) = Rs. 315 million The results of Haris Limited and his subsidiaries must be combined, taking account of the fact that Haris Limited has only controlled Suria Limited for 6 months of the year, and so only the time apportioned figure should be included. In addition, the inter-company trading must be cancelled as the sale has been double counted by the group. The Rs. 30m sale by Faris Limited will be cancelled against the Rs. 30m purchase by Haris Limited. The same adjustment is needed irrespective of whether the goods remain within the group at the year-end or not.		
52.	(a)	45% × 72 million = Rs. 32.4 million There is no adjustment for the unrealised profit as the sale is from the parent.		

53.	(c)				Rs. million	
		Burhan Limited			180	
		Hussain Limited			144	
					324	
Meerab Limited is an ordinary investment, and not a subsidiary or an associate. The revenue of Meerab Limited is therefore irrelevant for the preparation of Burhan Limited's consolidated financial statements.						
54.	(a)		HL Rs. m	ML Rs. m	Adjustment Rs. m	Consolidated Rs. m
		Revenue	900	450	(90)	1,260
		COS.	(450)	(234)	90	(594)
		GP	450	216	-	666
No adjustment for unrealised profit is required as all the goods had been sold outside the group by the end of the reporting period.						
55.	(a)	The inter-company sale by Bilal Limited must be cancelled in full to give revenue of Rs. 150 million + Rs. 120 million - Rs. 45 million = Rs. 225 million. Sohail Limited will have recorded the associated purchase, so Rs. 45 million must also be removed from cost of sales, together with the elimination of the unrealised profit of Rs. 7.5 million on the remaining inventory. This gives cost of sales of Rs. 75 million + Rs. 60 million - Rs. 45 million + Rs. 7.5 million = Rs. 97.5 million resulting in a profit figure of Rs. 225 million - Rs. 97.5 million = Rs.127.5 million.				
56.	(b)				Rs. million	
		Abrar Limited			547.7	
		Haq Limited (206.9 × 10/12)			172.417	
		Unrealised profit ((46 × 30 / 130) × 25%)			(2.654)	
			717.463			
57.	(a)	Rs. 80,000 Rs. 2 million × 25 / 125 × 20% = Rs. 80,000				
58.	(c)				Rs. '000	
		Profit for the year			1,300	
		Impairment (50,000 – 30,000)			(20)*	
					1,280	
× 30%			384			
* The revaluation surplus is eliminated first, and the remainder charged to profit or loss.						
59.	(b)	Revenue = Rs. 600 million + Rs. 300 million – Rs.20 million intragroup sale = Rs. 880 million				
60.	(a)	Non-controlling interest is calculated as the NCI% × Mustufa Limited's PAT for the year. i.e. Rs. 5 million x 20% = Rs. 1 million.				

		The change in retained earnings between year 2014 and year 2015 will be the PAT for the year.
61.	(a) and (d)	Power to participate in the financial and operating policies of the investee Holding the majority of shares in investee's share capital
62.	(b)	Investment property in separate financial statements and Property, plant and equipment in consolidated financial statements.
63.	(a)	Subsidiary is seller, so effect will be on its post-acquisition profits. Unrealised profit Rs. 2m x 60% = Rs. 1.2m Reduction in inventory by Rs. 1.2m Reduction in Subsidiary's post-acquisition Rs. 1.2m • 75% effect on Group Reserves $1.2m \times 75\% = Rs. 0.9m$ • 25% effect on NCI $1.2m \times 25\% = Rs. 0.3m$

STICKY NOTES

Summary of Adjustments: Goodwill

Consolidated SFP	Consolidated SCI
Impairment of goodwill (partial)	
- Decrease in the amount of goodwill. - No impact on NCI - Decrease in group reserve.	- Increase in operating/admin expenses if impairment relates to current year. - No impact on NCI share.
Impairment of goodwill (full)	
- Decrease in the amount of goodwill - Decrease in NCI (NCI%). - Decrease in group reserve (Parent%)	- Increase in operating/admin expenses if impairment relates to current year - Include the impact in calculation of NCI share
Bargain purchase (negative goodwill)	
- Set goodwill to zero - Increase group reserves (due to gain)	- Increase other income (or present in separate line item) if relates to current year - No impact on NCI share
Transaction costs incorrectly capitalised	
- Decrease the amount of investment in subsidiary (goodwill working) - Decrease group reserves (charging as expense)	- Increase administrative expenses if costs were incurred in the current year - No impact on NCI share
Share exchange not yet recorded	
- Increase investment in subsidiary (goodwill working) - Increase parent's share capital and share premium	No impact
Deferred consideration and/or interest thereon not recorded yet	
- Increase investment in subsidiary: measure at present value (goodwill working) - Decrease group reserve (the interest expense) - Increase liability (at acquisition + interest)	- Increase finance cost to the extent it relates to current year - No impact on NCI share
Contingent consideration and/or change therein not recorded yet	
- Increase investment in subsidiary: measure at fair value (goodwill working) - Increase or decrease group reserve (change in fair value) - Increase liability (at acquisition $\pm$ change since then)	- Increase or decrease finance cost to the extent it relates to current year - No impact on NCI share

Summary of Adjustments: Fair value at the date of acquisition

• Increase or decrease net assets of subsidiary ○ At acquisition (will impact goodwill) ○ Post-acquisition: effect of subsequent depreciation/impairment (will impact NCI and group reserves) ○ At SFP date: net amount • Increase or decrease PPE or other asset/liability: net amount	• Increase or decrease relevant expenses to the extent it relates to the current year • Include the impact in calculation of NCI share

Summary of Adjustments: Elimination of intra group items

Consolidated SFP	Consolidated SCI
Intra group trading	
• No impact if inventory has been sold outside group. The unrealised profit adjustment is required when inventory is still held within the group.	• Decrease revenue / other income etc. • Decrease cost of sales / other expense etc. • There is no impact on NCI share unless there is unrealised profit involved in the transaction.
Intra group outstanding balances	
• Decrease receivable • Decrease payable • Increase cash in transit OR inventory in transit	• No impact (other than adjustment of unrealised profit in inventory, if any)
Unrealised profit in inventory (if parent is seller)	
• Decrease inventory • Decrease group reserves	• Increase cost of sales • No impact on NCI share
Unrealised profit in inventory (if subsidiary is seller)	
• Decrease inventory • Decrease post-acquisition reserves of subsidiary (will ultimately effect NCI and group reserves)	• Increase cost of sales • Include the impact in calculation of NCI share
Unrealised profit on transfer of non-current assets (if parent is seller)	
• Decrease PPE / other asset • Decrease group reserves	• Decrease other income • No impact on NCI share
Unrealised profit on transfer of non-current assets (if subsidiary is seller)	
• Decrease PPE / other asset • Decrease post-acquisition reserves of subsidiary (will ultimately effect NCI and group reserves)	• Decrease other income • Include the impact in calculation of NCI share

AT A GLANCE

SPOTLIGHT

STICKY NOTES

INVESTMENT IN ASSOCIATE

IN THIS CHAPTER:

AT A GLANCE

SPOTLIGHT

1. Significant influence
2. Equity method of accounting
3. Transactions with associate
4. Comprehensive Examples
5. Objective Based Q&A

STICKY NOTES

AT A GLANCE

An associate is an entity over which the investor has significant influence.

Significant influence is the power to participate in the financial and operating policy decisions of the investee but is not control or joint control of those policies.

If an investor holds, directly or indirectly (e.g. through subsidiaries), 20 per cent or more of the voting power of the investee, it is presumed that the investor has significant influence, unless it can be clearly demonstrated that this is not the case.

Conversely, if the investor holds, directly or indirectly (e.g. through subsidiaries), less than 20 per cent of the voting power of the investee, it is presumed that the investor does not have significant influence, unless such influence can be clearly demonstrated.

While preparing consolidated financial statements, an entity with significant influence over, an investee shall account for its investment in an associate using the equity method except when that investment qualifies for exemption.

Under the equity method, the investment in an associate is initially recognised at cost and the carrying amount is increased or decreased to recognise the investor's share of the profit or loss of the investee after the date of acquisition.

The investor's share of the profit or loss of the investee is recognised in the investor's profit or loss. Distributions received from an investee reduce the carrying amount of the investment.

1. SIGNIFICANT INFLUENCE

1.1 Whether an investee is an associate? [IAS 28: 3, 5 & 6]

IAS 28 defines an “associate” as an entity over which the investor has significant influence (but not control or joint control).

“**Significant influence**” is the power to participate in the financial and operating policy decisions of the investee but is not control or joint control of those policies.

1.1.1 Presumptions

There is presumption of significant influence if an entity holds, directly or indirectly (e.g. through subsidiaries), 20% or more of the voting power of the investee. This presumption is rebutted if it can be clearly demonstrated that investor does not have significant influence.

Conversely, there is presumption of no significant influence, if the entity holds, directly or indirectly (e.g. through subsidiaries), less than 20% of the voting power of the investee. This presumption is rebutted if significant influence can be clearly demonstrated.

1.1.2 Evidence of significant influence

The existence of significant influence by an entity is usually evidenced in one or more of the following ways:

- representation on the board of directors or equivalent governing body of the investee;
- participation in policy-making processes, including participation in decisions about dividends or other distributions;
- material transactions between the entity and its investee;
- interchange of managerial personnel; or
- provision of essential technical information.

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

► Example 01:

Entity A has following shareholders with their Shareholding percentages:

Entity	Percentage of Shareholding
Entity B	1%
Entity C	99%

Entity B and C are owned by same group of shareholders and all Board of directors of Entity A are on the Board of Directors of Entity B and C. Entity B and C have other directors as well.

Required: Whether Entity A is an associate of Entity B?

► ANSWER:

Although Entity B has only 1% shareholding of Entity A, but Entity B has significant influence on the decision making of Entity A as all directors of Entity A are also the directors of Entity B, therefore, Entity A is Entity B's Associated Company.

1.2 Accounting in separate financial statements [IAS 27: 10]

When an entity prepares separate financial statements, it shall account for investments in associates either:

- at cost;
- in accordance with IFRS 9 (at fair value); or
- using the equity method as described in IAS 28.

1.3 Accounting in consolidated financial statements [IAS 28: 16 & 17]

An entity with significant influence over an investee shall account for its investment in an associate using the equity method except when that investment qualifies for exemption.

The entity is a parent that is exempt from preparing consolidated financial statements under IFRS 10 consolidated financial statements or if all of the following four conditions are met (in which case the entity need not apply the equity method):

- (i) the entity is a wholly-owned subsidiary, or is a partially-owned subsidiary of another entity and its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the investor not applying the equity method;
- (ii) the investor or joint venturer's debt or equity instruments are not traded in a public market;
- (iii) the entity did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market; and
- (iv) the ultimate or any intermediate parent of the entity produces financial statements available for public use that comply with IFRSs, in which subsidiaries are consolidated or are measured at fair value through profit or loss in accordance with IFRS 10.

2. EQUITY METHOD OF ACCOUNTING

2.1 Equity method [IAS 28: 3 & 26]

The equity method is a method of accounting whereby the investment:

- is initially recognised at cost; and
- adjusted thereafter for the post-acquisition change in the investor's share of the investee's net assets.

The investor's:

- profit or loss includes its share of the investee's profit or loss; and
- other comprehensive income includes its share of the investee's other comprehensive income.

Many of the procedures that are appropriate for the application of the equity method are similar to the consolidation procedures described in IFRS 10. Furthermore, the concepts underlying the procedures used in accounting for the acquisition of a subsidiary are also adopted in accounting for the acquisition of an investment in an associate or a joint venture.

2.2 Presentation in financial statements

In the statement of financial position of the reporting entity (the investor), investment in associate is presented in non-current assets. It is measured as follows:

Investment in associate (in SFP) using equity method		Rs.
Cost of investment		XX
Add (less): Share of profits (losses) of associate since acquisition	] Share of post-acquisition RE	XX
Less: Any dividend received		(X)
Add (less): Share of OCI of associate since acquisition		X
Less: Any impairment of the investment recognised		(X)
Less: Share of unrealised profit		(X)
<i>Effect of associate's adjustments (to be included in group reserves or investor's reserves)</i>		XX
		XX

In the statement of profit or loss and other comprehensive income, there should be separate lines for:

- 'Share of profits of associate' in the profit and loss section of the statement (net of impairment and share of unrealised profit, if any)
- 'Share of other comprehensive income of associate' in the 'other comprehensive income' section of the statement.

Dividend from associate is excluded from profit or loss & group retained earnings because share of profit is included instead. Dividend received is rather treated as return of investment.

Note: Share of unrealised profit adjustments have been covered in next section of this chapter.

► Example 02:

Entity P acquired 30% of the equity shares in Entity A during Year 1 at a cost of Rs. 147,000 when the balance on retained earnings of Entity A was Rs. 350,000. Entity P is able to exercise significant influence over Entity A.

At 31 December Year 5, the retained earnings of Entity A were Rs. 600,000. In the year to 31 December Year 5, the profits of Entity A after tax were Rs. 80,000 and other Comprehensive income was Rs. 5,000.

Required: Compute the figures that must be included to account for the associate in Entity P's consolidated financial statements for the year to 31 December Year 5.

► **ANSWER:**

In statement of financial position:

- Investment in associate (in non-current assets) to be presented at Rs. 223,500
- The group reserves to be increased by Rs. 76,500.

Working		Rs.
Cost of investment		147,000
Add: Share of post-acquisition RE	$[(600,000 - 350,000) \times 30\%]$	75,000
Add: Share of OCI	$[5,000 \times 30\%]$	1,500
	<i>Effect of associate's adjustments</i>	76,500
		223,500

In statement of profit or loss, share of profit of associate shall be presented in a separate line item at Rs. 24,000 (i.e. Rs. 80,000 x 30%).

In other comprehensive income section, share of OCI shall be included at Rs. 1,500 (i.e. Rs. 5,000 x 30%).

► **Example 03:**

Entity P acquired 40% of the equity shares in Entity A during Year 1 at a cost of Rs. 128,000 when the fair value of the net assets of Entity A was Rs. 250,000.

Since acquisition of the investment, there has been no change in the issued share capital of Entity A, nor in its share premium reserve or revaluation reserve.

On 31 December Year 5, the net assets of Entity A were Rs. 400,000. In the year to 31 December Year 5, the profits of Entity A after tax were Rs. 50,000.

It has also been assessed after accounting for all the above information that the investment in the associate has been impaired by Rs. 8,000.

Required: Compute the figures that must be included to account for the associate in Entity P's consolidated financial statements for the year to 31 December Year 5.

► **ANSWER:**

In statement of financial position:

- Investment in associate (in non-current assets) to be presented at Rs. 180,000
- The group reserves to be increased by Rs. 52,000.

Working		Rs.
Cost of investment		128,000
Add: Share of post-acquisition RE	$[(400,000 - 250,000) \times 40\%]$	60,000
Less: Impairment in investment		(8,000)
	<i>Effect of associate's adjustments</i>	52,000
		180,000

In statement of profit or loss, share of profit of associate shall be presented in a separate line item at Rs. 12,000 (i.e. Rs. 50,000 x 40% - 8,000 impairment).

► *Example 04:*

Kashif Limited (KL) acquired 30% shares in Hasan Limited (HL) on January 01, 20X1. Both companies' year-end is December 31.

Following are the details of events during the year:

- KL purchased 30% shares at a cost of Rs. 30 million.
- HL Limited's profit for the year 20X1 is Rs. 10 million.
- HL Limited distributed Rs. 5 million of dividend to its shareholders.

Required: Prepare extract of statement of financial position as at 31 December 20X1 and extract of statement of profit or loss for the year then ended, using cost model and equity method.

► *ANSWER:***Cost model**

Statement of financial position (extracts)		Rs.
Investment in associate	(at cost)	30,000,000
Statement of profit or loss (extracts)		
Dividend income	[Rs. 5m x 30%]	1,500,000

Equity method

Statement of financial position (extracts)		Rs.
Investment in associate	(working)	31,500,000
Statement of profit or loss (extracts)		
Share of profit from associate	[Rs. 10m x 30%]	3,000,000

Working		Rs.
Cost of investment		30,000,000
Add: Share of profit	[Rs. 10m x 30%]	3,000,000
Less: Dividend received	[Rs. 5m x 30%]	(1,500,000)
		1,500,000
		31,500,000

► *Example 05:*

The draft statements of financial position as at 31 December 2016 of three companies are set out below:

	Helium	Sulphur	Arsenic
	Rs.000	Rs.000	Rs.000
Non-current assets			
Property, plant and equipment	400	100	160
Investments:			
shares in Sulphur (60%)	75	–	–
shares in Arsenic (30%)	30	–	–
Current assets	445	160	80
	950	260	240

	Helium	Sulphur	Arsenic
Equity and liabilities			
Share capital	100	30	60
Retained earnings	650	180	100
Non-current loans	200	50	80
	950	260	240

The reserves of Sulphur and Arsenic when the investments were acquired were Rs. 70,000 and Rs. 30,000 respectively

Required: Prepare the consolidated statement of financial position as at 31 December 2016.

► **ANSWER:**

Consolidated statement of financial position

As at 31 December 2016

Non-current assets		Rs. 000
Property, plant & equipment	400 + 100	500
Goodwill	W3	15
Investment in associate	W6	51
		566
Current assets	445 + 160	605
		1,171
Equity		
Share capital		100
Retained earnings	W5	737
Non-controlling interest	W4	84
Non-current loans	200 + 50	250
		1,171

W1: Group Structure

Sulphur (Subsidiary)	Acquired on (not available)
Parent's ownership 60%	NCI ownership 40%
Arsenic (Associate)	Acquired on (not available)
Parent's ownership 30%	

W2: Net assets of subsidiary	At Acquisition	Post-acquisition	At reporting date
	Rs. 000	Rs. 000	Rs. 000
Share capital	30		30
Retained earnings	70	110	180
	100	110	210

W3: Goodwill

		Rs. 000
Investment		75
NCI at acquisition	100 x 40%	40
		115
Less: Net assets at acquisition	W2	(100)
Goodwill at acquisition		15

W4: Non-controlling interest

		Rs. 000
NCI at acquisition	100 x 40%	40
Share of post-acquisition reserves	110 x 40%	44
		84

W5: Group reserves (retained earnings)

		Rs. 000
Parent's retained earnings		650
Share of post-acquisition reserves	110 x 60%	66
Effect of associate	[(100 - 30) x 30%]	21
		737

W6: Investment in associate

		Rs. 000
Cost of Investment		30
Share of post-acquisition reserves	[(100 - 30) x 30%]	21
		51

► **Example 06:**

Hark acquired the following non-current investments on 1 April 2015:

- 4 million equity shares in Spark, by means of an exchange of one share in Hark for every one share in Spark, plus Rs. 6.05 million in cash. The professional fees associated with the acquisition amounted to Rs. 1 million, and is still unpaid. The market price of shares in Hark at the date of the acquisition was Rs. 9 per share. The market price of Spark shares just before the acquisition was Rs. 7. The cash part of the consideration is deferred and will not be paid until two years after the acquisition.
- 25% of the equity shares in Ark, at a cost of Rs. 6 per share. The money to make this payment was obtained by issuing one million new shares in Hark at Rs. 9 per share.

None of these transactions has yet been recorded in the summary statements of financial position that are shown below.

The summarised draft statements of financial position of the three companies at 31 March 2016 are as follows.

Statement of financial position

	Hark	Spark	Ark
Assets	Rs. million		
Non-current assets			
Property, plant and equipment	60.0	31.0	16.0
Other equity investments	0.8	nil	nil
	60.8	31.0	16.0
Current assets	18.2	8.0	9.0
Total assets	79.0	39.0	25.0
Equity and liabilities			
Equity shares of Rs. 1 each	16.0	5.0	6.0
Share premium	2.0	4.0	4.0
Retained earnings: At 1 April 2015	36.0	16.0	8.0
Profit for the year	8.0	3.0	2.0
	62.0	28.0	20.0
Non-current liabilities			
6% loan notes	10.0	–	–
7% loan notes	–	6.0	3.0
Current liabilities	7.0	5.0	2.0
Total equity and liabilities	79.0	39.0	25.0

The following information is relevant:

- Hark has chosen to value the non-controlling interest in Spark using the fair value method.
- At the date of acquisition of Spark, the fair values of its assets were equal to their carrying amounts.
- The cost of capital of Hark is 10% per year.
- During the year ended 31 March 2016, Spark sold goods to Hark for Rs. 3.6 million, at a mark-up of 50% on cost. Hark had 75% of these goods in its inventory at 31 March 2016.
- There were no intra-group receivables and payables at 31 March 2016.
- On 1 April 2015, Hark sold a group of machines to Spark at their agreed fair value of Rs. 3 million. At the time of the sale, the carrying amount of the machines was Rs. 2 million. Plant and machinery is depreciated to a residual value of nil using straight-line depreciation and at 1 April 2015 the machines had an estimated remaining life of five years.
- “Other equity investments” are included in the summary statement of financial position of Hark at their fair value on 1 April 2015. Their fair value at 31 March 2016 is Rs. 0.65 million. These investments have been classified as fair value through profit or loss.
- Impairment tests were carried out on 31 March 2016. These show that there is no impairment of the value of the investment in Ark or in the consolidated goodwill.
- No dividends were paid during the year by any of the three companies.

Required: Prepare the consolidated statement of financial position for Hark as at 31 March 2016.

► **ANSWER:**

Consolidated statement of financial position

As at 31 March 2016

Non-current assets			Rs. m
Property, plant & equipment	60 + 31 – 0.8 URP W5		90.2
Goodwill		W3	23
Investment in associate		W6	9.5
Other investments	0.8 – 0.15 loss		0.65
			123.35
Current assets	18.2 + 8 – 0.9 URP W2		25.3
			148.65
Equity			
Share capital	16 + 4 for Spark + 1 for Ark		21
Share premium	2 + (4 x 8) + (1 x 8)		42
Retained earnings		W5	43.73
			106.73
Non-controlling interest		W4	7.42
			114.15
Non-current liabilities			
Deferred consideration	5 W3.1 + 0.5 interest		5.5
6% loan notes	10 + 0		10
7% loan notes	0 + 6		6
			21.5
Current liabilities	7 + 5 + 1 for acquisition fee		13
			148.65

W1: Group Structure

Spark (Subsidiary)	Acquired on 1 April 2015
Parent's ownership 80% [4m/5m]	NCI ownership 20%
Ark (Associate)	Acquired on 1 April 2015
Parent's ownership 25%	

W2: Net assets of subsidiary

		At Acquisition	Post-acquisition	At reporting date
		Rs. m	Rs. m	Rs. m
Share capital		5		5
Share premium		4		4
Retained earnings		16	3	19
URP Inventory	$3.6 \times 75\% \times 50/150$		(0.9)	(0.9)
		25	2.1	27.1

W3: Goodwill

		Rs. m
Investment	W3.1	41
NCI at acquisition	5m shares x 20% x Rs. 7	7
		48
Less: Net assets at acquisition	W2	(25)
Goodwill at acquisition		23

W3.1: Investment

		Rs. m
Shares	4m shares x Rs. 9	36
Deferred consideration	Rs. 6.25m x (1.10) ⁻²	5
		41

W4: Non-controlling interest

		Rs. m
NCI at acquisition	5m shares x 20% x Rs. 7	7
Share of post-acquisition reserves	2.1 x 20%	0.42
		7.42

W5: Group reserves (retained earnings)

		Rs. m
Parent's retained earnings		44
Acquisition costs		(1)
Loss on other investments	0.65 - 0.80	(0.15)
URP on machine transfer	$3 - 2 = 1$ gain - (1/5 years)	(0.8)
Interest on deferred consideration	5 x 10%	(0.5)
Share of post-acquisition reserves	2.1 x 80%	1.68
Effect of associate	2 x 25%	0.5
		43.73

W6: Investment in associate

		Rs. m
Cost of Investment	1m shares x Rs. 9	9
Share of profit	2 x 25%	0.5
		9.5

3. TRANSACTIONS WITH ASSOCIATE

3.1 Inter-company balances and transactions

Associate is not part of group, therefore, inter-company balances and transactions are not eliminated, therefore, applying the equity method:

- A receivable from (or payable to) associate company would still be presented in statement of financial position; and
- Revenue and purchases (or other income and other expenses) are not cancelled in statement of comprehensive income.

3.2 Adjustment for unrealised profit for transactions with associate [IAS 28: 28]

Equity method also requires adjustment of unrealised profit on trading and transfer of assets between parent and associate entity. However, only parent's share of unrealised profit is eliminated (contrary to consolidation, where unrealised profit is eliminated in full).

IAS 28 neither specifies the double entry to achieve this nor prescribes the specific line items on which effect of such elimination shall be made. In practice, the following two methods are often used:

Simple approach:		Consolidation style approach:	
All adjustments to be effected in “investment in associate” and “share of profit of associate”		The similar adjustments as used in consolidating a subsidiary.	
Sale of inventory (parent sells to associate)			
Debit	Group reserves (share of A’s profit)	Debit	Group reserves (cost of sales)
Credit	Investment in associate	Credit	Investment in associate
Sale of inventory (associate sells to parent)			
Debit	Group reserves (share of A’s profit)	Debit	Group reserves (share of A’s profit)
Credit	Investment in associate	Credit	Inventory
Sale of PPE (parent sells to associate)			
Debit	Group reserves (share of A’s profit)	Debit	Group reserves (cost of sales/other income)
Credit	Investment in associate	Credit	Investment in associate
Sale of PPE (associate sells to parent)			
Debit	Group reserves (share of A’s profit)	Debit	Group reserves (share of A’s profit)
Credit	Investment in associate	Credit	Property, plant & equipment

The examples in this chapter use the simple approach, where relevant.

► **Example 07:**

Entity P acquired 40% of the equity shares of Entity A several years ago. The cost of the investment was Rs. 205,000.

As at 31 December Year 6 Entity A had made profits of Rs. 275,000 since the date of acquisition.

In the year to 31 December Year 6, Entity P sold goods to Entity A at a sales price of Rs. 200,000 at a mark-up of 100% on cost. Goods which had cost Entity A Rs. 30,000 were still held as inventory by Entity A at the year-end.

Required: Compute the figures that must be included to account for the associate in Entity P's consolidated statement of financial position as at 31 December Year 6.

► **ANSWER:**

In statement of financial position:

- Investment in associate (in non-current assets) to be presented at Rs. 309,000
- The group reserves to be increased by Rs. 104,000.

Working		Rs.
Cost of investment		205,000
Add: Share of post-acquisition profits	[275,000 x 40%]	110,000
Less: Share of URP inventory	[30,000 x 100/200 x 40%]	(6,000)
	<i>Effect of associate's adjustments</i>	104,000
		309,000

Note: Had the unrealised profit adjustment related to a subsidiary, the unrealised profit would have been eliminated by Rs. 15,000 (i.e. Rs. 30,000 x 100/200).

► **Example 08:**

Entity P acquired 40% of the equity shares of Entity A several years ago. The cost of the investment was Rs. 205,000.

As at 31 December Year 6 Entity A had made profits of Rs. 275,000 since the date of acquisition.

On 1 January Year 6, Entity P sold an item of Property, Plant & Equipment to Entity A at a price of Rs. 200,000 at a Profit of 100%. Useful life of such asset is 4 years.

Required: Compute the figures that must be included to account for the associate in Entity P's consolidated statement of financial position as at 31 December Year 6.

► **ANSWER:**

In statement of financial position:

- Investment in associate (in non-current assets) to be presented at Rs. 285,000
- The group reserves to be increased by Rs. 80,000.

Working		Rs.
Cost of investment		205,000
Add: Share of post-acquisition profits	[275,000 x 40%]	110,000
Less: Share of URP transfer of PPE		(30,000)
	<i>Effect of associate's adjustments</i>	80,000
		285,000

Share of unrealised profit on transfer of PPE		Rs.
Sale price		200,000
Gain on transfer	Rs. 200,000 x 100 / 200	100,000
Less: Realised through depreciation	Rs. 100,000 / 4 years	(25,000)
Unrealised gain		75,000
Share of unrealised profit	Rs. 75,000 x 40%	30,000

Note: Had the unrealised profit adjustment related to a subsidiary, the unrealised profit would have been eliminated by Rs. 75,000.

► **Example 09:**

Entity P acquired 30% of the equity shares of Entity A several years ago at a cost of Rs. 275,000.

As at 31 December Year 6 Entity A had made profits of Rs. 380,000 since the date of acquisition.

In the year to 31 December Year 6, the reported profits after tax of Entity A were Rs. 100,000.

In the year to 31 December Year 6, Entity P sold goods to Entity A for Rs. 180,000 at a mark-up of 20% on cost. Goods which had cost Entity A Rs. 60,000 were still held as inventory by Entity A at the year-end.

Required: Compute the figures that must be included to account for the associate in Entity P's consolidated statement of financial position as at 31 December Year 6.

► **ANSWER:**

In statement of financial position:

- Investment in associate (in non-current assets) to be presented at Rs. 386,000
- The group reserves to be increased by Rs. 111,000.

Working		Rs.
Cost of investment		275,000
Add: Share of post-acquisition profits	[380,000 x 30%]	114,000
Less: Share of URP inventory	[60,000 x 20/120 x 30%]	(3,000)
	<i>Effect of associate's adjustments</i>	111,000
		386,000

In statement of profit or loss, share of profit of associate shall be presented in a separate line item at Rs. 27,000 (i.e. Rs. 100,000 x 30% - 3,000 unrealised profit).

► **Example 10:**

Hamachi Limited (HL) acquired 90% of Saba Limited (SL)'s Rs. 10 ordinary shares on 1 April 2014 paying Rs. 30 per share. The balance on SL's retained earnings at this date was Rs. 800,000. On 1 October 2015, HL acquired 30% of Anogo Limited (AL)'s Rs. 10 ordinary shares for Rs. 35 per share. The statements of financial position of the three companies at 31 March 2016 are shown below:

	HL		SL		AL	
	Rs.000	Rs.000	Rs.000	Rs.000	Rs.000	Rs.000
Non-current assets						
PPE		8,050		3,600		1,650
Investments		4,000		910		nil
		12,050		4,510		1,650
Current assets						
Inventory	830		340		250	
Accounts receivable	520		290		350	
Bank	240		nil		100	
		1,590		630		700
Total		13,640		5,140		2,350
Equity and liabilities						

	HL		SL		AL	
	Rs.000	Rs.000	Rs.000	Rs.000	Rs.000	Rs.000
Equity:						
Ordinary shares (Rs. 10)		5,000		1,200		600
Retained earnings b/f	6,000		1,400		800	
Profit for the year	1,500	7,500	900	2,300	600	1,400
		12,500		3,500		2,000
Non-current liabilities						
10% Loan notes		500		240		Nil
Current liabilities						
Accounts payable	420		960		200	
Taxation	220		250		150	
Overdraft	Nil		190		Nil	
		640		1,400		350
Total		13,640		5,140		2,350

The following information is relevant

- (i) On 1 April 2014 SL owned an investment property that had a fair value of Rs. 120,000 in excess of its carrying value (book value). The value of this property has not changed since acquisition. This property is included within investments in the statement of financial position.
Just prior to its acquisition, SL was successful in applying for a six-year licence to dispose of hazardous waste. The licence was granted by the government at no cost, however HL estimated that the licence was worth Rs. 180,000 at the date of acquisition.
- (ii) In January 2016 HL sold goods to AL for Rs. 65,000. These were transferred at a mark-up of 30% on cost. Two thirds of these goods were still in the inventory of AL at 31 March 2016.
- (iii) To facilitate the consolidation procedures the group insists that all inter-company current account balances are settled prior to the year-end. However a cheque for Rs.40,000 from SL to HL was not received until early April 2016. Inter-company balances are included in accounts receivable and payable as appropriate.
- (iv) AL is to be treated as an associated company of HL.
- (v) An impairment test at 31 March 2016 on the consolidated goodwill of SL concluded that it should be written down by Rs. 468,000. No other assets were impaired.

Required: Prepare the consolidated statement of financial position of HL as at 31 March 2016.

► **ANSWER:****Consolidated statement of financial position****As at 31 March 2016**

Non-current assets		Rs. 000
Property, plant & equipment	8,050 + 3,600	11,650
Goodwill	W3	702
Intangible asset (Licence)	W2	120
Investments (Property and other)	See note below	1,160
investment in associate	W6	717
		14,349
Current assets		
Inventory	830 + 340	1,170
Receivable	520 + 940 – 40 in transit	770
Cash	240 + 0 + 40 in transit	280
		2,220
		16,569
Equity		
Share capital		5,000
Retained earnings	W5	8,415
Non-controlling interest	W4	374
Non-current liabilities		
10% loan notes	500 + 240	740
Current liabilities		
Accounts payable	420 + 960	1,380
Taxation	220 + 250	470
Overdraft	190 + 0	190
		2,040
		16,569

Note:

		Rs. 000
Investments as given (HL)		4,000
Less: Investment in subsidiary	120,000 shares x 90% x Rs. 30	(3,240)
Less: Investment in associate	60,000 shares x 30% x Rs. 35	(630)
		130
Investments as given (SL)		910
Add: Fair value adjustment on acquisition		120
		1,030
		1,160

W1: Group Structure

Saba Limited (Subsidiary)	Acquired on 1 April 2014
Parent's ownership 90%	NCI ownership 10%
Anogo Limited (Associate)	Acquired on 1 October 2015
Parent's ownership 30%	

W2: Net assets of subsidiary

		At Acquisition	Post-acquisition	At reporting date
		Rs. 000	Rs. 000	Rs. 000
Share capital		1,200		1,200
Retained earnings		800	1,500	2,300
FV Adj: Investment property		120	-	120
FV Adj: licence	180 / 6 x 2 years	180	(60)	120
		2,300	1,440	3,740

W3: Goodwill

		Rs. 000
Investment		3,240
NCI at acquisition	2,300 x 10%	230
		3,470
Less: Net assets at acquisition	W2	(2,300)
Goodwill at acquisition		1,170
Less: Impairment		(468)
		702

W4: Non-controlling interest

		Rs. 000
NCI at acquisition	2,300 x 10%	230
Share of post-acquisition reserves	1,440 x 10%	144
		374

W5: Group reserves (retained earnings)

		Rs. 000
Parent's retained earnings		7,500
Impairment of goodwill		(468)
Share of post-acquisition reserves	1,440 x 90%	1,296
Effect of associate	W6	87
		8,415

W6: Investment in associate

		Rs. 000
Cost of Investment		630
Share of profit since acquisition	$600 \times 6/12 \times 30\%$	90
Share of URP inventory	$65 \times 2/3 \times 30/130 \times 30\%$	(3)
		87
		717

► **Example 11:**

Hide holds 80% of the ordinary share capital of Seek (acquired on 1 February 2016) and 30% of the ordinary share capital of Arrive (acquired on 1 July 2015).

Hide had no other investments.

The draft statements of profit or loss for the year ended 30 June 2016, are set out below.

	Hide	Seek	Arrive
	Rs.000	Rs.000	Rs.000
Revenue	12,614	6,160	8,640
Operating expenses	(11,318)	(5,524)	(7,614)
Dividends income	150	–	–
	1,446	636	1,026
Income tax	(621)	(275)	(432)
Profit after taxation	825	361	594

Included in the inventory of Seek at 30 June 2016 was Rs. 50,000 for goods purchased from Hide in May 2016 which the latter company had invoiced at cost plus 25%. These were the only goods sold by Hide to Seek but it did make sales of Rs. 180,000 to Arrive during the year. None of these goods remained in Arrive's inventory at the year end.

Required: Prepare a consolidated statement of profit or loss for Hide for the year ended 30 June 2016.

► **ANSWER:**

Consolidated statement of comprehensive income

For the year ended 30 June 2016

		Rs. 000
Revenue	$12,614 + [6,160 \times 5/12] - 50$	15,131
Operating expenses	$11,318 + [5,524 \times 5/12] - 50 + 10^*$	(13,580)
Dividend income	$150 - 150$ (See note 1)	0
Share of associate's profit	$594 \times 30\%$	178
Profit before tax		1,729
Taxation	$621 + [275 \times 5/12]$	(736)
Profit after tax		993

		Rs. 000
Profit attributable to:		
Parent	(balancing)	963
Non-controlling interest	$361 \times 5/12 \times 20\%$	30
		993

$$*50 \times 25/125 = 10$$

Note: Dividend of Rs. 150,000 must related to subsidiary (cancelled as intra group) and associate (not included as income under equity method) since parent entity does not have other investments.

► *Example 12:*

The statements of financial position of three entities Pure Limited (PL), Status Limited (SL) and Angel Limited (AL) are shown below, as at 31 December 2022. However, the statement of financial position of PL records its investment in AL incorrectly.

	PL	SL	AL
	Rs.	Rs.	Rs.
Non-current assets			
Property, plant and equipment	450,000	240,000	460,000
Investment in SL at cost	320,000	-	-
Investment in AL at cost	140,000	-	-
	910,000	240,000	460,000
Current assets			
Inventory	70,000	90,000	70,000
Current account with PL	-	60,000	-
Current account with AL	20,000	-	-
Other current assets	110,000	130,000	40,000
	200,000	280,000	110,000
	1,110,000	520,000	570,000
Equity and reserves			
Equity shares of Rs. 10	100,000	200,000	100,000
Share premium	160,000	80,000	120,000
Accumulated profits	650,000	140,000	250,000
	910,000	420,000	470,000
Long-term liabilities	40,000	20,000	30,000
Current liabilities			
Current account with PL	-	-	20,000
Current account with SL	60,000	-	-
Other current liabilities	100,000	80,000	50,000
	160,000	80,000	70,000
	1,110,000	520,000	570,000

Additional information

- (i) PL bought 15,000 shares in SL several years ago when the fair value of the net assets of SL was Rs. 340,000.
- (ii) PL bought 3,000 shares in AL several years ago when AL's accumulated profits were Rs.150,000.
- (iii) There has been no change in the issued share capital or share premium of either SL or AL since PL acquired its shares in them.
- (iv) There has been impairment of Rs. 20,000 in the goodwill relating to the investment in SL, but no impairment in the value of the investment in AL.
- (v) At 31 December 2022, AL holds inventory purchased during the year from PL which is valued at Rs. 16,000 and PL holds inventory purchased from SL which is valued at Rs.40,000. Sales from PL to AL and from SL to PL are priced at a mark-up of one-third on cost.
- (vi) None of the entities has paid a dividend during the year.
- (vii) PL uses the partial goodwill method to account for goodwill and no goodwill is attributed to the non-controlling interests in SL.

Required: Prepare the consolidated statement of financial position of the PL group as at 31 December 2022.

► **ANSWER:****Consolidated statement of financial position**

As at 31 December 2022

Non-current assets		Rs.
Property, plant & equipment	450,000 + 240,000	690,000
Goodwill	W3	45,000
Investment in associate	W6	168,800
		903,800
Current assets		
Inventory	70,000 + 90,000 - 10,000 URP W2	150,000
Receivable (SL)	0 + 60,000 - 60,000 cancel	0
Receivable (AL)	20,000 + 0	20,000
Other	110,000 + 130,000	240,000
		410,000
		1,313,800
Equity		
Share capital		100,000
Share premium		160,000
Retained earnings	W5	711,300
		971,300
Non-controlling interest	W4	102,500
		1,073,800
Long term liabilities	40,000 + 20,000	60,000

		Rs.
Current liabilities		
Payable (SL)	60,000 + 0 – 60,000 cancel	0
Other	100,000 + 80,000	180,000
		180,000
		1,313,800

W1: Group Structure

Status Limited (Subsidiary)	Acquired several years ago
Parent's ownership 75% [15,000 / 20,000 shares]	NCI ownership 25%
Angel Limited (Associate)	Acquired several years ago
Parent's ownership 30% [3,000 / 10,000 shares]	

W2: Net assets of subsidiary

		At Acquisition	Post-acquisition	At reporting date
		Rs.	Rs.	Rs.
Share capital		200,000		200,000
Share premium		80,000		80,000
Retained earnings		60,000	80,000	140,000
URP Inventory	40,000 x 1/4		(10,000)	(10,000)
		340,000	70,000	410,000

W3: Goodwill

		Rs.
Investment		320,000
NCI at acquisition	340,000 x 25%	85,000
		405,000
Less: Net assets at acquisition	W2	(340,000)
Goodwill at acquisition		65,000
Less: Impairment		(20,000)
		45,000

W4: Non-controlling interest

		Rs.
NCI at acquisition	340,000 x 25%	85,000
Share of post-acquisition reserves	70,000 x 25%	17,500
		102,500

W5: Group reserves (retained earnings)

		Rs.
Parent's retained earnings		650,000
Impairment of goodwill		(20,000)
Share of post-acquisition reserves	70,000 x 75%	52,500
Effect of associate	W6	28,800
		711,300

W6: Investment in associate

		Rs.
Cost of Investment		140,000
Share of post-acquisition reserves	(250,000 – 150,000) x 30%	30,000
Share of URP Inventory	16,000 x ¼ x 30%	(1,200)
		28,800
		168,800

► **Example 13:**

Bilal Limited (BL) acquired a subsidiary Mishal Limited on July 01, 2014 and an associate Zoha Limited (ZL), on January 01, 2017. The details of the acquisition at the respective dates are as follows:

Investment	Retained earnings	Share Premium	Fair value of net assets at acquisition	Cost of investment	Shares acquired
	-----Rs. in million-----				million
ML	160	140	800	765	32
ZL	269	83	652	203	5.5

Statement of financial position as at June 30, 2018

	BL	ML	ZL
	-----Rs. in million-----		
Non-current assets			
Property, plant and equipment	1,012	920	442
Intangible assets	-	350	27
Investment in ML	765	-	-
Investment in ZL	203	-	-
	1,980	1,270	469
Current assets			
Inventories	620	1,460	214
Trade receivables	950	529	330
Cash and cash equivalents	900	510	45
	2,470	2,499	589
	4,450	3,769	1,058

	BL	ML	ZL
	-----Rs. in million-----		
Equity			
Share capital (Rs. 10 each)	1,000	400	220
Share premium	200	140	83
Retained earnings	1,370	929	361
	2,570	1,469	664
Current liabilities			
Trade and other payables	1,880	2,300	394
	4,450	3,769	1,058

Statement of comprehensive income for the year ended June 30, 2018

	BL	ML	ZL
	-----Rs. in million-----		
Revenue	4,480	4,200	1,460
Cost of sales	(2,690)	(2,940)	(1,020)
Gross profit	1,790	1,260	440
Distribution and administrative cost	(620)	(290)	(196)
Finance cost	(50)	(80)	(24)
Dividend income	260	-	-
Profit before tax	1,380	890	220
Income tax expense	(330)	(274)	(72)
Profit for the year	1,050	616	148
Dividend declared and paid during the year	250	300	80
Retained earnings brought forward	570	613	293

Additional information:

- The BL Group has the policy of measuring NCI at fair value at the date of acquisition and fair value of NCI in ML was Rs. 210 million at the date of acquisition.
- Neither ML nor ZL had reserves other than retained earnings and share premium at the date of acquisition. Neither issued new shares since acquisition.
- The fair value difference on the subsidiary relates to property, plant and equipment being depreciated through cost of sales over the remaining useful life of 10 years from the acquisition date. The fair value difference on the associate relates to a piece of land which has not been sold since acquisition.
- ML's intangible assets include Rs. 87 million of training and marketing cost incurred during the year ended June 30, 2018. The directors of ML believe that these should be capitalized as they relate to the start-up period of a new business and intend to amortize the balance over five years from July 01, 2018.
- During the year ended June 30, 2018 ML sold goods to BL for Rs. 1,300 million. The company makes a profit of 30% on the selling price. Rs. 140 million of these goods were held by BL on June 30, 2018.

- (vi) BL sold goods worth Rs. 1,000 to ZL during the year by charging 25% margin on sales, 10% of the goods still remains unsold by ZL.
- (vii) Annual impairment tests have indicated impairment losses of Rs. 100 million relating to the recognized goodwill of ML including Rs. 25 million in the current year. No impairment losses to date have been necessary for the investment in ZL.

Required: Prepare the Consolidated statement of financial position and the statement of comprehensive income for the year ended June 30, 2018 for the BL Group.

► **ANSWER:**

Consolidated statement of financial position

As at 30 June 2018

Non-current assets		Rs. m
Property, plant & equipment	1,012 + 920 + 60 W2	1,992
Goodwill	W3	75
Intangible assets	0 + 350 – 87 incorrect capitalised	263
Investment in associate	W6	219.75
		2,549.75
Current assets		
Inventory	620 + 1,460 – 42 URP W2	2,038
Receivable	950 + 529	1,479
Cash	900 + 510	1,410
		4,927
		7,476.75
Equity		
Share capital		1,000
Share premium		200
Retained earnings	W5	1,786.75
		2,986.75
Non-controlling interest	W4	310
		3,296.75
Current liabilities	1,880 + 2,300	4,180
		7,476.75

W1: Group Structure

Mishal Limited (Subsidiary)	Acquired on 1 July 2014 (4 years)
Parent's ownership 80% (32m / 40m shares)	NCI ownership 20%
Zoha Limited (Associate)	Acquired on 1 January 2017 (1.5 years)
Parent's ownership 25% (5.5m / 22m shares)	

W2: Net assets of subsidiary

		At Acquisition	Post-acquisition	At reporting date
		Rs. m	Rs. m	Rs. m
Share capital		400	-	400
Share premium		140	-	140
Retained earnings		160	769	929
FV Adj: PPE	(balancing)	100	(40)	60
Intangible asset error			(87)	(87)
URP inventory	140 x 30%		(42)	(42)
Fair value (at acq.)	(as given)	800	600	1,400

*100 / 10 years x 4 years

W3: Goodwill

		Rs. m
Investment		765
NCI at acquisition	(fair value)	210
		975
Less: Net assets at acquisition	W2	(800)
Goodwill at acquisition		175
Less: Impairment		(100)
		75

W4: Non-controlling interest

		Rs. m
NCI at acquisition	(fair value)	210
Share of post-acquisition reserves	600 x 20%	120
Share of impairment loss	100 x 20%	(20)
		310

W5: Group reserves (retained earnings)

		Rs. m
Parent's retained earnings		1,370
Share of impairment loss	100 x 80%	(80)
Share of post-acquisition reserves	600 x 80%	480
Effect of associate	W6	16.75
		1,786.75

W6: Investment in associate

		Rs. m
Cost of Investment		203
Share of post-acquisition RE	$[(361 - 269) \times 25\%]$	23
Share of URP inventory	$1,000 \times 10\% \times 25\% \times 25\%$	(6.25)
		16.75
		219.75

Consolidated statement of comprehensive income

For the year ended 30 June 2018

		Rs. m
Revenue	$4,480 + 4,200 - 1,300$	7,380
Cost of sales	$2,690 + 2,940 - 1,300 + 42 + 10^*$	(4,382)
Gross profit		2,998
Distribution & admin costs	$620 + 290 + 87 + 25$ impairment	(1,022)
Finance costs	$50 + 80$	(130)
Dividend income	$260 - 240 \text{ ML} - 20 \text{ ZL}$	0
Share of profit from associate	N2	30.75
Profit before tax		1,876.75
Tax	$330 + 274$	(604)
Profit after tax		1,272.75
Profit attributable to:		
Parent	(balancing)	1,182.35
Non-controlling interest	N1	90.4
		1,272.75

*Depreciation effect of fair value adjustment (current year only) = Rs. 100m / 10 years

N1: NCI share in profit		Rs. m
Subsidiary profit as given		616
URP Inventory W2		(42)
Incorrect intangible asset		(87)
Impairment loss	(current year only)	(25)
Depreciation (FV adj)	(current year only)	(10)
		452
	NCI share	20%
		90.4

N2: Share of profit from associate		Rs. m
Share of profit (as given)	148 x 25%	37
Share of URP Inventory	1,000 x 10% x 25% x 25%	(6.25)
		30.75

► **Example 14:**

Qudsia Limited (QL) has investments in two companies as detailed below:

Manto Limited (ML)

- On 1 January 2010, QL acquired 40 million ordinary shares in ML, when its retained earnings were Rs. 150 million.
- The fair value of ML's net assets on the acquisition date was equal to their carrying amounts.

Hali Limited (HL)

- On 30 November 2012, QL acquired 16 million ordinary shares in HL, when its retained earnings stood at Rs. 224 million.
- The purchase consideration was made up of:
 - Rs. 190 million in cash, paid on acquisition; and
 - 4 million shares in QL. At the date of acquisition, QL's shares were being traded at Rs.15 per share but the price had risen to Rs. 16 per share by the time the shares were issued on 1 January 2013.

The draft summarised statements of financial position of the three companies on 31 December 2012 are shown below:

	QL	ML	HL
	-----Rs. in million-----		
Assets			
Property, plant and equipment	5,000	550	500
Investment in ML	630	-	-
Investment in HL	190	-	-
Current assets	5,480	400	350
	11,300	950	850
Equity and liabilities			
Ordinary share capital (Rs.10 each)	6,000	500	400
Retained earnings	2,900	100	240
Current liabilities	2,400	350	210
	11,300	950	850

The following additional information is available:

- As on 31 December 2012, the recognised goodwill is to be written down by Rs. 30 million.
- QL values the non-controlling interest at its proportionate share of the fair value of the subsidiary's net identifiable assets.

- (iii) On 1 October 2012, ML sold a machine to QL for Rs. 24 million. The machine had been purchased on 1 October 2010 for Rs. 26 million. The machine was originally assessed as having a useful life of ten years and that estimate has not changed.
- (iv) In December 2012, QL sold goods to HL at cost plus 30%. The amount invoiced was Rs. 52 million. These goods remained unsold at year end and the invoiced amount was also paid subsequent to the year end.

Required:

Prepare a consolidated statement of financial position for QL as on 31 December 2012.

► **ANSWER:**

Consolidated statement of financial position

As at 31 December 2012

Non-current assets		Rs. m
Property, plant & equipment	5,000 + 550 – 3.1 W2.1	5,546.9
Goodwill	W3	80
Investment in associate	W6	251.6
		5,878.5
Current assets	5,480 + 400	5,880
		11,758.5
Equity		
Share capital		6,000
Shares to be issued	4m shares x Rs. 15	60
Retained earnings	W5	2,829.12
		8,889.12
Non-controlling interest	W4	119.38
		9,008.5
Current liabilities	2,400 + 350	2,750
		11,758.5

W1: Group Structure

Manto Limited (Subsidiary)	Acquired on 1 January 2010 (3 years)
Parent's ownership 80% (40m/50m shares)	NCI ownership 20%
Hali Limited (Associate)	Acquired on 30 November 2012 (1 month)
Parent's ownership 40% (16m /40m shares)	

W2: Net assets of subsidiary

		At Acquisition	Post-acquisition	At reporting date
		Rs. m	Rs. m	Rs. m
Share capital		500		500
Retained earnings		150	(50)	100
URP machine transfer	W2.1		(3.1)	(3.1)
		650	(53.1)	596.9

W2.1: Unrealised profit on transfer of machine

		Rs. m
NBV with transfer	$[24 - (24/8 \text{ years} \times 3/12)]$	23.25
NBV without transfer	$[26 - (26/10 \text{ years} \times 2.25 \text{ years})]$	(20.15)
		3.10

W3: Goodwill

		Rs. m
Investment		630
NCI at acquisition	$650 \times 20\%$	130
		760
Less: Net assets at acquisition	W2	(650)
Goodwill at acquisition		110
Less: Impairment		(30)
		80

W4: Non-controlling interest

		Rs. m
NCI at acquisition	$650 \times 20\%$	130
Share of post-acquisition reserves	$(53.1) \times 20\%$	(10.62)
		119.38

W5: Group reserves (retained earnings)

		Rs. m
Parent's retained earnings		2,900
Impairment of goodwill		(30)
Share of post-acquisition reserves	$(53.1 \times 80\%)$	(42.48)
Effect of associate	W6	1.6
		2,829.12

W6: Investment in associate

		Rs. m
Cost of Investment	$190 + (4\text{m shares} \times \text{Rs. } 15)$	250
Share of post-acquisition RE	$[(240 - 224) \times 40\%]$	6.4
Share of URP inventory	$52 \times 30/130 \times 40\%$	(4.8)
		1.6
		251.6

4. COMPREHENSIVE EXAMPLES

► Example 15:

The following balances are extracted from the records of Golden Limited (GL), Silver Limited (SL) and Bronze Limited (BL) for the year ended 30 June 2019:

	GL	SL	BL
	----- Rs. in million -----		
Sales	2,500	2,050	1,000
Cost of sales	1,550	1,150	590
Operating expenses	810	520	288
Other income	350	180	50
Finance cost	90	60	35
Surplus arising on revaluation of property, plant and equipment during the year	60	-	20
Investment in SL - at cost	1,400	-	-
Investment in BL - at cost	2,500	-	-
Retained earnings as at 30 June 2019	8,000	3,500	2,200

Additional information:

- (i) Details of GL's investments are as follows:

Date of investment	Holding %	Investee	Share capital (Rs. 10 each) of investee	Retained earnings of investee
			----- Rs. in million -----	
1 Jan 17	35%	BL	5,000	1,800
1 Jul 18	70%	SL	6,000	3,000

- (ii) Cost of investment in S L includes professional fee of Rs. 20 million incurred on acquisition of SL.

- (iii) The following considerations relating to acquisition of SL's shares are still unrecorded:

- Issuance of 175 million ordinary shares of GL.
- Cash payment of Rs. 1,000 million after three years.

On the date of investment, the market price of shares of GL and SL were Rs. 20 and Rs. 17 respectively. Applicable discount rate is 12%.

- (iv) At the date of acquisition of SL, carrying values of its net assets were equal to fair value except the following:
- an internally developed software by SL which had a fair value of Rs. 150 million. The cost of Rs. 120 million incurred by SL on development had been expensed out by SL since the software did not meet the criteria for capitalization during development. At acquisition date, the software had a remaining useful life of 5 years.
 - a contingent liability of Rs. 90 million as disclosed in financial statements of SL which had an estimated fair value of Rs. 60 million. Subsequent to acquisition, the liability has been recognised by SL in its books at Rs. 40 million.

- (v) Following inter-company sales at cost plus 15% were made during the year ended 30 June 2019:

	Sales	Included in buyer's closing stock-in-trade
	----- Rs. in million -----	
SL to GL	506	138
GL to BL	161	69

- (vi) On 1 January 2019, GL granted loans of Rs. 150 million and Rs. 130 million to SL and BL respectively, at interest rate of 12% per annum.
- (vii) GL and BL follow revaluation model whereas SL follows cost model for subsequent measurement of property, plant and equipment. If SL had adopted the revaluation model, SL would have recorded revaluation surplus of Rs. 35 million for the year ended 30 June 2019.
- (viii) GL measures non-controlling interest at the acquisition date at its fair value.

Required:

- (a) Prepare GL's consolidated 'statement of profit or loss and other comprehensive income' for the year ended 30 June 2019.
- (b) Compute the amount of investment in associate as would appear in GL's consolidated statement of financial position as at 30 June 2019.

► **ANSWER:**

Part (a)

Consolidated Statement of Comprehensive Income

For the year ended 30 June 2019

			Rs. m
Revenue	[2,500 + 2,050 - 506]		4,044
Cost of sales	[1,550 + 1,150 - 506 + 18]		(2,212)
Gross profit			1,832
Operating expenses	[810 + 520 + 20 + 30 - 40]		(1,340)
Other income	[350 + 180 - 9**]		521
Finance costs	[90 + 60 + 85.41* - 9**]		(226.41)
Gain on bargain purchase		W3	438.22
Share of associate's profit		N2	44.80
Profit before tax			1,269.61
Tax			0
Profit after tax			1,269.61
Other Comprehensive income			
Gain on revaluation	[60 + 35]		95
Share of associate's OCI	[20 x 35%]		7
Total Comprehensive income			1,371.61

			Rs. m
Profit attributable to:			
Owners of parent			1,122.01
Non-controlling interest		N1	147.6
			1,269.61
Total comprehensive income attributable to:			
Owners of parent			1,213.51
Non-controlling interest		[147.6 + (35 x 30%)]	158.1
			1,371.61

*Interest: deferred consideration $[711.78 \times 12\%] = 85.41$

**Intra group interest $[150 \times 12\% \times 6/12] = 9$

N1: NCI share in profit			Rs. m
Subsidiary's profit (as given)		[2,050 - 1,150 - 520 + 180 - 60]	500
Dep. Software (FV Adj)			(30)
Reversal of contingent liability			40
URP Inventory			(18)
Subsidiary's profit (after adjustments)			492
			30%
			147.6

N2: Share of associate's profit			Rs. m
Share of (given) profit		$[1,000 - 590 - 288 + 50 - 35] \times 35\%$	47.95
Share of URP Inventory		$[69 \times 15/115 \times 35\%]$	(3.15)
			44.8

Part (b)

Investment in Associate			Rs. m
Cost of Investment			2,500
Share of post-acquisition RE		$[(2,200 - 1,800) \times 35\%]$	140
Share of OCI		$[20 \times 35\%]$	7
Share of URP Inventory		$[69 \times 15/115 \times 35\%]$	(3.15)
			2,643.85

W1 Group Structure

Silver Limited (Subsidiary)	Acquired on 1 July 2018 (1 year)
Parent's ownership 70%	NCI ownership 30%
Bronze Limited (Associate)	Acquired on 1 January 2017 (2.5 years)
Parent's ownership 35%	

W2 Net Assets of Subsidiary		At Acquisition
		Rs. m
Share capital		6,000
Retained earnings		3,000
FV Adj: Software	[150 / 5 years]	150
Contingent liability (reversal)		
Contingent liability (recognise)		(60)
URP Inventory	[138 x 15/115]	
		9,090

W3 Goodwill		Rs. m
Investment	W3.1	5,591.78
NCI at Acquisition	[600m shares x 30% x Rs. 17]	3,060
		8,651.78
Less: Net assets at acquisition	W2	(9,090)
Goodwill at acquisition		(438.22)
Transfer to RE (PL)		438.22
Goodwill in SFP		0

W3.1 Investment in subsidiary		Rs. m
Already recorded	[1,400 - 20]	1,380
Share capital & Premium	[175m shares x Rs. 20]	3,500
Deferred consideration	[1,000 x 1.12 ⁻³]	711.78
		5,591.78

► **Example 16:**

Following are the summarized statements of financial position of Pistachio Limited (PL), Mint Limited (ML) and Jalapeno Limited (JL) as on 31 December 2019:

	PL	ML	JL
	----- Rs. in million -----		
Property, plant and equipment	850	750	500
Investment in ML at cost	900	-	-
Investment in JL at cost	170	-	-
Inventories	300	340	200
Trade receivables	240	200	150
Cash and bank balances	60	170	50
	2,520	1,460	900
Share capital (Rs. 10 per share)	1,400	700	400
Share premium	-	100	-
Retained earnings	780	480	340
Liabilities	340	180	160
	2,520	1,460	900

Additional information:

(i) Details of PL's investments are as follows:

Date of investment	Holding %	Investee	Retained earnings of investee Rs. in million
1-Jan-19	25%	JL	200
1-Apr-19	80%	ML	360

(ii) The following considerations relating to acquisition of ML's shares are still unrecorded:

- Transfer of PL's freehold land having carrying value and fair value of Rs. 88 million and Rs. 108 million respectively.
- Cash of Rs. 115 million would be paid in at start of 2020 if ML's net profit for the year 2019 would increase by 20% as compared to last year. Fair value of this consideration on acquisition date was estimated at Rs. 70 million. At year-end, the said target has been achieved by ML.

- (iii) On the date of investment, the fair values of each share of ML and JL were Rs. 18 and Rs. 16 respectively.
- (iv) At the date of acquisition of ML, carrying values of ML's net assets were equal to fair value except for inventory which was carried at Rs. 130 million and had a fair value of Rs. 180 million. 20% of this inventory is still included in ML's inventory as at 31 December 2019.
- (v) On 1 July 2019, ML sold a machine to PL for Rs. 55 million at a gain of Rs. 10 million. The remaining useful life of the machine at the time of disposal was 5 years.
- (vi) JL paid 10% dividend for the half year ended 30 June 2019. PL recorded this as other income.
- (vii) During the year, PL made sales of Rs. 72 million to JL at 20% above cost. 60% of these goods were sold by JL during the year.
- (viii) As at 31 December 2019, PL has receivable of Rs. 8 million from JL.

- (ix) An impairment test carried out at year-end has indicated that goodwill of ML has been impaired by 10%.
- (x) PL measures non-controlling interest at the acquisition date at its fair value.
- (xi) PL's discount rate is 14%.

Required:

- (a) Prepare PL's consolidated statement of financial position as at 31 December 2019 in accordance with the requirements of IFRSs.
- (b) List down the additional information having no effect in your working in (a) above.

► **ANSWER:****Part (a)****Consolidated Statement of financial Position****As at 31 December 2019**

Non-current assets			Rs. m
Property, plant & equipment	[850 + 750 - 88 - 9]		1,503
Goodwill		W3	108
Investment in Associate		W6	203.8
			1,814.8
Current assets			
Inventories	[300 + 340 + 10]		650
Trade receivables	[240 + 200]		440
Cash and bank balances	[60 + 170]		230
			1,320
			3,134.8
Equity			
Share Capital			1,400
Share premium			0
Retained earnings (group)		W5	836
			2,236
Non-Controlling Interest		W4	263.8
			2,499.8
Liabilities	[340 + 180 + 70 + 45]		635
			3,134.8

Part (b)**Additional information having no effect on Consolidated SFP**

(iii)	Fair value per share of JL	
(vi)	Dividend received from JL (Associate)	
(vii)	Receivable from JL (Associate)	
(xi)	Parent's discount rate as there is no deferred consideration.	

W1 Group Structure

Mint Limited (Subsidiary)	Acquired on 1 April 2019 (9 months)
Parent's ownership 80%	NCI ownership 20%
Jalapeno Limited (Associate)	Acquired on 1 January 2019 (1 year)
Parent's ownership 25%	

W2 Net Assets of Subsidiary		At Acquisition	Post-acquisition	At SFP date
		Rs. m	Rs. m	Rs. m
Share capital		700		700
Share premium		100		100
Retained earnings		360	120	480
FV Adj: Inventory	[50 & 50 x 20%]	50	(40)	10
URP machine transfer	[10 - (10/5 x 6/12)]		(9)	(9)
		1,210	71	1,281

W3 Goodwill		Rs. m
Investment	W3.1	1,078
NCI at Acquisition	[70m shares x 20% x Rs. 18]	252
		1,330
Less: Net assets at acquisition	W2	(1,210)
Goodwill at acquisition		120
Impairment loss	@10%	(12)
Goodwill in SFP		108

W3.1 Investment		Rs. m
Cash consideration		900
Land at fair value		108
Contingent consideration		70
		1,078

W4 Non-Controlling Interest		Rs. m
NCI at acquisition	[70m shares x 20% x Rs. 18]	252
Share of post-acquisition reserves	[71 x 20%]	14.2
Share of impairment of goodwill	[12 x 20%]	(2.4)
		263.8

W5 Group Retained Earnings		Rs. m
Parent's RE		780
Gain on transfer of land	[108 - 88]	20
Increase in contingent consideration	[115 - 70]	(45)
Share of impairment of goodwill	[12 x 80%]	(9.6)
Share of post-acquisition reserves	[71 x 80%]	56.8
Effect of Associate adjustments	W6	33.8
		836

W6 Investment in Associate		Rs. m
Cost of Investment		170
Share of Post-acquisition RE	[(340 - 200) x 25%]	35
Share of URP Inventory	[(72 x 40% x 20/120) x 25%]	(1.2)
		33.8
		203.8

► **Example 17:**

The following amounts are extracted from the records of Manzil Limited (ML), Himmat Limited (HL) and Koshish Limited (KL) for the year ended 31 December 2019:

	ML	HL	KL
	----- Rs. in million -----		
Sales	800	315	132
Cost of sales	(540)	(180)	(97)
Operating expenses	(114)	(60)	(6)
Other income	41	-	8
Finance cost	(20)	(12)	(5)
Retained earnings as at 31 December 2019	3,600	322	200

Additional information:

- (i) Details of ML's investments are as follows:

Date of investment	Holding %	Investee	Share capital (Rs. 10 each) of investee
1 Aug 2015	25%	KL	Rs. 400 million
1 May 2019	60%	HL	Rs. 600 million

- (ii) Consideration for acquisition of HL's shares comprises of:
- transfer of ML's building having carrying value and fair value of Rs. 150 million and Rs. 226 million respectively at acquisition date. The disposal of building has been recorded at carrying value.
 - issuance of 16 million ordinary shares of ML after one month of acquisition. The market price of ML's shares at the date of acquisition was Rs. 30 each. However, the market price increased to Rs. 32 when shares were issued.
- (iii) At the date of acquisition of HL, carrying value of its net assets was equal to fair value except the following:
- A manufacturing plant whose fair value exceeded its carrying value by Rs. 60 million. The remaining useful life of the plant on the acquisition date was 8 years.
 - A contingent asset of Rs. 50 million as disclosed in HL's financial statements which had an estimated fair value of Rs. 15 million. At year-end, this contingent asset is disclosed in HL's financial statements at Rs. 46 million.
- (iv) Impairment test carried out at year-end has indicated that goodwill of HL has been impaired by 10%.
- (v) On 15 August 2019, HL and KL paid 5% dividend for the half year ended 30 June 2019. ML recorded its share as other income.
- (vi) On 30 June 2019, KL sold a machine having carrying value of Rs. 60 million to ML for Rs. 68 million. The remaining useful life of the machine at the time of disposal was 5 years.
- (vii) On 15 November 2019, HL and KL purchased 600,000 and 400,000 ordinary shares of Jazba Limited (JL) respectively at price of Rs. 150 each plus 2% transaction cost. HL and KL classified the investment as financial asset at fair value through other comprehensive income. These investments have not been re-measured at year-end. Market price of JL's share was Rs. 138 at year-end. Total share capital of JL consists of 20 million shares.
- (viii) ML measures non-controlling interest at the proportionate share of acquiree's identifiable net assets.

Required: Prepare ML's consolidated statement of profit or loss and other comprehensive income for the year ended 31 December 2019.

► **ANSWER:**

Consolidated Statement of Comprehensive Income

For the year ended 31 December 2019

			Rs. m
Revenue	$[800 + 315 \times 8/12]$		1,010
Cost of sales	$[540 + 180 \times 8/12 + 5]$		(665)
Gross profit			345
Operating expenses	$[114 + 60 \times 8/12 + 12.4]$		(166.4)
Other income	$[41 - 18^* - 5^{**} + (226 - 150)]$		94
Finance costs	$[20 + 12 \times 8/12]$		(28)
Share of associate's profit		N2	6.2
Profit before tax			250.8
Tax			0
Profit after tax			250.8
Other Comprehensive income			
Loss on investments	$0.6\text{m shares} \times [138 - (150 \times 102\%)]$		(9)
Share of associate's OCI	$0.4\text{m shares} \times [138 - (150 \times 102\%)] \times 25\%$		(1.5)
Total Comprehensive income			240.3

			Rs. m
Profit attributable to:			
Owners of parent	(balancing)		236
Non-controlling interest	N1		14.8
			250.8
Total comprehensive income attributable to:			
Owners of parent			229.1
Non-controlling interest	[14.8 - (9 x 40%)]		11.2
			240.3

*Intra group dividend Rs. 600m x 5% x 60% = Rs. 18m

**Dividend from associate Rs. 400m x 5% x 25% = Rs. 5m

N1: NCI share in profit		Rs. m
Subsidiary's profit (as given)	[315 - 180 - 60 - 12] x 8/12	42
Depreciation (FV Adj)		(5)
Subsidiary's profit (after adjustments)		37
	NCI share	40%
		14.8

N2: Share of Profit from Associate		Rs. m
Share of Profit	[132 - 97 - 6 + 8 - 5] x 25%	8
Share of URP machine transfer	[8 gain - 8 / 5 years x 6/12] x 25%	(1.8)
		6.2

W1 Group Structure

Himmat Limited (Subsidiary)	Acquired on 1 May 2019 (8 months)
Parent's ownership 60%	NCI ownership 40%
Koshish Limited (Associate)	Acquired on 1 August 2015 (4+ years)
Parent's ownership 25%	

W2 Net Assets of Subsidiary		At Acquisition	Post-acquisition	At SFP date
		Rs. m	Rs. m	Rs. m
Share capital		600		600
Retained earnings	W2.1	310	12	322
± FV Adj: Plant	60 / 8 years x 8/12	60	(5)	55
		970	7	977

W2.1 Post acquisition retained earnings		Rs. m
Profit since acquisition	$[315 - 180 - 60 - 12] \times 8/12$	42
Less: Dividend	$[600 \times 5\%]$	(30)
		12

W3 Goodwill		Rs. m
Investment	$[\text{Rs. } 226\text{m Building} + 16\text{m shares} \times \text{Rs. } 30]$	706
NCI at Acquisition	$[970 \times 40\%]$	388
		1,094
Less: Net assets at acquisition	W2	(970)
Goodwill at acquisition		124
Impairment loss	@10%	(12.4)
Goodwill in SFP		111.6

► **Example 18:**

Following are the summarized statements of financial position of Himaliya Limited (HL) and Method Limited (ML) as on 31 December 2020:

	HL	ML
	--- Rs. in million ---	
Property, plant and equipment	2,400	1,750
Investments	4,320	-
Inventories	1,050	700
Trade receivables	840	525
Cash and bank balances	210	175
	8,820	3,150
Share capital (Rs. 10 per share)	4,700	1,400
Share premium	720	-
Retained earnings	2,210	1,190
Liabilities	1,190	560
	8,820	3,150

Additional information:

- On 1 April 2020, HL acquired 90% shareholdings in ML at Rs. 2,220 million which was recorded as cost of investment by HL. It includes professional fee of Rs. 30 million for advice on acquisition of ML. At acquisition date, ML's retained earnings were Rs. 700 million.
- On acquisition date, carrying value of ML's net assets was equal to fair value except a brand which had not been recognized by ML. The fair value of the brand was assessed at Rs. 160 million. HL estimated that benefit would be obtained from the brand for the next 5 years.
- Upon acquisition, HL had a plan to restructure ML at a cost of Rs. 80 million. Up to 31 December 2020, ML has incurred and recorded cost of Rs. 70 million for restructuring as per HL's plan.

- (iv) On 1 January 2020, HL acquired 35% shareholdings in Pears Limited (PL) by investing Rs. 1,500 million. This investment is carried at cost on 31 December 2020. Details of PL's net asset on 31 December 2020 are as follows:

Assets and liabilities	Rs. in million
Property, plant and equipment	2,625
Inventories	1,190
Trade receivables	700
Cash and bank balances	595
Liabilities	(630)
Net assets	4,480

- (v) During the year ended 31 December 2020, PL earned a net profit of Rs. 910 million.
- (vi) PL paid dividend of Rs. 490 million for the half year ended 30 June 2020. HL recorded its share as other income.
- (vii) Subsequent to investments made by HL in ML and PL, inter-company sales of goods are invoiced at a mark-up of 25%. The relevant details are as under:

	Rs. in million
ML's inventory on 31 December 2020 includes goods purchased from HL	50
HL's inventory on 31 December 2020 includes goods purchased from PL	120
Receivable from ML on 31 December 2020 as per HL's books	74
Payable to PL on 31 December 2020 as per HL's books	98

- (viii) HL values non-controlling interest at the acquisition date at its fair value which was Rs. 240 million.

Required:

- a) Prepare HL's consolidated statement of financial position as at 31 December 2020 in accordance with the requirements of IFRSs.
- b) List down the additional information having no effect in your working in (a) above.

► **ANSWER:**

Part (a)

Consolidated Statement of financial Position

As at 31 December 2020

Non-current assets			Rs. m
Property, plant & equipment	[2,400 + 1,750]		4,150
Investment in Associate		W6	1,638.6
Other investments	[4,320 - 2,220 - 1,500]		600
Intangible assets (Brand)			136
Goodwill		W3	170
			6,694.6

Current assets			Rs. m
Inventories	[1,050 + 700 - 10]		1,740
Trade receivables	[840 + 525 - 74]		1,291
Cash and bank balances	[210 + 175]		385
			3,416
			10,110.6
Equity			
Share Capital			4,700
Share premium			720
Retained earnings (group)		W5	2,728
			8,148
Non-Controlling Interest		W4	286.6
			8,434.6
Liabilities			
	[1,190 + 560 - 74]		1,676
			10,110.6

Part (b)**Additional information having no effect on Consolidated SFP**

- (i) Restructuring costs
- (ii) Book value of net assets of Associate
- (iii) Payable to PL (Associate)

W1 Group Structure

Method Limited (Subsidiary)	Acquired on 1 April 2020 (9 months)
Parent's ownership 90%	NCI ownership 10%
Pears Limited (Associate)	Acquired on 1 January 2020 (1 year)
Parent's ownership 35%	

W2 Net Assets of Subsidiary		At Acquisition	Post-acquisition	At SFP date
		Rs. m	Rs. m	Rs. m
Share capital		1,400		1,400
Retained earnings		700	490	1,190
FV Adj: Brand	[160 / 5 years x 9/12]	160	(24)	136
		2,260	466	2,726

W3 Goodwill		Rs. m
Investment	[2,220 – 30]	2,190
NCI at Acquisition	[at FV]	240
		2,430
Less: Net assets at acquisition	W2	(2,260)
Goodwill in SFP		170
W4 Non-Controlling Interest		Rs. m
NCI at Acquisition	[at FV]	240
Share of post-acquisition reserves	[466 x 10%]	46.6
		286.6
W5 Group Retained Earnings		Rs. m
Parent's RE		2,210
Professional fee on acquisition		(30)
URP Inventory	[50 x 25/125]	(10)
Share of post-acquisition reserves	[466 x 90%]	419.4
Effect of associate adjustments	W6	138.6
		2,728
W6 Investment in Associate		Rs. m
Cost of Investment		1,500
Share of profit	[910 x 35%]	319
Share of dividend	[490 x 35%]	(171.5)
Share of URP Inventory	[120 x 25/125 x 35%]	(8.4)
		138.6
		1,638.6

► **Example 19:**

Following are the summarized statements of financial position of Safawi Limited (SL) and Khudri Limited (KL) as at 30 June 2021:

	SL	KL
	--- Rs. in million ---	
Property, plant and equipment	2,390	1,210
Intangible assets	525	135
Investment in Anbara Limited – at cost	540	-
Inventories	1,200	600
Other current assets	1,485	445
	6,140	2,390
Share capital (Rs. 10 per share)	2,500	1,000
Share premium	1,040	-
Retained earnings	1,280	1,200
Liabilities	1,320	190
	6,140	2,390

Additional information:

- (i) On 1 October 2020, SL acquired 80% shareholdings in KL through share exchange of one share in SL for every share in KL. At acquisition date, KL's retained earnings were Rs. 1,000 million and the fair values of each share of SL and KL were Rs. 25 and Rs. 23 respectively. Shares issued by SL have not been recorded in the books.
- (ii) On acquisition date, carrying values of KL's net assets were equal to their fair values except the following:
- Inventories were carried at Rs. 240 million and had a fair value of Rs. 340 million. 60% of these were sold during the year ended 30 June 2021.
 - Land was carried at nil value and had a fair value of Rs. 50 million. The land was allotted unconditionally to KL by the government free of cost in 2018 when its fair value was Rs. 40 million.
- (iii) On 1 January 2021, SL disposed of a software license to KL for Rs. 120 million. Its carrying value and remaining useful life at that date was Rs. 90 million and 3 years respectively.
- (iv) Due to temporary adverse economic conditions, an impairment test carried out at 30 June 2021 indicated that goodwill has been impaired by Rs. 60 million.
- (v) On 1 July 2020, SL acquired 3 million shares of Anbara Limited (AL) representing 25% shareholdings. On that date, AL's retained earnings and fair value of each share were Rs. 2,400 million and Rs. 172 respectively.
- (vi) During the year ended 30 June 2021, AL reported net loss of Rs. 280 million and other comprehensive income of Rs. 60 million.
- (vii) On 1 July 2020, SL disposed of machinery to AL for Rs. 200 million at a gain of 100%. The remaining useful life of the machinery at the time of disposal was 5 years.
- (viii) An impairment test carried out at year end has indicated that investment in AL has been impaired by Rs. 130 million.
- (ix) SL values non-controlling interest on the acquisition date at its fair value.

Required: Prepare SL's consolidated statement of financial position as at 30 June 2021 in accordance with the requirements of IFRSs.

► **ANSWER:****Consolidated Statement of financial Position**

As at 30 June 2021

Assets			Rs. m
Property, plant & equipment	[2,390 + 1,210 + 50]		3,650
Intangible assets	[525 + 135 - 25]		635
Goodwill		W3	250
Investment in Associate (AL)		W6	335
Inventories	[1,200 + 600 + 40]		1,840
Other current assets	[1,485 + 445]		1,930
			8,640

Equity			Rs. m
Share Capital	[2,500 + (100m x 80% x Rs. 10)]		3,300
Share premium	[1,040 + (100m x 80% x Rs. 15)]		2,240
Retained earnings (group)		W5	1,114
Non-Controlling Interest		W4	476
Liabilities	[1,320 + 190]		1,510
			8,640

W1 Group Structure

Khudri Limited (Subsidiary)	Acquired on 1 October 2020 (9 months)
Parent's ownership 80%	NCI ownership 20%
Anbara Limited (Associate)	Acquired on 1 July 2020 (1 year)
Parent's ownership 25%	

W2 Net Assets of Subsidiary		At Acquisition	Post-acquisition	At SFP date
		Rs. m	Rs. m	Rs. m
Share capital		1,000		1,000
Retained earnings		1,000	200	1,200
FV Adj: Inventories	[340 - 240]	100	(60)	40
FV Adj: Land		50	-	50
		2,150	140	2,290

W3 Goodwill		Rs. m
Investment	[100m shares x 80% x 1/1 x Rs. 25]	2,000
NCI at Acquisition	[100m shares x 20% x Rs. 23]	460
		2,460
Less: Net assets at acquisition	W2	(2,150)
Goodwill at acquisition		310
Impairment loss		(60)
Goodwill in SFP		250

W4 Non-Controlling Interest		Rs. m
NCI at acquisition	[100m shares x 20% x Rs. 23]	460
Share of post-acquisition reserves	[140 x 20%]	28
Share of impairment of goodwill	[60 x 20%]	(12)
		476

W5 Group Retained Earnings		Rs. m
Parent's RE		1,280
URP on transfer of software	$[120 - 90 = 30 - (30 / 3 \text{ years} \times 6/12)]$	(25)
Share of impairment of goodwill	$[60 \times 80\%]$	(48)
Share of post-acquisition reserves	$[140 \times 80\%]$	112
Effect of associate adjustments	W6	(205)
		1,114

W6 Investment in Associate		Rs. m
Cost of Investment		540
Share of net loss	$[(280) \times 25\%]$	(70)
Share of OCI	$[60 \times 25\%]$	15
Share of URP on machinery transfer	$[(100\text{m} - 100\text{m} / 5 \text{ years}) \times 25\%]$	(20)
Impairment in investment	(given)	(130)
		(205)
		335

5. OBJECTIVE BASED Q&A

- 01.** Which of the following is the criterion for treatment of an investment as an associate?
- Ownership of a majority of the equity shares
 - Ability to exercise control
 - Existence of significant influence
 - Exposure to variable returns from involvement with the investee
- 02.** An associate is an entity in which an investor has significant influence over the investee. Which TWO of the following indicate the presence of significant influence?
- The investor owns 330,000 of the 1,500,000 equity voting shares of the investee
 - The investor has representation on the board of directors of the investee
 - The investor is able to insist that all of the sales of the investee are made to a subsidiary of the investor
 - The investor controls the votes of a majority of the board members.
- 03.** How should an associate be accounted for in the consolidated statement of comprehensive income?
- The associate's income and expenses are added to those of the group on a line-by-line basis
 - The group share of the associate's income and expenses is added to the group figures on a line-by-line basis
 - The group share of the associate's profit after tax is recorded as a one-line entry
 - Only dividends received from the associate are recorded in the group statement of comprehensive income
- 04.** Ansar Limited has held a 90% subsidiary, Fine Limited, for many years, and 3 months before the year end, acquired a 40% associate, Ishaq Limited. Their turnover figures for the year were:

	Rs. million
Ansar Limited	360
Fine Limited	270
Ishaq Limited	180

Calculate the turnover figure to appear in the consolidated statement of comprehensive income for the group.

- Rs. 630 million
 - Rs. 603 million
 - Rs. 810 million
 - Rs. 675 million
- 05.** Which of the following methods is used when accounting for an associate
- Acquisition accounting
 - Proportionate consolidation
 - Equity accounting
 - Pooling of interests

- 06.** Naima Limited owns 70% of Faiza Limited and 30% of Farhan Limited. The tax charge for each company for the year is Naima Limited Rs. 80 million Faiza Limited Rs. 64 million and Farhan Limited Rs. 48 million respectively.

What should be shown as the tax charge in the consolidated statement of comprehensive income?

- (a) Rs. 124.8 million
- (b) Rs. 144 million
- (c) Rs. 139.2 million
- (d) Rs. 192 million

- 07.** IAS 28 defines significant influence in relation to associates as:

- (a) Power to participate in policy decisions
- (b) Power to participate in financial and operating policy decisions but not control them
- (c) Power to participate in policy decisions but not control them
- (d) Power to participate in financial and operating policy decisions

- 08.** Best Limited has a 60% subsidiary Better Limited and a 40% associate Good Limited.

The three companies have profits after tax of Rs. 150 million each.

Calculate the profit after tax for the period that will be shown in the consolidated statement of comprehensive income.

- (a) Rs. 360 million
- (b) Rs. 450 million
- (c) Rs. 300 million
- (d) Rs. 390 million

- 09.** Idrees Limited has an 80% subsidiary, Sajjad Limited and a 40% associate, Sehrish Limited.

The three companies have revenue of Rs. 120 million each.

What should be shown as the revenue figure in the consolidated statement of comprehensive income?

- (a) Rs. 264 million
- (b) Rs. 360 million
- (c) Rs. 240 million
- (d) Rs. 288 million

- 10.** Which of the following investments should be accounted for by Shah Zain Limited as associates?

18% of the equity capital of Company A. Shah Zain Limited is the largest shareholder in this company, has a director on its board, and provides management expertise.

23% of the equity share capital of Company B. Shah Zain Limited has no representative on the board and takes no part in the management of Company B. The majority shareholders in Company B have historically used their combined voting rights to keep any nominee of Shah Zain Limited off the board.

50% of the equity share capital of Company C. The remaining 50% is held by an unrelated company. Policy decisions relating to Company C must be agreed to by both of its shareholders.

46% of the equity share capital of Company D. The other shareholdings are split between various small investors. Shah Zain Limited nominates eight of the ten directors on the board of Company D, under a written agreement between the two companies.

- (a) 1 only
- (b) 1 and 2 only
- (c) 1, 2 and 3 only
- (d) All four investments

11. Fahad Limited bought 30% of Mahad Limited on 1 July 2014. Mahad Limited's statement of comprehensive income for the year shows a profit of Rs. 400 million. Mahad Limited paid a dividend to Fahad Limited of Rs. 50 million on 1 December 2014. At the year end, the investment in Fahad Limited was judged to have been impaired by Rs. 10 million.

What will be the share of profit from associate shown in the consolidated statement of profit or loss for the year ended 31 December 2014?

- (a) Rs. 57 million
- (b) Rs. 50 million
- (c) Rs. 60 million
- (d) Rs. 110 million

12. Bahadur Limited bought 30% of Shahzor Limited on 1 January 2018, when Shahzor Limited had share capital of 10 million Rs. 10 shares. The consideration comprised one Bahadur Limited share for every 3 shares bought in Shahzor Limited.

At the date of acquisition, Bahadur Limited's shares had a market value of Rs. 40.50 and Shahzor Limited's had a market value of Rs. 12. Shahzor Limited reported net loss of Rs. 40 million for the year 2018 and no dividend was paid or declared during 2018. However, Bahadur Limited has determined that its value of investment in Shahzor Limited has not impaired.

What is the value of investment in associate shown in the consolidated statement of financial position as at 31 December 2018?

- (a) Rs. 3.5 million
- (b) Rs. 28.5 million
- (c) Rs. 58.5 million
- (d) Rs. 123 million

13. Falcon Limited acquired 30% of Eagle Limited on 1 July 2013 at a cost of Rs. 5.5 million. Falcon Limited has classified Eagle Limited as an associate.

For the year ended 30 September 2013, Eagle Limited has reported a net profit of Rs. 625,000.

What is the value of the associate investment in the group statement of financial position as at 30 September 2013?

- (a) Rs. 5,546,875
- (b) Rs. 5,500,000
- (c) Rs. 6,125,000
- (d) Rs. 5,968,750

14. Radiant Group acquired 24,000 of Alia Limited's 80,000 equity shares for Rs. 60 per share on 1 April 2014. Alia Limited's profit after tax for the year ended 30 September 2014 was Rs. 400,000.

On the assumption that Alia Limited is an associate of Radiant Group, what would be the carrying amount of the investment in Alia Limited in the consolidated statement of financial position of Radiant Group as at 30 September 2014?

- (a) Rs. 1,455,000
- (b) Rs. 1,500,000
- (c) Rs. 1,515,000
- (d) Rs. 1,395,000

15. 'An associate is an entity over which the investor has significant influence'.

Which TWO of the following do not indicate the presence of significant influence?

- (a) The investor owns 660,000 of the 3,000,000 equity voting shares of the investee
- (b) The investor has representation on the board of directors of the investee
- (c) The investor is able to insist that all of the sales of the investee are made to a subsidiary of the investor
- (d) The investor controls the votes of a majority of the board members

16. Yooshay Limited owns 30% of Hussain Limited, which it purchased on 1 May 2017 for Rs. 2.5 million. At that date Hussain Limited had retained earnings of Rs. 5.3 million. At the year-end date of 31 October 2017 Hussain Limited had retained earnings of Rs. 6.4 million after paying out a dividend of Rs. 1 million. On 30 September 2017 Yooshay Limited sold Rs. 700,000 of goods to Hussain Limited, on which it made 30% profit.

Hussain Limited had resold none of these goods by 31 October.

At what amount will Yooshay Limited record its investment in Hussain Limited in its consolidated statement of financial position at 31 October 2017?

- (a) Rs. 2,500,000
- (b) Rs. 2,767,000
- (c) Rs. 2,830,000
- (d) Rs. 2,893,000

17. On 1 February 2011 Saima Limited acquired 35% of the equity shares of Anum Limited, its only associate, for Rs. 10 million in cash. The post-tax profit of Anum Limited for the year to 30 September 2011 was Rs. 3 million.

Profits accrued evenly throughout the year. Anum Limited made a dividend payment of Rs. 1 million on 1 September 2011. At 30 September 2011 Saima Limited decided that an impairment loss of Rs. 500,000 should be recognised on its investment in Anum Limited.

What amount will be shown as 'investment in associate' in the statement of financial position of Saima Limited as at 30 September 2011?

- (a) Rs. 9,850,000
- (b) Rs. 10,350,000
- (c) Rs. 10,700,000
- (d) Rs. 10,850,000

18. Zarqoon Limited owns 30% of Emerald Limited and exercises significant influence over it. Emerald Limited sold goods to Zarqoon Limited for Rs. 160,000. Emerald Limited applies a one third mark up on cost. Zarqoon Limited still had 25% of these goods in inventory at the year end.

What amount should be deducted from consolidated retained earnings in respect of this transaction?

- (a) Rs. 3,000
- (b) Rs. 10,000
- (c) Rs. 12,000
- (d) None of above

19. On 1 October 2018 Usuf Limited acquired 3 million of Abdullah Limited's 10 million shares in exchange for 7.5 million of its own shares. The stock market value of Usuf Limited's shares at the date of this share exchange was Rs. 16 each.

Abdullah Limited's profit is subject to seasonal variation. Its profit for the year ended 31 March 2019 was Rs. 100 million. Rs. 20 million of this profit was made from 1 April 2018 to 30 September 2018.

Usuf Limited has one subsidiary and no other investments apart from Abdullah Limited.

What amount will be shown as 'investment in associate' in the consolidated statement of financial position of Usuf Limited as at 31 March 2019?

- (a) Rs. 120 million
 - (b) Rs. 144 million
 - (c) Rs. 150 million
 - (d) Rs. 200 million
20. Shazim Limited owns 30% of Shazil Limited. During the year to 31 December 2014 Shazil Limited sold Rs. 2 million of goods to Shazim Limited, of which 40% were still held in inventory by Shazim Limited at the year end. Shazil Limited applies a mark-up of 25% on all goods sold.

What is the amount of adjustment for removal of unrealized profit from inventory?

- (a) Rs. 48,000
- (b) Rs. 120,000
- (c) Rs. 160,000
- (d) Rs. 240,000

ANSWERS

01.	(c)	The criteria is existence of significant influence (there is presumption that 20%+ shareholding results in significant influence).
02.	(a) & (b)	The present of significant influence is indicated by a shareholding of 20% or more or representation on the board. Regarding the third option, material transactions would need to be between the investor itself and the investee. The final option denotes control, not significant influence.
03.	(c)	The group's share of the associate's profit after tax is recorded as a one-line entry. Line by line treatment would be correct for a subsidiary, not an associate. The dividends received from the associate are all that is recorded in the individual entity financial statements of the parent, but in the consolidated financial statements this is replaced by the group share of profit after tax.
04.	(a)	The turnover figure will only include the parent and the subsidiary.
05.	(c)	Equity method of accounting is used.
06.	(b)	Naima Limited Rs. 80 million + Faiza Limited Rs. 64 million. In profit or loss, there is a line item for the group's share of the profit of the associate after tax; therefore, the tax on profits of the associate is not included in the tax charge for the group.
07.	(b)	Participation in, but not control over financial and operating policies is the key test of significant influence.
08.	(a)	Best Limited 150 + Better Limited 150 + Good Limited (40% × 150) = Rs. 360 million The consolidated financial statements include all the profit of a subsidiary, and analyses this into the amount attributable to owners of the parent and the amount attributable to non-controlling interests.
09.	(c)	Idrees Limited Rs. 120 million+ Sajjad Limited 120 million = Rs. 240 million. Associate is not consolidated rather it is accounted for under equity method. The consolidated statement of comprehensive income will include the entity's share of the associate's profit after tax but will not include figures for the associate in other items (such as revenue) in profit or loss.
10.	(a)	Company B - is unlikely that significant influence exists Company C - this is a joint venture due to joint control Company D - control exists so this is a subsidiary
11.	(b)	The dividend would not have been in Mahad Limited's statement of comprehensive income, so no adjustment to this would be made. The adjustment to remove the dividend would be made in investment income, where Fahad Limited will have recorded the income in its individual financial statements. The profit needs to be time-apportioned for the six months of ownership, with the Rs. 10 million impairment then deducted. Share of profit of associate = 30% × Rs. 200 million (Rs. 400 million × 6/12) – Rs. 10 million = Rs. 50 million
12.	(b)	Bahadur Limited own 30% of Shahzor Limited's shares, which is 3 million shares (30% of Shahzor Limited 10 million shares). As Bahadur Limited issued 1 share for every 3 purchased, Bahadur Limited issued 1 million shares. These had a market value of Rs. 40.5 and were therefore worth Rs. 40.5 million. In valuing an associate Bahadur Limited must include 30% of Shahzor Limited post-acquisition loss, share of the loss is Rs. 12 million loss (30%).

			Rs. million
		Cost of investment	40.5
		Share of post-acquisition loss	(12)
		Investment in associate	28.5
13.	(a)		Rs.
		Cost of Investment	5,500,000
		Post-acquisition profits $30\% \times (625,000 \times 3/12)$	46,875
		Total	5,546,875
14.	(b)		Rs. 000
		Cost $(24,000 \times \text{Rs. } 60)$	1,440
		Share of associate's profit $(400 \times 6/12 \times 24/80)$	60
			1,500
15.	(c) & (d)	Items (c) and (d) would signify control and not significant control.	
16.	(b)		Rs. '000
		Cost of investment	2,500
		Share of post-acquisition profit $(6,400 - 5,300) \times 30\%$	330
		PURP $(700 \times 30\% \times 30\%)$	(63)
			2,767
17.	(a)		Rs. '000
		Cost of investment	10,000
		Post -acquisition profit $(3,000 \times 8/12) - 1,000) \times 35\%$	350
		Impairment	(500)
			9,850
18.	(a)	Rs. 3,000 i.e. $(\text{Rs. } 160,000 \times 33.33/133.33) \times 25\% \times 30\% = \text{Rs. } 3,000$	

19.	(b)		
			Rs. m
		Cost (7.5m × Rs. 16)	120
		Post -acquisition retained earnings (100 – 20) × 30%	24
			144
20.	(a)	((Rs. 2 million × 40%) × 25 / 125) × 30% = Rs. 48,000	

STICKY NOTES

Statement of financial position

Investment in associate		Rs.
Cost of investment		XX
Add (less): Share of profit (loss) of associate since acquisition	] Note	XX
Less: Any dividend received		(X)
Add (less): Share of OCI of associate since acquisition		X
Less: Any impairment of the investment recognised		(X)
Less: Share of unrealised profit		(X)
<i>Effect of associate's adjustments (to be included in group reserves)</i>		XX
		XX

Share of post-acquisition retained earnings = Share of post-acquisition profits – dividend received from associate.

Statement of comprehensive income

In statement of profit or loss, 'Share of profits of associate' (net of impairment and share of unrealised profit, if any).

In other comprehensive income, 'Share of other comprehensive income of associate'

Dividend from associate is excluded from profit or loss & group retained earnings because share of profit is included instead. Dividend received is rather treated as return of investment.

AT A GLANCE

SPOTLIGHT

STICKY NOTES

IAS 33 EARNINGS PER SHARE

IN THIS CHAPTER:

AT A GLANCE

SPOTLIGHT

1. Basic EPS: earnings
2. Basic EPS: number of shares
3. Diluted EPS
4. Other aspects
5. Comprehensive Examples
6. Objective Based Q&A

STICKY NOTES

AT A GLANCE

IAS 33 prescribes principles for the determination and presentation of earnings per share (EPS), so as to improve performance comparisons between different entities in the same reporting period and between different reporting periods for the same entity.

The concept of EPS is quite straightforward. It is simply the profit for the year (adjusted for a few things) divided by the weighted average number of ordinary shares outstanding during the period.

IAS 33 deals with calculation and presentation of both basic and diluted EPS and is applicable to entities which are listed or in the process of listing. It specifies the profit figure that should be used and explains how to calculate the appropriate number of shares when there have been changes in share capital during the reporting period.

Basic EPS is based on earnings (as numerator) which is available to ordinary shareholders i.e., the profit after tax – share of NCI – irredeemable preference dividend. The number of shares (as denominator) will be the weighted average number of shares outstanding during the period.

Diluted EPS is based on the issued and potential ordinary shares. The earnings for diluted EPS are the earnings used for basic EPS adjusted for net of tax effect adjustment of assuming potential ordinary shares as issued. The number of shares used for diluted EPS means the number of shares used for basic EPS and weighted average of dilutive potential ordinary shares.

If there is bonus issue, right issue, split of shares, consolidation of shares, change in accounting policy or/and correction of prior period error then both basic and diluted EPS shall be restated retrospectively as well.

An entity is required to present basic and diluted EPS, even if the amounts are negative (i.e. a loss per share). Basic and Diluted EPS are required to be presented on the face of statement of profit or loss account with equal prominence.

1. BASIC EPS: EARNINGS

1.1 Introduction [IAS 33: 1 & 2]

IAS 33 Earnings per share applies to entities whose ordinary shares are publicly traded (listed companies) or are in the process of being issued in public markets. A listed entity is required to present basic and diluted earnings per share, even if the amounts are negative (i.e. a loss per share). When an entity prepares consolidated financial statements as well as separate financial statements, IAS 33 only requires disclosure of EPS based on figures in consolidated financial statements.

As its name implies, earnings per share (EPS) is calculated as reported earnings divided by the number of ordinary shares in issue.

EPS is widely accepted as one of the important indicator of entity's financial performance. EPS is a useful measure of profitability and when compared with EPS of other similar entities, it gives a view of the comparative earning ability of the entities. EPS when calculated over a number of years indicates whether the earning ability of an entity has improved or deteriorated.

EPS may be used by investors or potential investors as a measure of performance, and they are usually interested in the value of EPS relative to the current market price of the entity's shares.

It is important for users of financial statements to compare the EPS of different entities in the same reporting period and the EPS of the same entity over different reporting periods. IAS 33 achieves the objective of comparability by:

- Defining earnings
- Prescribing methods to determine number of shares
- Prescribing standardised presentation and disclosure

1.2 Basic EPS [IAS 33: 5, 6 & 10]

Basic earnings per share is calculated by dividing the profit or loss less share of non-controlling interest and any preference dividend of irredeemable preference shares (the numerator) by the weighted average number of ordinary shares outstanding (the denominator) during the period.

An **ordinary share** is an equity instrument that is subordinate to all other classes of equity instruments. The ordinary shares used in the EPS calculation are those entitled to the residual profits of the entity, after dividends relating to all other types of shares have been deducted.

The calculation of the basic EPS is as follows:

$$\text{Basic EPS} = \frac{\text{Earnings attributable to ordinary shareholders}}{\text{Weighted average number of ordinary shares}}$$

1.3 Earnings attributable to ordinary shareholders [IAS 33: 12 to 14]

Earnings attributable to ordinary shareholders usually means profit after tax less preference dividend.

In case of consolidated financial statements, share of profit of non-controlling interest is also excluded. However, total earnings include any share of profit or loss from associate. In summary, earnings attributable to owners of the parent entity are used for calculation of EPS.

The following guidance is relevant:

Type of preference shares	Impact on calculation
Redeemable preference shares	These shares are classified as liabilities. Any dividend relating to such shares is recognised as a finance cost in the statement of profit or loss. It is already deducted from the profit or loss and no further adjustment is required.
Irredeemable preference shares	These shares are classified as equity and the dividend relating to such shares is presented in the statement of changes in equity. This dividend must be deducted from profit for the year to arrive at profit attributable to the ordinary shareholders.
Convertible (into ordinary shares) preference shares	These shares are usually classified as equity. Any dividend relating to such shares is recognised in the statement of changes in equity. This dividend must be deducted from profit for the year to arrive at profit attributable to the ordinary shareholders.
Cumulative preference shares	These are preference shares on which dividend, if not declared, shall be accumulated and be payable in subsequent period. The dividend on such shares is deducted from profit for the year to arrive at profit attributable to the ordinary shareholders, regardless that dividend is actually declared or not.
Non-Cumulative preference shares	These are preference shares on which dividend, if not declared, shall not be accumulated and shall not be payable in subsequent period. The dividend on such shares is deducted from profit only if declared during the year.

► *Example 01:*

In the year ended 31 December 20X1, Ghalib Limited (GL) made profit after tax of Rs. 3,500,000.

GL paid ordinary dividends of Rs. 150,000 and preference dividends of Rs. 65,000 on redeemable preference shares. The preference shares were correctly classified as liabilities and accounted for in accordance with relevant IFRS.

GL had 1 million ordinary shares of Rs. 10 each in issue throughout the year.

Required:

Calculate basic EPS for the year ended 31 December 20X1.

► *Answer:*

$$\text{Basic EPS} = \frac{\text{Rs. 3,500,000}}{1,000,000 \text{ shares}} = \text{Rs. 3.5 per share}$$

► *Example 02:*

In the year ended 31 December 20X1, Jazib Limited (JL) made profit after tax of Rs. 3,000,000.

JL paid ordinary dividends of Rs. 150,000 and preference dividends of Rs. 65,000 on irredeemable preference shares. The preference shares were correctly classified as equity in accordance with relevant IFRS.

JL had 1 million ordinary shares of Rs. 10 each in issue throughout the year.

Required:

Calculate basic EPS for the year ended 31 December 20X1.

► *Answer:*

$$\text{Basic EPS} = \frac{\text{Rs. } 3,000,000 - 65,000}{1,000,000 \text{ shares}} = \text{Rs. } 2.94 \text{ per share}$$

► *Example 03:*

In the year ended 31 December 20X1, Aqeel Limited (AL) made profit after tax of Rs. 3,500,000.

AL has Rs. 1,000,000 10% cumulative preference shares (classified as equity) in issue. This would entitle the investors to receive a dividend of Rs. 100,000 (10% of Rs. 1,000,000) if declared.

AL had 1 million ordinary shares of Rs. 10 each in issue throughout the year.

Required:

Calculate basic EPS for the year ended 31 December 20X1.

► *Answer:*

$$\text{Basic EPS} = \frac{\text{Rs. } 3,500,000 - 100,000}{1,000,000 \text{ shares}} = \text{Rs. } 3.4 \text{ per share}$$

Notice that the Rs. 100,000 deducted above would be deducted irrespective whether a dividend has been declared or not.

► *Example 04:*

In the year ended 31 December 20X1, Adeel Limited (AL) made profit after tax of Rs. 3,500,000.

AL has Rs. 1,000,000 10% non-cumulative preference shares (classified as equity) in issue. This would entitle the investors to receive a dividend of Rs. 100,000 (10% of Rs. 1,000,000) if declared. The preference dividend was declared during the year ended 31 December 20X1.

AL had 1 million ordinary shares of Rs. 10 each in issue throughout the year.

Required:

Calculate basic EPS for the year ended 31 December 20X1.

► *Answer:*

$$\text{Basic EPS} = \frac{\text{Rs. } 3,500,000 - 100,000}{1,000,000 \text{ shares}} = \text{Rs. } 3.4 \text{ per share}$$

► *Example 05:*

In the year ended 31 December 20X1, Kashif Limited (KL) made profit after tax of Rs. 3,500,000.

KL has Rs. 1,000,000 10% non-cumulative preference shares (classified as equity) in issue. This would entitle the investors to receive a dividend of Rs. 100,000 (10% of Rs. 1,000,000) if declared. The preference dividend was not declared during the year ended 31 December 20X1.

KL had 1 million ordinary shares of Rs. 10 each in issue throughout the year.

Required:

Calculate basic EPS for the year ended 31 December 20X1.

► *Answer:*

$$\text{Basic EPS} = \frac{\text{Rs. 3,500,000}}{1,000,000 \text{ shares}} = \text{Rs. 3.5 per share}$$

2. BASIC EPS: NUMBER OF SHARES

2.1 Weighted average number of shares outstanding [IAS 33: 19 & 27]

For the purpose of calculating basic EPS, the number of ordinary shares shall be weighted average number of ordinary shares outstanding during the period.

The weighted average ordinary shares can be calculated as:

$$= \text{number of ordinary shares outstanding} \times \text{time weighting factor} \times \text{adjustment factor (if any)}$$

The number of shares may increase or decrease during the year due to various reasons, including:

- Issue of shares at full market price
- Issue of shares for no consideration (bonus issue)
- Share split (where one share is divided into several shares of smaller denomination)
- Share consolidation (where two or more shares are consolidated into one share of larger denomination)
- Right issue (with bonus element i.e. issue at below market price)

2.2 Issue of shares at full market price [IAS 33: 20]

The weighted average ordinary shares are to be considered taking into account of the date any new shares are issued during the year since the shares issued during the year provided additional resources only for part of the year. Therefore, new shares issued during the period are taken into account by applying a time weighting factor.

When shares are issued at full price, there is no adjustment required for previously held shares or shares held during comparative periods.

► Example 06:

Friday Limited (FL) has a financial year ending 31 December.

On 1 January 20X1, there were 6,000,000 ordinary shares (Rs. 10 each) in issue. On 1 April 20X1, it issued 1,000,000 new shares at full market price.

Total earnings for the year ended 31 December 20X1 were Rs. 27,000,000.

Required:

Calculate basic EPS for the year ended 31 December 20X1.

► Answer:

$$\text{Basic EPS} = \frac{\text{Rs. 27,000,000}}{6,750,000 \text{ shares}} = \text{Rs. 4 per share}$$

Date	Number of shares	Time factor	Weighted average number
1 January to 31 March	6,000,000	x 3/12	1,500,000
New issue on 1 April	1,000,000		
1 April to 31 December	7,000,000	x 9/12	5,250,000
			6,750,000

► *Example 07:*

Sunday Limited (SL) has a financial year ending 31 December.

On 1 January 20X3, there were 9,000,000 ordinary shares in issue. On 1 May 20X3, SL issued 1,200,000 new shares at full market price. On 1 October 20X3, SL issued a further 1,800,000 shares, also at full market price.

Total earnings in 20X3 were Rs.36,900,000.

Required:

Calculate basic EPS for the year ended 31 December 20X3.

► *Answer:*

$$\text{Basic EPS} = \frac{\text{Rs. 36,900,000}}{10,250,000 \text{ shares}} = \text{Rs. 3.6 per share}$$

Date	Number of shares	Time factor	Weighted average number
1 January to 30 April	9,000,000	x 4/12	3,000,000
<i>New issue on 1 May</i>	1,200,000		
1 May to 30 September	10,200,000	x 5/12	4,250,000
<i>New issue on 1 October</i>	1,800,000		
1 October to 31 December	12,000,000	x 3/12	3,000,000
			10,250,000

2.3 Issue of shares for no consideration (bonus issue) [IAS 33: 26 & 28]

A bonus issue of shares (also called a scrip issue, scrip dividend, specie dividend or a capitalisation issue) is an issue of new shares to existing shareholders, in proportion to their existing shareholding, for no consideration.

The new shares are issued by converting equity reserves (e.g. share premium, retained earnings, etc.) into ordinary share capital.

As no cash is raised from a bonus issue, the resources of the entity remain same. Thus, the bonus issue does not contribute to an entity's ability to earn additional earnings. However, as the number of shares is increased it reduces the per share earnings compared to when such bonus shares were not issued. This might create a misleading impression as if the performance of the business has worsened, which might not be the actual case.

To avoid such misleading impression and to make EPS correctly comparable, bonus issue of shares are treated as if they have always been in issue (i.e. in all previous years as well). This is achieved by applying an 'adjustment factor' to ordinary shares already in issue while calculating weighted average number of shares outstanding.

$$\text{Adjustment factor} = \frac{\text{Number of shares in holding after the bonus issue}}{\text{Number of shares in holding before the bonus issue}}$$

The EPS of comparative periods is restated by either:

- Applying adjustment factor to number of shares in issue in comparative period; or
- Applying reverse adjustment factor to the reported EPS in comparative period.

► **Example 08:**

Pink Limited (PL) has a 31 December financial year end.

On 1 January 20X4 it has 4,000,000 shares in issue. There were no share issues in Year 20X4. On 1 July 20X5 it made a 1 for 4 bonus issue.

Basic EPS reported in 20X4 was: Rs. 20,000,000/4,000,000 shares = Rs. 5 per share

Earning attributable to ordinary shareholders for the year 20X5 are Rs. 24,000,000

Required:

Calculate basic EPS for the year ended 31 December 20X5 (including comparative for 20X4).

► **Answer:**

Adjustment factor = 5 / 4

$$\text{Basic EPS (20X5)} = \frac{\text{Rs. 24,000,000}}{5,000,000 \text{ shares}} = \text{Rs. 4.8 per share}$$

Date	Number of shares	Time factor	Adjustment factor	Weighted average number
1 January to 30 June	4,000,000	x 6/12	x 5/4	2,500,000
New issue on 1 July	1,000,000			
1 July to 31 December	5,000,000	x 6/12		2,500,000
				5,000,000

$$\text{Basic EPS (20X4 restated)} = \frac{\text{Rs. 20,000,000}}{4,000,000 \times 5/4 \text{ shares}} = \text{Rs. 4 per share}$$

Alternatively, **Basic EPS (20X4 restated)** = Rs. 5 x 4/5 = Rs. 4 per share

► **Example 09:**

Red Limited (RL) has a 31 December financial year-end and had 2,000,000 ordinary shares in issue on 1 January 20X2.

On 31 March 20X2, it issued 500,000 ordinary shares, at full market price.

On 1 July 20X2, RL made a 1 for 2 bonus issue.

In Year 20X1, the EPS had been calculated as Rs. 30 per share.

In Year 20X2, total earnings were Rs. 85,500,000.

Required:

Calculate the EPS for the year to 31 December 20X2, and the comparative EPS figure for 20X1.

► **Answer:**

Adjustment factor = $3 / 2$

$$\text{Basic EPS (20X2)} = \frac{\text{Rs. 85,500,000}}{3,562,500 \text{ shares}} = \text{Rs. 24 per share}$$

Date	Number of shares	Time factor	Adjustment factor	Weighted average number
1 January to 31 March	2,000,000	x 3/12	x 3/2	750,000
<i>Issue at full price on 31 March</i>	500,000			
1 April to 30 June	2,500,000	x 3/12	x 3/2	937,500
<i>Bonus issue on 1 July</i>	1,250,000			
1 July to 31 December	3,750,000	x 6/12		1,875,000
				3,562,500

Basic EPS (20X1 restated) = Rs. 30 x $2/3$ = Rs. 20 per share

2.4 Share split [IAS 33: 26 & 28]

Share split is the division of the existing issued share capital of a company into a larger number of shares but with smaller denominations. The overall amount of capital remains the same.

For example, a shareholder had 100 ordinary shares of Rs. 50 par value per share, that is total Rs. 5,000. The company made a 5 for 1 share split. Now the shareholder would have 500 shares of Rs. 10 par value per share, that is same total of Rs. 5,000.

Since there is no change in actual resources of the entity, the calculation perspective is same as that of bonus issue and an 'adjustment factor' is applied to ordinary shares already in issue while calculating weighted average number of shares outstanding.

$$\text{Adjustment factor} = \frac{\text{Number of shares in holding after share split}}{\text{Number of shares in holding before share split}}$$

The EPS of comparative periods is restated by either:

- Applying adjustment factor to number of shares in issue in comparative period; or
- Applying reverse adjustment factor to the reported EPS in comparative period.

► **Example 10:**

Pacific Limited (PL) has a 31 December financial year end.

On 1 January 20X4 it has 4,000,000 shares in issue. There were no share issues or other changes in Year 20X4. On 1 July 20X5 it made a 5 for 2 share split.

Basic EPS reported in 20X4 was: Rs. 20,000,000/4,000,000 shares = Rs. 5 per share

Earning attributable to ordinary shareholders for the year 20X5 are Rs. 24,000,000

Required:

Calculate basic EPS for the year ended 31 December 20X5 (including comparative for 20X4).

► **Answer:**

Adjustment factor = $5 / 2$

$$\text{Basic EPS (20X5)} = \frac{\text{Rs. 24,000,000}}{10,000,000 \text{ shares}} = \text{Rs. 2.4 per share}$$

Date	Number of shares	Time factor	Adjustment factor	Weighted average number
1 January to 30 June	4,000,000	$\times 6/12$	$\times 5/2$	5,000,000
Increase due to share split	6,000,000			
1 July to 31 December	10,000,000	$\times 6/12$		5,000,000
				10,000,000

$$\text{Basic EPS (20X4 restated)} = \frac{\text{Rs. 20,000,000}}{4,000,000 \times 5/2 \text{ shares}} = \text{Rs. 2 per share}$$

Alternatively, Basic EPS (20X4 restated) = Rs. $5 \times 2/5$ = Rs. 2 per share

2.5 Share consolidation [IAS 33: 26 & 29]

Consolidation of shares, also known as reverse share split, results in smaller number of shares with larger denominations without affecting the total value of share capital.

For example, a shareholder had 500 ordinary shares of Rs. 10 par value per share, that is total Rs. 5,000. The company made a 1 for 5 share consolidation. Now the shareholder would have 100 shares of Rs. 50 par value per share, that is same total of Rs. 5,000.

Since there is no change in actual resources of the entity, the calculation perspective is same as that of bonus issue and an 'adjustment factor' is applied to ordinary shares already in issue while calculating weighted average number of shares outstanding.

$$\text{Adjustment factor} = \frac{\text{Number of shares in holding after share consolidation}}{\text{Number of shares in holding before share consolidation}}$$

The EPS of comparative periods is restated by either:

- Applying adjustment factor to number of shares in issue in comparative period; or
- Applying reverse adjustment factor to the reported EPS in comparative period.

► **Example 11:**

Atlantic Limited (AL) has a 31 December financial year end.

On 1 January 20X4 it has 4,000,000 shares in issue. There were no share issues or other changes in Year 20X4. On 1 July 20X5 it made a 2 for 5 share consolidation.

Basic EPS reported in 20X4 was: Rs. 20,000,000/4,000,000 shares = Rs. 5 per share

Earning attributable to ordinary shareholders for the year 20X5 are Rs. 24,000,000

Required:

Calculate basic EPS for the year ended 31 December 20X5 (including comparative for 20X4).

► **Answer:**

Adjustment factor = 2 / 5

$$\text{Basic EPS (20X5)} = \frac{\text{Rs. 24,000,000}}{1,600,000 \text{ shares}} = \text{Rs. 15 per share}$$

Date	Number of shares	Time factor	Adjustment factor	Weighted average number
1 January to 30 June	4,000,000	x 6/12	x 2/5	800,000
<i>Reduction: share consolidation</i>	<i>(2,400,000)</i>			
1 July to 31 December	1,600,000	x 6/12		800,000
				1,600,000

$$\text{Basic EPS (20X4 restated)} = \frac{\text{Rs. 20,000,000}}{4,000,000 \times 2/5 \text{ shares}} = \text{Rs. 12.5 per share}$$

Alternatively, **Basic EPS (20X4 restated)** = Rs. 5 x 5/2 = Rs. 12.5 per share

2.6 Right issue [IAS 33: 26 & A2]

A rights issue of shares is an issue of new shares for cash, where the new shares are offered initially to current shareholders in proportion to their existing shareholdings.

The issue price of the new shares in a rights issue is usually below the current market price and, in such a case, a bonus element exists in such issue which must be adjusted i.e. an 'adjustment factor' is applied to ordinary shares already in issue while calculating weighted average number of shares outstanding.

$$\text{Adjustment factor} = \frac{\text{Fair value per share immediately before the exercise of rights}^*}{\text{Theoretical ex-rights fair value per share}}$$

*also called cum-rights price

The theoretical ex-rights price is the expected price (in theory) at which the shares ought to be, in theory, after the rights issue. It is computed as under:

$$= \frac{(\text{Shares before right issue} \times \text{cum-rights price}) + (\text{Right issue shares} \times \text{Exercise price})}{\text{Shares before right issue} + \text{Right issue shares}}$$

The EPS of comparative periods is restated by either:

- Applying adjustment factor to number of shares in issue in comparative period; or
- Applying reverse adjustment factor to the reported EPS in comparative period.

► **Example 12:**

Peach Limited (PL) has a 31 December financial year-end.

PL had 3,600,000 shares in issue on 1 January 20X2.

It made a 1 for 4 rights issue on 1 June 20X2, at a price of Rs. 40 per share. (After the rights issue, there will be 1 new share for every 4 shares previously in issue). The share price just before the rights issue was Rs. 50.

Total earnings in the financial year to 31 December 20X2 were Rs. 25,125,000.

The reported EPS in Year 20X1 was Rs. 6.4 per share.

Required:

Calculate the EPS for the year to 31 December 20X2, and the comparative EPS figure for 20X1.

► **Answer:**

$$\text{Theoretical ex-rights price} = \frac{(4 \text{ shares} \times \text{Rs. } 50) + (1 \text{ share} \times \text{Rs. } 40)}{4 \text{ shares} + 1 \text{ share}} = \text{Rs. } 48 \text{ per share}$$

$$\text{Adjustment factor} = 50 / 48$$

$$\text{Basic EPS (20X2)} = \frac{\text{Rs. } 25,125,000}{4,187,500 \text{ shares}} = \text{Rs. } 6 \text{ per share}$$

Date	Number of shares	Time factor	Adjustment factor	Weighted average number
1 January to 31 May	3,600,000	x 5/12	x 50/48	1,562,500
<i>Right issue on 1 June</i>	900,000			
1 June to 31 December	4,500,000	x 7/12		2,625,000
				4,187,500

$$\text{Basic EPS (20X1 restated)} = \text{Rs. } 6.4 \times 48/50 = \text{Rs. } 6.14 \text{ per share}$$

► **Example 13:**

Grapes Limited (GL) has a 31 December financial year-end.

GL had 3 million ordinary shares in issue on 1 January 20X7.

On 1 April 20X7, it made a 1 for 2 rights issue of 1,500,000 ordinary shares at Rs. 20 per share. The market price of the shares prior to the rights issue was Rs. 50.

An issue of 400,000 shares at full market price was then made on 1 August 20X7.

In the year to 31 December 20X7, total earnings were Rs. 17,468,750.

In Year 20X6, EPS had been reported as Rs. 3.5 per share

Required:

Calculate the EPS for the year to 31 December 20X7, and the adjusted EPS for 20X6 for comparative purposes.

► **Answer:**

$$\text{Theoretical ex-rights price} = \frac{(2 \text{ shares} \times \text{Rs. } 50) + (1 \text{ share} \times \text{Rs. } 20)}{2 \text{ shares} + 1 \text{ share}} = \text{Rs. } 40 \text{ per share}$$

$$\text{Adjustment factor (right issue)} = 50 / 40$$

$$\text{Basic EPS (20X7)} = \frac{\text{Rs. } 17,468,750}{4,479,167 \text{ shares}} = \text{Rs. } 3.9 \text{ per share}$$

Date	Number of shares	Time factor	Adjustment factor	Weighted average number
1 January to 31 March	3,000,000	x 3/12	x 50/40	937,500
<i>Right issue on 1 April</i>	1,500,000			
1 April to 31 July	4,500,000	x 4/12		1,500,000
<i>Full price issue 1 August</i>	400,000			
1 August to 31 December	4,900,000	x 5/12		2,041,667
				4,479,167

$$\text{Basic EPS (20X6 restated)} = \text{Rs. } 3.5 \times 40/50 = \text{Rs. } 2.8 \text{ per share}$$

2.7 Retrospective adjustments [IAS 33: 64]

2.7.1 Retrospective adjustment: earnings

The basic (and diluted) EPS of all periods presented shall be adjusted for the effects of errors and adjustments resulting from changes in accounting policies accounted for retrospectively (in accordance with IAS 8).

► *Example 14:*

Nawabpur Limited (NL) has a 31 December financial year end. On 1 January 20X4 it has 4,000,000 shares in issue. There were no share issues or other changes.

Basic EPS reported in 20X4 was:

Rs. 20,000,000/4,000,000 shares = Rs. 5 per share

In October 20X5, it was discovered that registry cost of Rs. 1,000,000 had been incorrectly charged as expense in year 20X4 (i.e. the profit of 20X4 should have been Rs. 21,000,000)

Earning attributable to ordinary shareholders for the year 20X5 are Rs. 24,000,000.

Required: Calculate basic EPS for the year ended 31 December 20X5 (including comparative for 20X4).

► *Answer:*

$$\text{Basic EPS (20X5)} = \frac{\text{Rs. 24,000,000}}{4,000,000 \text{ shares}} = \text{Rs. 6 per share}$$

$$\text{Basic EPS (20X4)} = \frac{\text{Rs. 21,000,000 profit restated}}{4,000,000 \text{ shares}} = \text{Rs. 5.25 per share}$$

2.7.2 Retrospective adjustments: number of ordinary shares

The calculation of basic (and diluted) EPS for all periods presented shall be adjusted retrospectively (including the restatement of comparatives) as a result of:

- Bonus issue
- Share split
- Reverse share split; or
- Right issue with bonus element

IAS 33 requires this retrospective adjustment to the number of ordinary shares even if changes in shareholding structure occur after the reporting period but before the financial statements are authorised for issue. The fact that per share calculations reflect such changes in the number of shares shall be disclosed.

► *Example 15:*

Multan Limited (ML) has a 31 December financial year end.

On 1 January 20X4 it has 4,000,000 shares in issue. Basic EPS reported in 20X4 was:

Rs. 20,000,000/4,000,000 shares = Rs. 5 per share

Earning attributable to ordinary shareholders for the year 20X5 are Rs. 24,000,000

There were no share issues or other changes during Year 20X4 or 20X5. However, ML made a bonus issue of 25% (i.e. 1,000,000 shares) on 15th February 20X6 before finalization of financial statements.

Required: Calculate basic EPS for the year ended 31 December 20X5 (including comparative for 20X4).

► *Answer:*

Adjustment factor = $5 / 4$

$$\text{Basic EPS (20X5)} = \frac{\text{Rs. 24,000,000}}{5,000,000 \text{ shares}} = \text{Rs. 4.8 per share}$$

Date	Number of shares	Time factor	Adjustment factor	Weighted average number
1 January to 31 Dec	4,000,000	x 12/12	x 5/4	5,000,000
<i>Bonus issue on 15 Feb 20X6</i>	1,000,000			
After the year-end	5,000,000	x 0/12		0
				5,000,000

Basic EPS (20X4 restated) = $\text{Rs. } 5 \times 4/5 = \text{Rs. 4 per share}$

3. DILUTED EPS

3.1 The concept [IAS 33: 5, 31 & 32]

Diluted EPS is another measure the amount of earnings each share will receive had all dilutive potential ordinary shares were in issue. This helps investors understand the possible future impacts of potential ordinary shares on their earnings.

The objective of diluted EPS is consistent with that of basic earnings per share, that is, to provide a measure of the performance of each ordinary share taking into account dilutive potential ordinary shares outstanding during the period.

A **potential ordinary share** is a financial instrument or other contract that may entitle its holder to ordinary shares (at some time in the future).

Examples of potential ordinary shares include:

- Convertible bonds (debentures)
- Convertible preference shares
- Share options or warrants (i.e. financial instruments that give the holder the right to purchase ordinary shares).

Note: potential ordinary shares do not impact calculation of basic EPS.

3.2 Dilution [IAS 33: 5 & 41]

Dilution is a reduction in earnings per share or an increase in loss per share resulting from the assumption that convertible instruments are converted, that options or warrants are exercised, or that ordinary shares are issued upon the satisfaction of specified conditions.

If potential shares become actual ordinary shares, the earnings figure will be shared with a larger number of ordinary shares. This might dilute the EPS. The literal meaning of 'dilution' is 'watering down' or 'reduction in strength'. The earnings may also change as entity will no longer be paying interest on convertible bonds or dividend on convertible preference shares.

► Example 16:

Ben Limited (BL) had profit after tax of Rs. 200 million. The following shares are in issue since incorporation of BL on 1 January 2021:

- 100 million ordinary shares of Rs. 10 each
- 20 million 8% cumulative preference shares of Rs. 20 each. One preference share is convertible into two ordinary shares on 31 December 2025.

Required: Calculate basic and diluted EPS for the year ended 31 December 2022.

► Answer:

$$\text{Basic EPS (2022)} = \frac{\text{Rs. 200} - *32 \text{ million}}{100 \text{ million shares}} = \text{Rs. 1.68 per share}$$

*Preference dividend = 20 million x Rs. 20 each x 8% = Rs. 32 million

$$\text{Diluted EPS (2022)} = \frac{\text{Rs. 168} + 32 \text{ million}}{100 + 40 \text{ million shares}} = \text{Rs. 1.43 per share}$$

	Incremental earnings (Rs. m)	Incremental shares (m)	Incremental EPS (Rs.)
Convertible preference shares	32 [20m x Rs. 20 x 8%]	40 [20m x 2 shares]	0.8 Dilutive

These convertible preference shares are dilutive since incremental EPS from the conversion is lower than basic EPS.

3.3 Anti-dilution [IAS 33: 5 & 43]

Not all potential ordinary shares are dilutive, though, and may be anti-dilutive and are disregarded in the calculation of diluted EPS.

Anti-dilution is an increase in earnings per share or a reduction in loss per share resulting from the assumption that convertible instruments are converted, that options or warrants are exercised, or that ordinary shares are issued upon the satisfaction of specified conditions.

If there are no dilutive potential ordinary shares at all, the diluted EPS shall be equal to basic EPS.

► **Example 17:**

Stokes Limited (SL) had profit after tax of Rs. 200 million. The following shares are in issue since incorporation of SL on 1 January 2021:

- 100 million ordinary shares of Rs. 10 each
- 20 million 8% cumulative preference shares of Rs. 20 each. Two preference shares are convertible into one ordinary share on 31 December 2025.

Required: Calculate basic and diluted EPS for the year ended 31 December 2022.

► **Answer:**

$$\text{Basic EPS (2022)} = \frac{\text{Rs. 200} - *32 \text{ million}}{100 \text{ million shares}} = \text{Rs. 1.68 per share}$$

*Preference dividend = 20 million x Rs. 20 each x 8% = Rs. 32 million

$$\text{Diluted EPS (2022)} = \text{Same as basic EPS} = \text{Rs. 1.68 per share}$$

	Incremental earnings (Rs. m)	Incremental shares (m)	Incremental EPS (Rs.)
Convertible preference shares	32 [20m x Rs. 20 x 8%]	10 [20m x 1/2 shares]	3.2 Anti-dilutive
These convertible preference shares are anti-dilutive since incremental EPS from the conversion is higher than basic EPS. If we include the impact of these convertible preference shares in EPS, the resulting EPS will be: [Rs. 168 + 32 m] / [100 + 10 m shares] = Rs. 1.82 per share (increase in EPS)			

3.4 Computation: convertible instruments [IAS 33: 33, 35, 36, 38 & 39]

When there are convertible bonds or convertible preference shares, diluted EPS is calculated as follows:

3.4.1 Earnings

Had the convertible instruments been converted into ordinary shares, the entity would not have to pay the dividend or interest, therefore, earnings are adjusted as follows:

- For convertible preference shares, add back the preference dividend for the year.
- For convertible bonds, add back the interest charge on the bonds for the year (net of tax).

3.4.2 Number of shares

The weighted average number of shares computed in basic EPS are increased by adding the number of new shares that would have been issued if all the potential ordinary shares were converted into ordinary shares.

IAS 33 provides for use of most dilutive option when multiple conversion options are available.

The additional number of shares are included in computation of diluted EPS for such period they remained outstanding during the year.

► **Example 18:**

Gold Limited (GL) has 12,000,000 ordinary shares and Rs. 4,000,000 5% convertible bonds in issue as at 31 December 20X2, there have been no new issues of shares or bonds for several years.

The bonds are convertible into ordinary shares in 20X3 or 20X4, at the following rates:

- At 30 shares for every Rs. 100 of bonds if converted at 31 December 20X3
- At 25 shares for every Rs. 100 of bonds if converted at 31 December 20X4

Total earnings for the year to 31 December 20X2 were Rs. 36,000,000. Tax is payable at a rate of 30% on profits.

Required:

Calculate basic EPS and diluted EPS for the year ended 31 December 20X2.

► **Answer:**

$$\text{Basic EPS (20X2)} = \frac{\text{Rs. 36,000,000}}{12,000,000 \text{ shares}} = \text{Rs. 3 per share}$$

Convertible bonds

Interest saving = Rs. 4,000,000 x 5% = Rs. 200,000

Tax effect = Rs. 200,000 x 30% = Rs. 60,000

Incremental earnings = Rs. 200,000 – 60,000 = Rs. 140,000

Incremental shares (maximum) = Rs. 4,000,000 / 100 x 30 shares = 1,200,000 shares

Incremental EPS = Rs. 140,000 / 1,200,000 shares = Rs. 0.1167 (dilutive)

$$\text{Diluted EPS (20X2)} = \frac{\text{Rs. 36,000,000} + 140,000}{12,000,000 + 1,200,000 \text{ shares}} = \text{Rs. 2.74 per share}$$

► **Example 19:**

Silver Limited (SL) has 10,000,000 ordinary shares in issue on 1 January 20X5. There has been no new issue of shares for several years. However, SL issued Rs. 2,000,000 of 6% convertible preference shares on 1 April 20X5.

These are convertible into ordinary shares at the following rates:

- On 31 March 20X8: 25 shares for every Rs. 100 of convertible preference shares
- On 31 March 20X9: 20 shares for every Rs. 100 of convertible preference shares

In the financial year to 31 December 20X5 total earnings attributable to ordinary shareholders were Rs. 40,870,000. Tax is at the rate of 30%, however, preference dividend is not deductible for tax purposes.

Required:

Calculate basic EPS and diluted EPS for the year ended 31 December 20X5.

► *Answer:*

$$\text{Basic EPS (20X5)} = \frac{\text{Rs. 40,870,000}}{10,000,000 \text{ shares}} = \text{Rs. 4.09 per share}$$

Convertible Preference shares

Preference dividend saving = Rs. 2,000,000 x 6% x 9/12 = Rs. 90,000

Tax effect = Nil since there is no tax relief on preference dividend

Incremental earnings = Rs. 90,000

Incremental shares (maximum) = Rs. 2,000,000 / 100 x 25 shares x 9/12 = 375,000 shares

Incremental EPS = Rs. 90,000 / 375,000 shares = Rs. 0.24 (dilutive)

These are potentially dilutive since incremental EPS is less than basic EPS.

$$\text{Diluted EPS (20X5)} = \frac{\text{Rs. 40,870,000} + 90,000}{10,000,000 + 375,000 \text{ shares}} = \text{Rs. 3.95 per share}$$

3.5 Share options or warrants [IAS 33: 45 & 47]

Share options issued by an entity are also potential ordinary shares, and exercise of such options will bring some resources to the business which may not dilute the earnings. However, if the option's exercise price is less than average market price of the period (i.e. the option is 'in the money'), the option holders will get extra shares for which entity's resources will not be increased. These extra (or free) shares are treated as dilutive because they will not contribute towards earnings but number of shares will be increased.

Free shares can be calculated as follows:

$$\text{Free shares} = \text{number of options in issue} \times \frac{\text{Average market price during the period} - \text{Exercise price}}{\text{Average market price during the period}}$$

Diluted EPS will be calculated by adding these free shares in weighted average number of shares used in basic EPS calculation. However, these will not impact earnings.

► *Example 20:*

Bronze Limited (BL) had total earnings during Year 20X3 of Rs. 25,000,000. It has 5,000,000 ordinary shares in issue.

There are outstanding share options on 400,000 shares, which can be exercised at a future date, at an exercise price of Rs. 25 per share.

The average market price of shares in BL during Year 20X3 was Rs. 40.

Required:

Calculate basic EPS and diluted EPS for the year ended 31 December 20X3.

► *Answer:*

$$\text{Basic EPS (20X3)} = \frac{\text{Rs. 25,000,000}}{5,000,000 \text{ shares}} = \text{Rs. 5 per share}$$

Share options

These are dilutive since exercise price of Rs. 25 is less than share market price of Rs. 40 i.e. in the money options.

Free shares = 400,000 options x (40 - 25) / 40 = 150,000 shares

$$\text{Diluted EPS (20X3)} = \frac{\text{Rs. 25,000,000}}{5,000,000 + 150,000 \text{ shares}} = \text{Rs. 4.85 per share}$$

3.6 Order of dilution [IAS 33: 44]

In determining whether potential ordinary shares are dilutive or antidilutive, each issue or series of potential ordinary shares is considered separately rather than in aggregate.

The sequence in which potential ordinary shares are considered may affect whether they are dilutive. Therefore, to maximise the dilution of basic earnings per share, each issue or series of potential ordinary shares is considered in sequence from the most dilutive to the least dilutive, i.e. dilutive potential ordinary shares with the lowest 'earnings per incremental share' are included in the diluted earnings per share calculation before those with a higher earnings per incremental share.

Options and warrants are generally included first because they do not affect the numerator (i.e. earnings) of the calculation.

► **Example 21:**

The following information relates to Olympics Limited (OL) for the year ended 31 December 20X5.

Number of ordinary shares in issue	2,000,000
Reported earnings attributable to ordinary shares	Rs. 6,000,000
Average market price of shares during the year	Rs. 80

Potential ordinary shares:

Options	600,000 options, with an exercise price of Rs. 60
1,000,000 7% convertible preference shares of Rs. 10 each	Each preference share is convertible in 20X8 into ordinary shares at the rate of 3 ordinary share for every 10 preference shares
4% convertible bond: Rs. 5,000,000	Each bond is convertible in 20X9 into ordinary shares at the rate of 20 new shares for every Rs. 100 of bonds.

Tax rate is 30%.

Required:

Calculate basic EPS and diluted EPS for the year ended 31 December 20X5.

► **Answer:**

$$\text{Basic EPS (20X5)} = \frac{\text{Rs. 6,000,000}}{2,000,000 \text{ shares}} = \text{Rs. 3 per share}$$

Ranking order

Options			Rank
Incremental earnings		Rs. Nil	
Incremental shares	$600,000 \times (80 - 60) / 80$	150,000	
Incremental EPS		Nil	1
Convertible preference shares			
Incremental earnings	$1,000,000 \times \text{Rs. 10} \times 7\%$	Rs. 700,000	
Incremental shares	$1,000,000 / 10 \times 3 \text{ shares}$	300,000	
Incremental EPS		Rs. 2.33	3

Options			Rank
Convertible bond			
Incremental earnings (net of tax)	Rs. 5,000,000 x 4% x 70%	Rs. 140,000	
Incremental shares	Rs. 5,000,000 / 100 x 20 shares	1,000,000	
Incremental EPS		Rs. 0.14	2

Although individually all of the above are dilutive, we must consider each item one by one to consider dilution.

	Earnings Rs.	Shares	EPS Rs.	Impact
Basic EPS	6,000,000	2,000,000	3.00	
Options (Rank 1)	0	150,000		
	6,000,000	2,150,000	2.79	Dilutive
Convertible bonds (Rank 2)	140,000	1,000,000		
	6,140,000	3,150,000	1.95	Dilutive
Convertible pref. shares (Rank 3)	700,000	300,000		
	6,840,000	3,450,000	1.98	Anti-dilutive

The convertible preference shares are not dilutive, and the reported diluted EPS should be Rs. 1.95 (and not Rs. 1.98).

4. Other aspects

4.1 Presentation requirements [IAS 33: 66 to 67A & 69]

An entity should present in the statement of profit or loss:

- the basic EPS; and
- the diluted EPS.

The basic and the diluted EPS should be presented, even if it is a negative figure (even if it is a loss per share).

The basic EPS and diluted EPS should be presented with equal prominence for all the periods presented (the current year and the previous year). These figures are presented at the end of the statement of comprehensive income.

If the entity presents a separate statement of profit or loss:

- the EPS and diluted EPS should be shown in this statement of profit or loss; and
- not in the statement presenting comprehensive income.

If diluted earnings per share is reported for at least one period, it shall be reported for all periods presented, even if it equals basic earnings per share. If basic and diluted earnings per share are equal, dual presentation can be accomplished in one line in the statement of comprehensive income.

4.2 Disclosure requirements [IAS 33: 70]

IAS 33 also requires disclosure of the following:

- The total amounts used as the numerators (total earnings figures) to calculate the basic EPS and diluted EPS, and a reconciliation of these numerator figures to the profit or loss for the period.
- The weighted average number of ordinary shares used as a denominator to calculate the basic EPS and diluted EPS, and a reconciliation of these two denominators to each other.

► Example 22:

Abrar Limited (AL) had profit after tax of Rs. 200 million and Rs. 156 million for the year ended 31 December 2022 and 2021 respectively.

The details of shares including potential ordinary shares are as follows:

- 100 million ordinary shares of Rs. 10 each. These shares are in issue since incorporation.
- 20 million 8% cumulative preference shares of Rs. 20 each are also in issue since incorporation. One preference share is convertible into two ordinary shares on 31 December 2025.
- 4 million share options were issued on 1 January 2022 which can be exercised at a future date, at an exercise price of Rs. 20 per share. The average market price of shares in AL during the year was Rs. 40.

Required: Show presentation of basic and diluted EPS and prepare disclosure note for EPS in accordance with IAS 33 for the year ended on 31 December 2022 (including the comparative).

► Answer:

Statement of profit or loss (extracts)	2022	2021
	Rs.	Rs.
Basic earnings per share	1.68 [168m / 100m]	1.24 [124m / 100m]
Diluted earnings per share	1.41 [200m / 142m]	1.11 [156m / 140m]

Notes to the financial statements for the year ended 31 December 2022

Earnings per share	2022	2021
Earnings	Rs. m	Rs. m
Profit after tax	200	156
Less: Preference dividend $[20m \times Rs. 20 \times 8\%]$	(32)	(32)
Earnings for calculation of basic EPS	168	124
Add: Effect of conversion of preference shares	32	32
Add: Effect of share options	-	
Earnings for calculation of diluted EPS	200	156

Weighted average number of shares	Shares m	Shares m
Shares for calculation of basic EPS	100	100
Add: Conversion of preference shares $[20m \times 2]$	40	40
Add: Free shares under options W1	2	
Shares for calculation of diluted EPS	142	140

W1: $4m \times [(40-20)/40] = 2m$ free shares

4.3 Usefulness of EPS as financial information

The trend (improvement or deterioration) in an entity's published EPS figure is often a reliable indicator of future performance. There are a number of reasons for this:

- EPS measures an entity's performance from the viewpoint of investors. It shows the amount of earnings available to each ordinary shareholder. This means that EPS takes the effect of preference dividends (if any) into account. It also takes share issues into account.
- Diluted EPS can provide an 'early warning' of any changes to an investor's potential return on their investment due to future share issues.
- EPS not only helps measure an entity's current financial standing but also helps track its past performances.

In particular, EPS helps investors:

- to identify suitable investment options by comparing the performance of different entities.
- to compare the financial standing of an entity over the years (i.e. a steady increase in EPS over the years is considered a reliable investment option).
- to predict future dividend pay-out on their investments as higher EPS means more profitability, which suggests entity may increase dividend pay-out over time.

EPS is also an important component of determining an entity's P/E ratio i.e. calculated as market value per share divided by earnings per share. P/E ratio is often used by investor in making stock market decisions. The reliable EPS means reliable P/E ratio leading to better and informed decisions by investors.

4.4 Limitations of EPS

EPS is probably the single most important indicator of an entity's performance. It is a very useful measure when it is used as the starting point for a more detailed analysis of an entity's performance. However, EPS can have serious limitations:

- Not all entities use the same accounting policies. It may not always be possible to make meaningful comparisons between the EPS of different entities.
- EPS does not take account of inflation, so that growth in EPS over time might be misleading.
- EPS measures an entity's profitability, but this is only part of an entity's overall performance. An entity's cash flow can be just as important as its profit (and more essential to its immediate survival). Changes in the value of assets (holding gains) can also be an important part of performance for some entities.
- Diluted EPS is often described as an 'early warning' to investors that the return on their investment may fall sometime in the future. However, diluted EPS is based on current earnings, not forecast earnings. This means that it may not be a reliable predictor of future EPS.

One of the main problems with EPS can be the way that it is used by investors and others. Users often rely on EPS as the main or only measure of an entity's performance. Management knows this and try to make EPS appear as high as possible. They may attempt to manipulate the figure by using 'creative accounting'. They may also make decisions which increase EPS in the short term, but which damage the entity in the longer term.

5. COMPREHENSIVE EXAMPLES

► Example 23:

Daffodil Limited (DL) had share capital of Rs. 1,600 million (ordinary share of Rs. 10 each) as at 31 December 2015.

	2017	2016
	Rs. m	Rs. m
Net profit for the year	660.25	331.67

Details of share issues:

- 25% right shares were issued on 1 May 2016 at Rs. 18 per share. The market price per share immediately before the entitlement date was also Rs. 18 per share.
- A bonus issue of 10% was made on 1 April 2017 as final dividend for 2016.
- 50 million right shares were issued on 1 July 2017 at Rs. 15 per share. The market price per share immediately before the entitlement date was Rs. 25 per share.
- A bonus issue of 15% was made on 1 September 2017 as interim dividend.

Required: Calculate the basic EPS for the year ended 31 December 2017 (including the comparative).

► Answer:

$$\text{Basic EPS (2017)} = \frac{\text{Rs. 660.25 million}}{291.87 \text{ million shares}} = \text{Rs. 2.26 per share}$$

$$\text{Basic EPS (2016)} = \frac{\text{Rs. 331.67 million}}{255.02 \text{ million shares}} = \text{Rs. 1.30 per share}$$

Date	Number of shares (m)	Time factor	Adjustment factor(s)	Weighted average (m)
2016				
1 Jan to 30 Apr	160	x 4/12	x 1.1 x 1.08 x 1.15	72.86
<i>Right issue (1 May) full price</i>	40			
1 May to 31 Dec	200	x 8/12	x 1.1 x 1.08 x 1.15	182.16
				255.02
2017				
1 Jan to 31 Mar	200	x 3/12	x 1.1 x 1.08 x 1.15	68.31
<i>Bonus issue (1 Apr)</i>	20			
1 Apr to 30 June	220	x 3/12	x 1.08 x 1.15	68.31
<i>Right issue (1 Jul)</i>	50			
1 Jul to 31 Aug	270	x 2/12	x 1.15	51.75
<i>Bonus issue (1 Sep)</i>	40.5			
1 Sep to 31 Dec	310.5	x 4/12		103.5
				291.87

Adjustment factor (bonus issue 1 April 10%) = $110 / 100 = 1.1$

Adjustment factor (right issue 1 Jul) = $25 / 23.15 = 1.08$

Adjustment factor (bonus issue 1 Sep 15%) = $115 / 100 = 1.15$

$$\text{Theoretical ex-rights price} = \frac{(220\text{m shares} \times \text{Rs. } 25) + (50\text{m share} \times \text{Rs. } 15)}{220\text{m shares} + 50\text{m shares}} = \text{Rs. } 23.15 \text{ per share}$$

► **Example 24:**

Durable Electronics Limited (DEL) is a manufacturing concern specializing in the manufacturing and marketing of home appliances. The profit after tax is Rs. 48 million for the year ended December 31, 2005.

The details of movement in the share capital of the company during the year are as follows:

- (i) As on January 1, 2005, 10 million ordinary shares of Rs. 10 each were outstanding having a market value of Rs. 350 million.
- (ii) The board of directors of the company announced an issue of right share in the proportion of 1 for 5 at Rs. 40 per share. The entitlement date of right shares was April 30, 2005. The market price of the shares immediately before the entitlement date was Rs. 40 per share.
- (iii) The company announced 2 million bonus shares for its shareholders on June 1, 2005. The entitlement date was June 30, 2005. The ex-bonus market value per share was Rs. 32.
- (iv) A further right issue was made in the proportion of 1 for 4 on October 31, 2005 at a premium of Rs. 15 per share. The market value of the shares before the right entitlement was Rs. 33 per share.

Required:

Calculate the basic earnings per share for the year ended December 31, 2005 in accordance with IAS 33 (comparative are not required).

► **Answer:**

$$\text{Basic EPS (2015)} = \frac{\text{Rs. } 48 \text{ million}}{14.36 \text{ million shares}} = \text{Rs. } 3.34 \text{ per share}$$

Date	Number of shares (m)	Time factor	Adjustment factor(s)	Weighted average (m)
1 Jan to 30 Apr	10	x 4/12	x 7/6 x 33/31.4	4.09
Right issue (30 Apr)	2			
1 May to 30 Jun	12	x 2/12	x 7/6 x 33/31.4	2.45
Bonus issue (30 Jun)	2			
1 Jun to 31 Oct	14	x 4/12	x 33/31.4	4.90
Right issue (31 Oct)	3.5			
1 Nov to 31 Dec	17.5	x 2/12		2.92
				14.36

Right issue on 30 April is at full market price.

Adjustment factor (bonus issue 1 June) = $14 / 12 = 7 / 6$

Adjustment factor (right issue 31 Oct) = $33 / 31.4$

$$\text{Theoretical ex-rights price} = \frac{(4 \text{ shares} \times \text{Rs. } 33) + (1 \text{ share} \times \text{Rs. } 25)}{4 \text{ shares} + 1 \text{ share}} = \text{Rs. } 31.4 \text{ per share}$$

► **Example 25:**

The following information pertains to the financial statements of Home Dynamics Limited (HDL), a listed company, for the year ended 31 December 20X6:

- (i) Profit after tax for the year is Rs. 765 million.
- (ii) Shareholders' equity as on 1 January 20X6 comprised of:
 - 10 million ordinary shares of Rs. 10 each, having market value of Rs. 25 each.
 - 4 million cumulative preference shares of Rs. 10 each entitled to a cumulative dividend at 10%.
- (iii) On 31 March 20X6, HDL announced 40% right shares to its ordinary shareholders at Rs. 25 per share. The entitlement date of right shares was 31 May 20X6. The market price per share immediately before the announcement date and entitlement date was Rs. 28 and Rs. 32 respectively.
- (iv) On 2 August 20X6, HDL announced 20% bonus issue. The entitlement date of bonus shares was 31 August 20X6.
- (v) On 1 February 20X7, the board of directors announced 20% cash dividend and 10% bonus issue being the final dividend to the ordinary shareholders and 10% cash dividend for preference shareholders.

Required:

Calculate basic earnings per share for inclusion in HDL's financial statements for the year ended 31 December 20X6. Show all relevant calculations.

► **Answer:**

$$\text{Basic EPS (20X6)} = \frac{\text{Rs. 765,000,000} - 4,000,000^*}{16,646,667 \text{ shares}} = \text{Rs. 45.71 per share}$$

*Preference dividend = 4 million x Rs. 10 x 10% = Rs. 4 million

Date	Number of shares	Time factor	Adjustment factor(s)	Weighted average
1 January to 31 May	10,000,000	x 5/12	x 32/30 x 1.2 x 1.1	5,866,667
<i>Right issue on 31 May</i>	4,000,000			
1 June to 31 August	14,000,000	x 3/12	x 1.2 x 1.1	4,620,000
<i>Bonus issue on 31 August</i>	2,800,000			
1 September to 31 December	16,800,000	x 4/12	x 1.1	6,160,000
<i>Bonus issue on 1 February</i>	1,680,000			
After the year-end	18,480,000	x 0/12		0
				16,646,667

Adjustment factor (31st May right issue) = 32 / 30

Adjustment factor (31st August bonus issue) = 120 / 100 = 1.2

Adjustment factor (1st February 20X7 bonus issue) = 110 / 100 = 1.1

$$\text{Theoretical ex-rights price} = \frac{(10\text{m shares} \times \text{Rs. 32}) + (4\text{m share} \times \text{Rs. 25})}{10\text{m shares} + 4\text{m share}} = \text{Rs. 30 per share}$$

► **Example 26:**

Chand Limited (CL) was incorporated on 1 January 2020 with an authorized share capital of Rs. 500 million comprising of 50 million shares.

(i) Details of shares issued are as follows:

- On 1 March 2020, CL issued 20 million shares at Rs. 18 each.
- On 1 October 2020, CL issued 15% bonus shares. The market price per share immediately before the announcement of bonus was Rs. 24 per share.
- On 1 September 2021, CL issued 40% right shares at a premium of Rs. 12.5 per share. The market price per share immediately before the entitlement date was Rs. 33 per share.

(ii) Following information has been extracted from CL's draft financial statements:

	2021	2020
	Draft	Audited
	--- Rs. in million ---	
Net profit	66	48
Revaluation surplus arising during the year	-	20
Transfer of incremental depreciation	4	-
Final cash dividend	-	10%

(iii) After the preparation of draft financial statements for the year ended 31 December 2021, it was discovered that installation cost of Rs. 12 million relating to a plant capitalized on 1 August 2020 was wrongly expensed out. The plant is subsequently measured using cost model and is being depreciated @ 20% per annum on reducing balance method.

Required:

- (a) Prepare CL's statement of changes in equity for the year ended 31 December 2021 along with comparative figures. (Column for total is not required)
- (b) Compute CL's basic and diluted earnings per share to be disclosed in the statement of profit or loss for the years ended 31 December 2021 and 2020.

► **Answer:****Part (a)****Chand Limited****Statement of changes in equity for the year ended 31 December 2021**

	Share capital	Share premium	Retained earnings	Revaluation surplus
	Rs. m	Rs. m	Rs. m	Rs. m
Balance as at 1 January 2020	-	-	-	-
Share issue [20m x Rs. 10 & 8]	200	160		
Bonus issue 15%	30	(30)		
Total comprehensive income				
Profit for the year (restated) W1			59	
Other comprehensive income				20
Balance as at 31 December 2020	230	130	59	20

	Share capital	Share premium	Retained earnings	Revaluation surplus
	Rs. m	Rs. m	Rs. m	Rs. m
Final cash dividend 10%			(23)	
Right issue [23m x 40% x Rs. 10 & 12.5]	92	115		
Profit for the year W1			63.8	
Transfer of incremental depreciation			4	(4)
Balance as at 31 December 2021	322	245	103.8	16

Working 1:	2021	2020
	Rs. m	Rs. m
Profit as given	66	48
Add: Reversal of installation costs		12
Less: Extra depreciation 2020 [Rs. 12m x 20% x 5/12]		(1)
Less: Extra depreciation 2021 [(Rs. 12m – 1m) x 20%]	(2.2)	
Corrected (restated) profit	63.8	59

Part (b)**EPS reported in statement of profit or loss for the year ended 31 December 2020**

$$\text{Basic and diluted EPS (2020)} = \frac{\text{Rs. 48 million}}{19.17 \text{ million shares}} = \text{Rs. 2.50 per share}$$

Date	Number of shares (m)	Time factor	Adjustment factor(s)	Weighted average (m)
1 Jan to 29 Feb	-	x 2/12		-
Share issue (1 Mar) full price	20			
1 Mar to 30 Sep	20	x 7/12	x 1.15	13.42
Bonus issue (1 Oct)	3			
1 Oct to 31 Dec	23	x 3/12		5.75
				19.17

Adjustment factor (bonus issue 1 October 15%) = $115 / 100 = 1.15$

EPS reported in statement of profit or loss for the year ended 31 December 2021

$$\text{Basic and diluted EPS (2021)} = \frac{\text{Rs. 63.8 million (Part a)}}{27.6 \text{ million shares}} = \text{Rs. 2.31 per share}$$

$$\text{Basic and diluted EPS (2020: restated)} = \frac{\text{Rs. 59 million (Part a)}}{*21.09 \text{ million shares}} = \text{Rs. 2.80 per share}$$

* $19.17 \text{ million shares} \times 1.1 \text{ (right issue adjustment factor)} = 21.09 \text{ million shares}$

Date	Number of shares (m)	Time factor	Adjustment factor(s)	Weighted average (m)
1 Jan to 31 Aug	23	x 8/12	x 1.1	16.87
Right issue (1 Sep)	9.2			
1 Mar to 30 Sep	32.2	x 4/12		10.73
				27.60

Adjustment factor (right issue 1 Sep 40%) = $33 / 30 = 1.1$

$$\text{Theoretical ex-rights price} = \frac{(100 \text{ shares} \times \text{Rs. } 33) + (40 \text{ shares} \times \text{Rs. } 22.5)}{100 \text{ shares} + 40 \text{ shares}} = \text{Rs. } 30 \text{ per share}$$

► **Example 27:**

The profit after tax earned by AAZ Limited during the year ended December 31, 2007 amounted to Rs. 127.83 million. The weighted average number of shares outstanding during the year was 85.22 million.

Details of potential ordinary shares as at December 31, 2007 are as follows:

- The company had issued debentures which are convertible into 3 million ordinary shares. The debenture holders can exercise the option on December 31, 2009. If the debentures are not converted into ordinary shares they shall be redeemed on December 31, 2009. The interest on debentures for the year 2007 amounted to Rs. 7.5 million.
- Preference shares issued in 2004 are convertible into 4 million ordinary shares at the option of the preference shareholders. The conversion option is exercisable on December 31, 2010. The dividend paid on preference shares during the year 2007 amounted to Rs. 2.45 million.
- The company has issued options carrying the right to acquire 1.5 million ordinary shares of the company on or after December 31, 2007 at a strike price of Rs. 9.90 per share. During the year 2007, the average market price of the shares was Rs. 11 per share.

The company is subject to income tax at the rate of 30%.

Required:

Compute basic and diluted earnings per share and prepare disclosure note in accordance with IAS 33 for the year ended December 31, 2007 (comparatives are not required).

► **Answer:**

$$\text{Basic EPS (2007)} = \frac{\text{Rs. } 127.83 - 2.45 \text{ million}}{85.22 \text{ million shares}} = \text{Rs. } 1.471 \text{ per share}$$

Ranking order

	Incremental earnings (Rs. m)	Incremental shares (m)	Incremental EPS (Rs.)
Convertible debentures	5.25 [7.5m x 70%]	3	1.75 Anti-dilutive
Convertible preference shares	2.45	4	0.61 Dilutive
Options	-	0.15 [(1.5m x [(11 - 9.90) / 11])]	Nil Dilutive

Options are most dilutive (Rank 1) and then are convertible preference shares (Rank 2). Convertible debentures will be ignored in calculation since they are anti-dilutive.

Calculation of diluted EPS

	Earnings Rs.	Shares	EPS Rs.	Impact
Basic EPS	125.38	85.22	1.471	
Options (1)	0	0.15		
	125.38	85.37	1.469	Dilutive
Convertible pref. shares (3)	2.45	4		
	127.83	89.37	1.430	Dilutive

Notes to the financial statements for the year ended 31 December 2007

Earnings per share		2007
Earnings		Rs. m
Profit after tax		127.83
Less: Preference dividend		(2.45)
Earnings for calculation of basic EPS		125.38
Add: Effect of conversion of preference shares		2.45
Add: Effect of share options		-
Earnings for calculation of diluted EPS		127.83

Weighted average number of shares		Shares m
Shares for calculation of basic EPS		85.22
Add: Free shares under options		0.15
Add: Conversion of preference shares		4
Shares for calculation of diluted EPS		89.37

► **Example 28:**

Peach Tree Limited (PTL) was incorporated on 1 July 2020. Following information has been extracted from its financial statements for the year ended 30 June 2022:

	2022	2021
	---- Rs. in million ----	
Net profit	250	210
Revaluation surplus arising during the year	30	50
Total comprehensive income	280	260

Details of shares and bonds issued by PTL since incorporation are as follows:

- (i) On 1 July 2020, 50 million ordinary shares having par value of Rs. 10 each were issued at Rs. 14 each.
- (ii) On 1 July 2020, 10 million 12% redeemable preference shares having par value of Rs. 50 each were issued at Rs. 64 each. Each preference share is convertible into 3 ordinary shares after 5 years.

- (iii) On 1 February 2021, further 20 million ordinary shares having par value of Rs. 10 each were issued at prevailing market price of Rs. 16 each.
- (iv) On 1 October 2021, 40% right shares were issued at a premium of Rs. 10 per share. The market price per share immediately before the entitlement date was Rs. 30 per share.
- (v) On 1 November 2021, 3 million convertible bonds having par value of Rs. 100 each were issued. The bonds carry interest @ 10% per annum payable on 31 October each year. Each bond is convertible into 7 ordinary shares after 3 years.

Required:

Compute basic and diluted earnings per share to be disclosed in PTL's financial statements for the years ended 30 June 2021 and 2022. (Show comparative figures).

► **Answer:****EPS for the year ended 30 June 2021**

$$\begin{aligned} \text{Basic EPS (2021)} &= \frac{\text{Rs. 210 million}}{58.34 \text{ million shares}} = \text{Rs. 3.60 per share} \\ \text{Diluted EPS (2021)} &= \frac{\text{Rs. 210} + 60 \text{ million}}{58.34 + 30 \text{ million shares}} = \text{Rs. 3.06 per share} \end{aligned}$$

Date	Number of shares (m)	Time factor	Adjustment factor(s)	Weighted average (m)
1 Jul to 31 Jan	50	x 7/12	-	29.17
Share issue (1 Feb) full price	20			
1 Feb to 30 Jun	70	x 5/12	-	29.17
				58.34

	Incremental earnings (Rs. m)	Incremental shares (m)	Incremental EPS (Rs.)
Convertible preference shares	60 [10m x Rs. 50 x 12%]	30 [10m x 3 shares]	2 Dilutive

EPS for the year ended 30 June 2022

$$\begin{aligned} \text{Basic EPS (2022)} &= \frac{\text{Rs. 250 million}}{92.84 \text{ million shares}} = \text{Rs. 2.69 per share} \\ \text{Diluted EPS (2022)} &= \frac{\text{Rs. 250} + 20 + 60 \text{ million}}{92.84 + 14 + 30 \text{ million shares}} = \text{Rs. 2.41 per share} \end{aligned}$$

$$\begin{array}{lcl} \text{Basic EPS} & & \text{Rs. 210 million} \\ \text{(2021: restated)} & = \frac{\quad}{64.49 \text{ million shares}} = & \text{Rs. 3.26 per share} \end{array}$$

* $58.34 \text{ million shares} \times 30/27.14 \text{ (right issue adjustment factor)} = 64.49 \text{ million shares}$

$$\begin{array}{lcl} \text{Diluted EPS} & & \text{Rs. 210 + 60 million} \\ \text{(2021: restated)} & = \frac{\quad}{64.49 + 30 \text{ million shares}} = & \text{Rs. 2.86 per share} \end{array}$$

Date	Number of shares (m)	Time factor	Adjustment factor(s)	Weighted average (m)
1 Jul to 30 Sep	70	x 3/12	x 30/27.14	19.34
Right issue (1 Oct)	28			
1 Oct to 30 Jun	98	x 9/12		73.50
				92.84

Adjustment factor (right issue 1 October 40%) = $30 / 27.14$

$$\begin{array}{lcl} \text{Theoretical ex-rights price} & = \frac{(100 \text{ shares} \times \text{Rs. } 30) + (40 \text{ shares} \times \text{Rs. } 20)}{100 \text{ shares} + 40 \text{ shares}} = & \text{Rs. 27.14 per share} \end{array}$$

	Incremental earnings (Rs. m)	Incremental shares (m)	Incremental EPS (Rs.)
Convertible bonds	20 [3m x Rs. 100 x 10% x 8/12]	14 [3m x 7 shares x 8/12]	1.43 Dilutive

Convertible bonds are more dilutive (ranking 1) than convertible preference shares (ranking 2) because incremental EPS of convertible bonds is lower than that of convertible preference shares.

Diluted EPS (convertible bonds only) = $[\text{Rs. } 250 + 20\text{m}] / [92.84 + 14\text{m shares}] = \text{Rs. } 2.53$

Diluted EPS (both convertibles) = $[\text{Rs. } 250 + 20 + 60\text{m}] / [92.84 + 14 + 30\text{m shares}] = \text{Rs. } 2.41$

► **Example 29:**

Following information relating to Akkadian Limited (AL) has been gathered for the purpose of calculating earnings per share:

- (i) Outstanding ordinary, preference and potential shares of AL as at 1 January 2021:
- 6 million ordinary shares having par value of Rs. 10 each.
 - 2 million irredeemable preference shares having par value of Rs. 20 each carrying cumulative dividend of 14% per annum.
 - 3 million share options for ordinary shares having exercise price of Rs. 36 each.

- (ii) On 1 September 2021, AL announced 40% right shares to its ordinary shareholders at Rs. 18 per share. The entitlement date of right shares was 1 October 2021. The market price per share immediately before the announcement date and entitlement date were Rs. 30 and Rs. 32 respectively.
- (iii) The average market price of ordinary shares during the years 2021 and 2022 were Rs. 30 and Rs. 45 per share respectively.
- (iv) Profits for the years 2021 and 2022 amounted to Rs. 24 million and Rs. 34 million respectively.
- (v) No dividend was declared in the years 2021 and 2022.
- (vi) Share options were not exercised in the years 2021 and 2022.

Required: Compute AL's basic and diluted earnings per share to be disclosed in the statement of profit or loss for the years ended 31 December 2021 and 2022.

► **Answer:**

EPS for 2021:

$$\text{Basic EPS} = \frac{\text{Rs. 24} - 5.6^*}{7.24 \text{ W1}} = \text{Rs. 2.54 per share}$$

*Preference dividend = 2m x Rs. 20 x 14% = Rs. 5.6 million

$$\text{Diluted EPS} = \frac{\text{Rs. 24} - 5.6^*}{7.24 \text{ W1}} = \text{Rs. 2.54 per share}$$

*As share options are out of money, their effect has not been considered.

EPS for 2022:

$$\text{Basic EPS} = \frac{\text{Rs. 34} - 5.6^*}{8.4 \text{ W1}} = \text{Rs. 3.38 per share}$$

*Preference dividend = 2m x Rs. 20 x 14% = Rs. 5.6 million

$$\text{Diluted EPS} = \frac{\text{Rs. 34} - 5.6}{8.4 \text{ W1} + 0.6 \text{ W3}} = \text{Rs. 3.16 per share (dilutive)}$$

W1: Weighted average number of shares

Date	Number of shares (m)	Time factor	Adjustment factor(s)	Weighted average (m)
1 Jan to 30 Sep	6	x 9/12	x 32/28 W2	5.14
Right issue 40%	2.4			
1 Oct to 31 Dec	8.4	x 3/12		2.10
				7.24

W2: Right adjustment factor

Adjustment factor = 32 / 28

$$\text{Theoretical ex-rights price} = \frac{(6\text{m shares} \times \text{Rs. 32}) + (2.4\text{m share} \times \text{Rs. 18})}{6\text{m shares} + 2.4\text{m share}} = \text{Rs. 28 per share}$$

W3: Free shares under options (2022)

Free shares = 3m options x (45 - 36) / 45 = 0.6m shares

► **Example 30:**

The following information pertains to Ray Limited (RL):

- (i) The profit for the year ended 31 December 2022 amounted to Rs. 84 million (2021: loss of Rs. 60 million).
- (ii) The outstanding weighted average number of ordinary shares was 15 million during the years 2022 and 2021.
- (iii) On 1 January 2021, 2 million convertible bonds having a par value of Rs. 100 each were issued. The bonds carry interest @ 20% per annum, payable on 31 December each year. Each bond is convertible into 3 ordinary shares if converted after three years, or 4 ordinary shares if converted after five years.
- (iv) On 1 January 2021, 12 million share warrants were issued, which can be exercised after two years at an exercise price of Rs. 21 per share. The average market price of each of RL's share during the years 2022 and 2021 was Rs. 28 and Rs. 21, respectively.
- (v) On 1 January 2022, 6 million 16% cumulative irredeemable preference shares having a par value of Rs. 10 each were issued. Every 3 preference shares are convertible into 1 ordinary share after four years.
- (vi) Applicable tax rate is 30%.

Required: Compute RL's diluted earnings per share for the years ended 31 December 2021 and 2022.

► **Answer:****EPS for 2021:**

$$\text{Basic EPS} = \frac{\text{Rs. (60)}}{15} = \text{Rs. (4.0) per share}$$

Loss per share of Rs. 4.0

$$\text{Diluted EPS} = \frac{\text{Rs. (60) + 28}^*}{15 + 6}^{**} = \text{Rs. (1.52) per share (anti-dilutive)}$$

Diluted EPS for 2021 is also Rs. (4.0) i.e. loss per share of Rs. 4.0

*2m x Rs. 100 each x 20% x 70% = Rs. 28m

**2m x 3 each = 6m

Note: Warrants ignored in 2021 being out of money.

EPS for 2022:

$$\text{Basic EPS} = \frac{\text{Rs. 84 - 9.6}}{15} = \text{Rs. 4.96 per share}$$

*Preference dividend = 2m x Rs. 20 x 14% = Rs. 5.6 million

$$\text{Diluted EPS (+warrants)} = \frac{\text{Rs. 74.4}}{15 + 3} = \text{Rs. 4.13 per share (dilutive)}$$

$$\text{Diluted EPS (+ Bonds)} = \frac{\text{Rs. 74.4 + 28}}{18 + 8} = \text{Rs. 3.94 per share (dilutive)}$$

$$\text{Diluted EPS (+ Pref. shares)} = \frac{\text{Rs. 102.4 + 9.6}}{26 + 2} = \text{Rs. 4.80 per share (anti-dilutive)}$$

Note: Diluted EPS for 2022 is Rs. 3.94 per share

W1: Ranking of potential ordinary shares 2022

Description	Increase in earnings	Increase in shares	Incremental EPS	Rank
	Rs. in million	In million		
Convertible bonds	28 (200×20%×70%)	8 (2×4)	Rs. 3.5/share	2
Share warrants	-	3 [12×(28-21)÷28]	-	1
Preference shares	9.6 (60×16%)	2 (6÷3×1)	Rs. 4.8/share	3

► **Example 31:**

Following information relating to ChatGPT Limited (CL) has been gathered for the purpose of calculating earnings per share:

- Profit after tax for the years ended 31 December 2022 and 2023 amounted to Rs. 308 million and Rs. 280 million respectively.
- 25 million ordinary shares, each with a par value of Rs. 10, were outstanding as at 1 January 2022.
- On 1 April 2022, 2 million convertible bonds with a par value of Rs. 100 each were issued. The bonds carry interest at a rate of 18% per annum, payable on 31 March each year. Every 2 bonds are convertible into 3 ordinary shares after 5 years.
- On 1 January 2023, 6 million 16% cumulative irredeemable preference shares, each with a par value of Rs. 50, were issued. Every preference share is convertible into 2 ordinary shares after four years.
- On 1 May 2023, CL announced 40% right issue to its ordinary shareholders at Rs. 45 per share. The entitlement date for the right issue was 1 June 2023. The market price per share immediately before the announcement date and entitlement date was Rs. 65 and Rs. 80 respectively.
- On 1 September 2023, CL issued 20% bonus shares to its ordinary shareholders.
- The applicable tax rate is 30%.

Required: Compute CL's basic and diluted earnings per share to be disclosed in CL's financial statements for the year ended:

- 31 December 2022
- 31 December 2023 along with comparative figures

► **Answer:**

Part (a) EPS for 2022 (originally reported):

$$\text{Basic EPS} = \frac{\text{Rs. 308}}{25} = \text{Rs. 12.32 per share}$$

$$\text{Diluted EPS} = \frac{\text{Rs. 308} + 18.9^*}{25 + 2.25^{**}} = \text{Rs. 12.00 per share (Dilutive)}$$

*2m x Rs. 100 each x 18% x 70% x 9/12 = Rs. 18.9m

**2m x 3/2 x 9/12 = 2.25m

Part (b) EPS for 2023:

$$\text{Basic EPS} = \frac{\text{Rs. 280} - 48 \text{ W2}}{38.79 \text{ W1}} = \text{Rs. 5.98 per share}$$

$$\begin{array}{lcl} \text{Diluted EPS} & & \text{Rs. 232 + 48 W2} \\ \text{(+Pref. shares)} & = & 38.79 + 12 \text{ W2} \\ & & = \text{Rs. 5.51 per share} \\ & & \text{(dilutive)} \end{array}$$

$$\begin{array}{lcl} \text{Diluted EPS} & & \text{Rs. 280 + 25.2 W2} \\ \text{(+ Bonds)} & = & 50.79 + 3 \text{ W2} \\ & & = \text{Rs. 5.67 per share} \\ & & \text{(anti-dilutive)} \end{array}$$

Note: Diluted EPS for 2023 is Rs. 5.51 per share

EPS for 2022 (reported in 2023):

$$\begin{array}{lcl} \text{Basic EPS (restated)} & = & \frac{\text{Rs. 308}}{34.29 \text{ W1}} \\ & & = \text{Rs. 8.98 per share} \end{array}$$

$$\begin{array}{lcl} \text{Diluted EPS (restated)} & & \text{Rs. 308 + 18.9} \\ \text{(+ Bonds)} & = & 34.29 + 2.25 \\ & & = \text{Rs. 8.95 per share} \\ & & \text{(dilutive)} \end{array}$$

W1: Weighted average number of shares for 2023

Date	Number of shares (m)	Time factor	Adjustment factor(s)	Weighted average (m)
1 Jan to May 31	25	5/12	x 8/7 x 1.2	14.29
Right issue @40%	10			
1 Jun to 31 Aug	35	3/12	x 1.2	10.50
Bonus issue @20%	7			
1 Sep to 31 Dec	42	4/12		14.00
				38.79

Weighted average number of shares for 2022 = $25\text{m} \times 8/7 \times 1.2 = 34.29\text{m}$

Right adjustment factor = $80 / 70 = 8/7$

Bonsu adjustment factor = $120 / 100 = 1.2$

$$\begin{array}{lcl} \text{Theoretical ex-rights price} & = & \frac{(100 \text{ shares} \times \text{Rs. } 80) + (40 \text{ share} \times \text{Rs. } 45)}{100 \text{ shares} + 40 \text{ share}} \\ & & = \text{Rs. 70 per share} \end{array}$$

W2: Ranking

Description	Increase in earnings	Increase in shares	Incremental EPS	Rank
	Rs. in million	In million		
Irredeemable pref. shares	48 (6 x 50 x 16%)	12 (6 x 2/1)	Rs. 4/share	1
Convertible bonds	25.2 (2x100 x18%x70%)	3 (2 x 3/2)	Rs. 8.4/share	2

6. OBJECTIVE BASED Q&A

- 01.** Anum Limited had 1 million ordinary shares of Rs. 10 each in issue throughout the year ended 30 June 20X3. On 1 July 20X2 it had issued Rs. 2 million of 6% convertible debentures, each Rs. 100 of debenture is convertible into 8 ordinary shares on 1 July 20X6 at the option of the holder.
- Anum Limited had profit after tax for the year ended 30 June 20X3 of Rs.1,850,000. It pays tax on profits at 30%.
- What was diluted EPS for the year ended 30 June 20X3?
- (a) Rs. 1.67
 - (b) Rs. 1.85
 - (c) Rs. 1.61
 - (d) Rs. 1.70
- 02.** Zahra Limited's basic EPS for the year ended 30 June 20X1 was Rs. 6 per share. Which of the following issue during the year ended 30 June 20X2 would result in restated comparative basic EPS (for the year ended 20 June 20X1) of more than Rs. 6?
- (a) Right issue
 - (b) Bonus issue
 - (c) Share split
 - (d) Share consolidation / Reverse share split
- 03.** Hania Limited has correctly calculated its basic earnings per share (EPS) for the current year. Which of the following items need to be additionally considered when calculating the diluted EPS of Hania Limited for the year?
- (i) A 1 for 5 rights issue of equity shares during the year at Rs. 12 when market price of equity shares was Rs. 18.
 - (ii) The issue during the year of a convertible debentures
 - (iii) Issue of directors' share options exercisable in three years' time
 - (iv) Equity shares issued during year as the purchase consideration for acquisition of plant & machinery
- (a) All four
 - (b) (i) and (ii) only
 - (c) (ii) and (iii) only
 - (d) (iii) and (iv) only
- 04.** Many analyst believe that the trend of earnings per share (EPS) is a more reliable indicator of underlying performance than the trend of net profit for the year.
- Which of the following statements supports this view?
- (a) Net profit can be manipulated by the choice of accounting policies but EPS cannot be manipulated in this way.
 - (b) EPS takes into account the additional resources made available to earn profit when new shares are issued for cash, whereas net profit does not.
 - (c) The disclosure of a diluted EPS figure is a forecast of the future trend of profit.
 - (d) The comparative EPS is restated where a change of accounting policy affects the previous year's profits.

- 05.** At 1 January 20X8 Maria Limited had 5 million Rs. 10 equity shares in issue. On 1 June 20X8 it made a 1 for 5 rights issue at a price of Rs. 15. The market price of the shares before right issue was Rs. 18. Total earnings for the year ended 31 December 20X8 was Rs. 7.6 million.
What is basic EPS for the year ended 31 December 20X8?
- (a) Rs.1.35
 - (b) Rs.1.36
 - (c) Rs.1.27
 - (d) Rs.1.06
- 06.** Gulfshan Limited (GL) had profits after tax of Rs. 30 million in the year ended 31 December 20X7.
On 1 January 20X7, GL had 2.4 million ordinary shares in issue. On 1 April 20X7 it made a 1 for 2 rights issue at a price of Rs. 14 when the market price of Garfish's shares was Rs. 20 before right issue.
What is the basic EPS for the year ended 31 December 20X7?
- (a) Rs. 4.95
 - (b) Rs. 8.90
 - (c) Rs. 9.12
 - (d) Rs. 9.26
- 07.** On 1st January 20X4, Sameen Limited had 3 million ordinary shares in issue. On 1st June 20X4, Sameen Limited made a 1 for 3 bonus issue. On 30th September 20X4, Sameen Limited then issued a further 1 million shares at full market price. Sameen Limited had profits attributable to ordinary shareholders of Rs. 20 million for the year ended 31st December 20X4.
What is the basic EPS for the year ended 31st December 20X4?
- (a) Rs. 4.71
 - (b) Rs. 4.29
 - (c) Rs. 4.93
 - (d) Rs. 5.22
- 08.** During the year, Mariam Limited made a 1 for 3 rights issue at Rs. 16 when the market price was Rs. 22. The previous year's financial statements showed an earnings per share figure of Rs. 4.
There were no other issues of shares during the year.
What will the restated earnings per share figure be for comparative purposes in the current year financial statements?
- (a) Insufficient data for calculation
 - (b) Rs. 3.73
 - (c) Rs. 4.00
 - (d) Rs. 4.29
- 09.** Saba Limited has net profit for the year ended 30 June 20X5 of Rs. 10.5 million. Saba Limited has had 6 million shares in issue for many years. In the current year, Saba Limited has issued a convertible bond. It was issued at its nominal value of Rs. 2.5 million and carries an effective interest rate of 8%.
The bond is convertible in five years in 50 shares for each Rs. 100 of the bond.
Saba Limited pays tax at a rate of 30%
What is the Basic EPS and Diluted EPS for the year ended 30 June 20X5?

- (a) Basic EPS Rs. 1.70 and Diluted EPS Rs. 1.50
- (b) Basic EPS Rs. 1.75 and Diluted EPS Rs. 1.70
- (c) Basic EPS Rs. 1.70 and Diluted EPS Rs. 1.55
- (d) Basic EPS Rs. 1.75 and Diluted EPS Rs. 1.47
10. Alia Limited's (AL) financial statements show a profit for the year of Rs. 20 million. On 1 January 20X5, AL had 4 million shares in issue.
- There were no new issues of shares in the year, but there were 1 million outstanding options to buy shares for Rs. 30 each. For the year to 31 December 20X5, the average market value of AL's shares was Rs. 50.
- What is AL's Diluted EPS for the year ended 31 December 20X5?
- (a) Rs. 3.00
- (b) Rs. 4.35
- (c) Rs. 4.55
- (d) Rs. 4.00
11. Which of the following statements in relation to the term 'dilution' is/are true or false, as per IAS 33 Earnings per share?
- 1) A reduction in earnings per share is an example of dilution.
- 2) A reduction in loss per share is an example of dilution.
- (a) Both statements are false
- (b) Statement 2 is true and statement 1 is false
- (c) Statement 1 is true and statement 2 is false
- (d) Both statements are true
12. Which TWO of the following items must be disclosed, as per IAS33 Earnings per share?
- (a) Forecast earnings per share for the following financial year
- (b) A five-year trend analysis of earnings per share
- (c) The weighted average number of ordinary shares used to calculate earnings per share
- (d) The earnings figures used in calculating basic and diluted earnings per share
13. Which of the following statements is/are true or false, according to IAS 33 Earnings per share?
- i. Earnings per share amounts should not be presented if they are negative, i.e. losses per share.
- ii. If basic and diluted earnings per share are equal, dual presentation can be accomplished in one line in the statement of comprehensive income.
- (a) Both statements are false
- (b) Statement (I) is false and statement (II) is true
- (c) Statement (I) is true and statement (II) is false
- (d) Both statements are true

14. Pareesa Limited issued new ordinary shares for cash at full market price and also made a 1 for 8 bonus issue.

Are the following statements true or false, according to IAS 33 Earnings per share?

- 1) New shares issued as a result of bonus issue should be time apportioned from their date of issue.
 - 2) New shares issued for cash at full market price should be time apportioned from their date of issue.
- (a) Both statements are false
 (b) Statement 1 is false and statement 2 is true
 (c) Statement 1 is true and statement 2 is false
 (d) Both statements are true

15. Saima Limited (SL) is a company listed on a Pakistan Stock Exchange. Given below is an extract from its statement of comprehensive income for the year ended 31 December 20X7.

	Rs.
Profit before tax	5,700,000
Tax expense	(1,500,000)
Profit after tax	4,200,000

SL paid during the year an ordinary dividend of Rs. 400,000 and a dividend on its redeemable preference shares of Rs. 500,000. These have been correctly accounted for in the financial statements.

SL had ordinary share capital of Rs. 2,000,000 (Rs. 10 each) throughout the year and authorised share capital of Rs. 10,000,000 (Rs. 10 each).

What is basic EPS for the year ended 31 December 20X7?

- (a) Rs. 21
 (b) Rs. 19
 (c) Rs. 38
 (d) Rs. 42

16. Shaista Limited is a company listed on Pakistan Stock Exchange. Its financial statements for the year ended 31 December 20X7 showed EPS of Rs. 8.5 per share.

On 1 July 20X8 Shaista Limited made a 1 for 3 bonus issue.

What figure for the 20X7 earnings per share will be shown as comparative information in the financial statements for the year ended 31 December 20X8?

- (a) Rs. 2.13
 (b) Rs. 2.55
 (c) Rs. 6.38
 (d) Rs. 2.83

17. Simba Limited is a listed company. At 31 December 20X7, it had ordinary share capital of Rs. 2,000,000 (Rs. 10 each). Profit before tax for the year was Rs. 500,000 and the tax charge was Rs. 125,000.

What is Simba Limited's basic EPS for the year?

- (a) Rs. 2.50
 (b) Rs. 3.75
 (c) Rs. 2.58
 (d) Rs. 1.88

18. Muntaha Limited (ML) is listed on Pakistan Stock Exchange. During the year ended 31 December 20X7, the company had 5 million ordinary shares of Rs.10 each and 500,000 6% irredeemable preference shares of Rs. 10 in issue. The profit after tax for the year 20X7 was Rs. 6,000,000.
What is ML's basic EPS for the year?
- (a) Rs. 1.14
 - (b) Rs. 1.09
 - (c) Rs. 1.60
 - (d) Rs. 1.20
19. Mansha Limited had 100,000 equity shares in issue on 1 January 20X7. On 1 July 20X7 it issued 20,000 new shares by way of a 1 for 5 bonus issue. On 1 October 20X7 it issued 28,000 new shares for cash at full market price.
What is weighted average number of shares for calculation of basic EPS?
- (a) 100,000 shares
 - (b) 117,000 shares
 - (c) 148,000 shares
 - (d) 127,000 shares
20. Which of the following need to be adjusted in profit after tax, for calculation of basic EPS?
- (a) Redeemable preference shares dividends
 - (b) Irredeemable preference shares dividends
 - (c) Ordinary (final) dividends
 - (d) Ordinary (interim) dividends
21. An entity reported a positive earnings per share in previous year. Which of the following would result in increase in earnings per share of previous year due to restatement?
- (a) Right issue
 - (b) Bonus issue
 - (c) Share split
 - (d) Share consolidation
22. Which of the following statements is/are correct?
- (I) Earnings per share amounts should not be presented if they are negative i.e. losses per share.
 - (II) Earnings per share amounts calculated for discontinued operations must be presented on the face of the statement of profit or loss.
- (a) Both are correct
 - (b) Only (I) is correct
 - (c) Only (II) is correct
 - (d) None is correct
23. Which of the following is NOT a 'potential ordinary share'?
- (a) Right issue of ordinary shares at less than market price
 - (b) Share options with an exercise price greater than average market price of the share
 - (c) Convertible redeemable preference shares
 - (d) Bonds convertible after 5 years

24. The basic earnings per share of Alpha Limited (AL) for the year 2023 amounts to Rs. 4 per share. On 1 January 2023, AL issued Rs. 2 million of 14% convertible debentures (Rs. 100 each), with each debenture convertible into 3 ordinary shares after 5 years at the option of the holder.

Which of the following is correct about diluted earnings per share of AL for 2023?

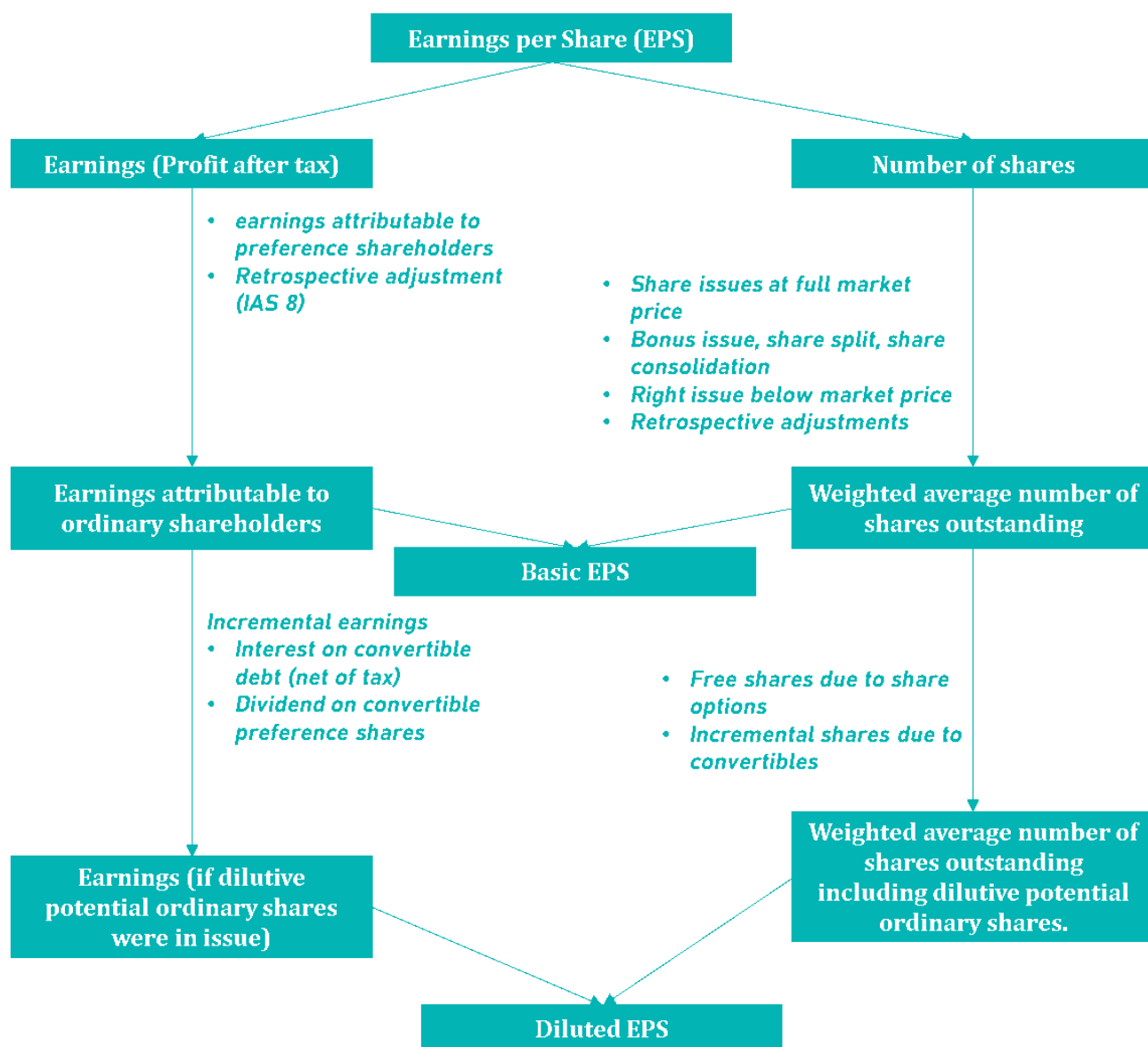
- (a) It would be more than Rs. 4 per share
- (b) It would be less than Rs. 4 per share
- (c) It would be Rs. 4 per share
- (d) It would be Nil per share

ANSWERS

01.	(a)	Basic EPS = Rs. 1,850,000 / 1,000,000 shares = Rs. 1.85 Incremental earnings = Rs. 2,000,000 x 6% x 70% = Rs. 84,000 Incremental shares = Rs. 2,000,000 / 100 x 8 shares = 160,000 shares Diluted EPS = [Rs. 1,850,000 + 84,000] / [1,000,000 + 160,000 shares] = Rs. 1.67
02.	(d)	Share consolidation/ reverse share split would result in lower number of denominator (shares) leading to higher comparative EPS than reported earlier. All other issues would result in higher number of shares (denominator) resulting in lower comparative EPS than reported earlier.
03.	(c)	The convertible loan note and the share options should be taken into account when calculating diluted EPS. Other items would have been incorporated in calculation of basic EPS already.
04.	(b)	EPS takes into account the additional resources made available to earn profit when new shares are issued for cash, whereas net profit does not.
05.	(a)	TERP = [(5x18) + (1x15)] / (5+1) = Rs. 17.5 per share Right issue adjustment factor = 18 / 17.5 Weighted average shares January to May 5 million x 5/12 x 18 / 17.5 = 2.14 million June to December 6 million x 7/12 = 3.50 million Total = 5.64 million Basic EPS = Rs. 7.6 million / 5.64 million shares = Rs. 1.35
06.	(b)	TERP = [(2x20) + (1x14)] / (2+1) = Rs. 18 per share Right issue bonus adjustment factor = 20 / 18 Weighted average shares January to March 2.4 million x 3/12 x 20 / 18 = 0.67 million April to December 3.6 million x 9/12 = 2.70 million Total = 3.37 million Basic EPS = Rs. 30 million / 3.37 million shares = Rs. 8.90
07.	(a)	Bonus issue adjustment factor = 4 / 3 Weighted average shares January to May 3 million x 5/12 x 4 / 3 = 1.67 million June to September 4 million x 4/12 = 1.33 million October to December 5 million x 3/12 = 1.25 million Total = 4.25 million Basic EPS = Rs. 20 million / 4.25 million shares = Rs. 4.71
08.	(b)	TERP = [(3x22) + (1x16)] / (3+1) = Rs. 20.5 per share Right issue adjustment factor = 22 / 20.5 Basic EPS (restated comparative) = Rs. 4 x 20.5 / 22 = Rs. 3.73
09.	(d)	Basic EPS = Rs. 10.5 million / 6 million shares = Rs. 1.75 Incremental earnings = Rs. 2.5 million x 8% x 70% = Rs. 0.14 million Incremental shares = Rs. 2.5 million / 100 x 50 = 1.25 million shares Diluted EPS = (Rs. 10.5m + 0.14m) / (6m + 1.25m shares) = Rs. 1.47

10.	(c)	Free shares = $1,000,000 \times (50 - 30) / 50 = 400,000$ shares Diluted EPS = $\text{Rs. } 20,000,000 / (4,000,000 + 400,000 \text{ shares}) = \text{Rs. } 4.55$
11.	(c)	A reduction in earnings per share is an example of dilution, but a reduction in loss per share is an example of anti-dilution.
12.	(c) & (d)	The earnings figures and the weighted average number of shares are required to be disclosed. Future forecasts and trend analysis are not required.
13.	(b)	EPS is to be presented even if negative (i.e. loss per share), so statement 1 is false. IAS 33 requires that if basic and diluted earnings per share are equal, dual presentation can be accomplished in one line in the statement of comprehensive income, therefore, this statement is true.
14.	(b)	Bonus shares provide no additional consideration to the issuer, so they are not time apportioned.
15.	(a)	The redeemable preference share dividend is recognised as a finance cost and deducted at arriving at profit before tax. Basic EPS = $\text{Rs. } 4,200,000 / 200,000 \text{ shares} = \text{Rs. } 21$
16.	(c)	Bonus issue adjustment factor = $4 / 3$ $\text{Rs. } 8.5 \text{ per share} \times 3 / 4 = \text{Rs. } 6.38 \text{ per share}$
17.	(d)	Basic EPS = $(\text{Rs. } 500,000 - \text{Rs. } 125,000) / 200,000 \text{ shares} = \text{Rs. } 1.88$
18.	(a)	Basic EPS = $(\text{Rs. } 6,000,000 - (6\% \times \text{Rs. } 5,000,000)) / 5,000,000 \text{ shares} = \text{Rs. } 1.14$
19.	(d)	Bonus issue is not time-apportioned while issue at full market price is time-apportioned. The weighted average is $100,000 + 20,000 + (28,000 \times 3/12) = 127,000$.
20.	(b)	Redeemable preference dividends will already have been removed from net profit when arriving at this figure in a profit or loss account. Therefore, this adjustment is not necessary. Similarly, ordinary dividends are not deducted as IAS 33 requires earnings "available" to ordinary shareholders and not earnings remaining after ordinary dividends.
21.	(d)	Share consolidation
22.	(d)	None is correct
23.	(a)	Right issue of ordinary shares at less than market price
24.	(c)	Incremental EPS = $\text{Rs. } 280,000 / 60,000 \text{ shares} = \text{Rs. } 4.66$ (anti-dilutive) Diluted EPS would be Rs. 4 per share i.e. equal to basic EPS.

STICKY NOTES



INTERPRETATION OF FINANCIAL STATEMENTS

IN THIS CHAPTER:

AT A GLANCE

SPOTLIGHT

1. Analysis of financial information
2. Profitability ratios
3. Working capital efficiency ratios
4. Liquidity and solvency ratios
5. Other aspects
6. Comprehensive Examples
7. Objective Based Q&A

STICKY NOTES

AT A GLANCE

Analysis and interpretation of financial statements helps users of financial statements:

- to assess the profitability, operational efficiency and financial health of an entity;
- to ascertain the relative importance of different components of the financial position;
- to identify the reasons for the changes in the profitability/financial position of the entity; and
- to judge the ability of the entity to repay its long term and short-term debts.

The term analysis means simplification of financial data by methodical study of the relationship among various financial facts and figures as given in a set of financial statements. Interpretation means explaining the meaning and significance of this data to gain an insight into the profitability, financial position, gearing, liquidity, and operational efficiency of the firm to assess its financial health and future prospects.

Analysis of financial statements includes:

- Horizontal analysis i.e. %age change in financial statements line items over the period(s).
- Vertical analysis i.e. expressing each financial statement line item as %age of revenue (for income and expenses) or total assets (for assets, liabilities and equity).
- Ratio analysis i.e. calculating significant relationships and trends which are not immediately evident from the examination of individual balances appearing in the financial information to understand profitability, working capital efficiency, liquidity and solvency of an entity.

Users of financial statements must also be aware of limitations of financial statements ratios and analysis, for example, unavailability of non-financial information, ignoring price level changes, effects of changes in accounting policies and estimates and historical nature of financial information.

1. ANALYSIS OF FINANCIAL INFORMATION

1.1 Users and their financial information needs [Conceptual Framework: 1.5, 1.9 & 10]

The conceptual framework identifies existing and potential investors, lenders and other creditors of a reporting entity as primary user of general-purpose financial statements. Other parties, such as regulators and members may also find general purpose financial reports useful.

The management of a reporting entity is also interested in financial information about the entity. However, management need not rely on general purpose financial reports because it is able to obtain the financial information it needs internally.

All these groups are interested in financial performance, financial position and cash flows of the entity. Some users are mainly interested in performance and profitability, while others may be more interested in liquidity and gearing or other matters. For example:

- An existing investor has to decide whether to continue to hold shares or to sell them and tends to be most interested in profitability ratios (such as gross and net profit margin and return on capital employed).
- A potential investor needs information about an entity's profitability and probably also information about whether or not the entity is managed efficiently and is likely to focus on profit margins, return on capital employed, asset turnover and working capital ratios.
- A lender (e.g. bank) needs to know whether it will receive interest payments when these are due and whether the money that it lends will eventually be repaid and will normally be most interested in cash flows and liquidity ratios (current ratio, acid test ratio) gearing and interest cover.
- A creditor has to decide appropriate credit limit and credit period in order to ensure that amount due will be collected eventually.
- Employees are interested in fair wages, adequate employment benefits, bonus linked with productivity/profitability and whether or not the entity will be able to offer them desired career growth.
- The management performs financial forecasting, planning (of a future based on the past and present) and controlling (budgets) as a decision maker. The management also needs to understand perspective of investors, lenders, creditors and other users as they are accountable for the entity's performance.

An exam question might ask you to interpret an entity's financial statements for the benefit of specific people or groups of people. Therefore, your analysis should focus on the needs of the users.

- What do they need to know?
- What are they interested in?
- What decision do they need to make?

1.2 Financial statements analysis

Financial statement analysis is the process of analysing a company's past, current and projected performance for decision-making purposes it allows analysts to identify trends by comparing ratios across multiple periods and statement types to allow analysts to measure liquidity, profitability, company-wide efficiency, and cash flow.

Financial statement analysis is of the following three types:

- Horizontal analysis
- Vertical analysis
- Ratio analysis

1.3 Horizontal analysis (trend analysis)

Horizontal analysis is used to compare historical data, such as ratios, or line items, over a number of accounting periods. It helps identify trends and growth patterns in an entity's performance over a number of periods.

Period wise percentage change is calculated that helps evaluate improvement or decline in an entity's performance. This also makes it easier to compare growth rates and profitability among different entities.

$$\text{Change \%} = \frac{\text{Current year amount} - \text{Base year amount}}{\text{Base year amount}} \times 100$$

► *Example 01:*

The following is a specimen of horizontal analysis calculated for Adeel Limited:

Statement of profit or loss for the year ended 31 December 2024

	2024	2023	Change from 2023 to 2024
	Rs. in millions		%
Sales	4,315	3,760	14.8
Cost of Sales	(3,020)	(2,669)	13.2
Gross Profit	1,295	1,091	18.7
Distribution costs	(800)	(760)	5.3
Administrative expenses	(296)	(162)	82.7
Other income	15	10	50
Profit before interest and tax	214	179	19.6
Interest expense	(13)	(15)	(13.3)
Profit before tax	201	164	22.6
Tax	(35)	(30)	16.7
Profit after tax	166	134	23.9

Statement of financial position as at 31 December 2024

	2024	2023	Change from 2024 to 2023
	Rs. in millions		%
Non-current assets			
Property, plant and equipment	865	880	(1.7)
Investment property	124	112	10.7
	989	992	(0.3)
Current assets			
Inventories	272	280	(2.9)
Trade receivables	168	173	(2.9)
Cash and bank	12	10	20.0
	452	463	(2.4)
Total assets	1,441	1,455	(1.0)

Equity			
Share capital	800	800	-
Retained earnings	360	310	16.1
	1,160	1,110	4.5
Non-current liabilities			
Long term loans	125	150	(16.7)
	125	150	(16.7)
Current liabilities			
Trade payables	153	162	(5.6)
Accruals and other payables	3	33	(90.9)
	156	195	(20.0)
Total equity and liabilities	1,441	1,455	(1.0)

1.4 Vertical analysis (common size analysis)

Vertical analysis is the proportional analysis of a financial statement, where each line item on a financial statement is listed as a percentage of another item. This means that every line item in statement of profit or loss is stated as a percentage of gross sales, while every line item in statement of financial position is stated as a percentage of total assets.

The most common use of vertical analysis is within a financial statement for a single reporting period, so that one can see the relative proportions of account balances. It is also useful for trend analysis, to see relative changes of an item over time, such as on a comparative basis over a five-year period. For example, if the cost of goods sold has a history of being 70% of sales in each of the past many years, then a new percentage of 77% would be a cause for alarm.

► Example 02:

The following is a specimen of vertical analysis calculated for Adeel Limited:

Statement of profit or loss for the year ended 31 December 2024

	2024		2023	
	Rs. m	%	Rs. m	%
Sales	4,315	100	3,760	100
Cost of Sales	(3,020)	(70.0)	(2,669)	(71.0)
Gross Profit	1,295	30.0	1,091	29.0
Distribution costs	(800)	(18.5)	(760)	(20.2)
Administrative expenses	(296)	(6.9)	(162)	(4.3)
Other income	15	0.3	10	0.3
Profit before interest and tax	214	5.0	179	4.8
Interest expense	(13)	(0.3)	(15)	(0.4)
Profit before tax	201	4.6	164	4.4
Tax	(35)	(0.8)	(30)	(0.8)
Profit after tax	166	3.8	134	3.6

Statement of financial position as at 31 December 2024

	2024		2023	
	Rs. m	%	Rs. m	%
Non-current assets				
Property, plant and equipment	865	60	880	60.5
Investment property	124	8.6	112	7.7
	989	68.6	992	68.2
Current assets				
Inventories	272	18.9	280	19.2
Trade receivables	168	11.7	173	11.9
Cash and bank	12	0.8	10	0.7
	452	31.4	463	31.8
Total assets	1,441	100	1,455	100
Equity				
Share capital	800	55.5	800	55.0
Retained earnings	360	25.0	310	21.3
	1,160	80.5	1,110	76.3
Non-current liabilities				
Long term loans	125	8.7	150	10.3
	125	8.7	150	10.3
Current liabilities				
Trade payables	153	10.6	162	11.1
Accrual and other payables	3	0.2	33	2.3
	156	10.8	195	13.4
Total equity and liabilities	1,441	100	1,455	100

1.5 Ratio analysis

A ratio is simply one figure divided by another meaningful figure with the objective of disclosing significant relationships and trends which are not immediately evident from the examination of individual balances appearing in the financial information. In this way, complicated information is summarised so that a meaningful comparison of financial performance and financial position can be made against following benchmarks:

- Previous years (i.e. trend analysis reflecting improvement or decline in performance and position).
- Industry averages or specific competitors (i.e. to determine whether entity's performance is better or worse than the industry or specific competitor).
- Pre-determined forecasts (i.e. whether the entity achieved its targets or has fallen short).

Ratios have the advantage of controlling for differences in size. For example, two businesses may be quite different in size but can be compared in terms of profitability, liquidity, etc., by the use of ratios.

The main financial ratios can be classified as:

- Profitability ratios (including investors' profitability ratios)
- Working capital efficiency ratios
- Liquidity ratios
- Debt or solvency ratios

2. PROFITABILITY RATIOS

2.1 Profit/sales ratio

The profit/sales ratio is the ratio of the profit that has been achieved for every Rs.1 of sales. Profit/sales ratios are commonly used by management to assess financial performance, and a variety of different figures for profit might be used. The definition of profit can be any of the following:

- Profit before interest and tax
- Gross profit (i.e. sales minus the cost of sales)
- Net profit (i.e. Profit after tax)

It is important to be consistent in the definition of profit, when comparing performance from one year to the next. So, there are 3 types of profit to sales ratio:

- Profitability/Operating profit ratio
- Gross profit margin ratio
- Net profit ratio

The gross profit ratio is often useful for comparisons between companies in the same industry, or for comparison with an industry average. It is also useful to compare the net profit ratio with the gross profit ratio. A high gross profit ratio and a low net profit ratio indicate high overhead costs for administrative expenses and selling and distribution costs.

► Example 03:

Using the data given in Example 01 for year 2024, profit /sales ratios can be calculated as follows:

If net profit is defined as profit before interest and tax

$$= \frac{\text{PBIT}}{\text{Sales}} = \frac{214}{4,315} = 4.96\%$$

If net profit is defined as profit after interest and tax

$$= \frac{\text{PAT}}{\text{Sales}} = \frac{166}{4,315} = 3.85\%$$

Comments:

The figure suggests that Rs. 4.96 is earned on every 100 rupees of sales before interest and tax are deducted. After the deduction this figure becomes Rs. 3.85 in the given scenario.

The profit to sales ratio shows the percentage of sales that is left over after the business has paid all its expenses. The ratio helps to determine how effectively a company's sales are converted into net income. Again the figures have to be compared with the industry averages and over the years for the same company to arrive at a more meaningful conclusion.

► Example 04:

Using the data given in Example 01 for year 2024, gross profit margin can be calculated as follows:

$$= \frac{\text{Gross profit}}{\text{Sales}} = \frac{1,295}{4,315} = 30\%$$

Comment:

The GP margin is 30% that implies the company may reduce the selling price of its products up to around 30% without incurring any loss. The GP ratio is an important ratio as it evaluates the operational performance of the entity. Gross profit is an important figure for the business, it should be sufficient enough to cover all the expenses and provide for the profit to the investors.

In general, a higher ratio is a better ratio. The profitability of the business can be measured by comparing it with the competing entities in the similar industry and with the past trend for the same company. A consistent growth over the years indicates a sustainable continuous improvement in the business's processes and practices.

2.2 Cost/ sales ratios

It is also useful to monitor the ratio of different types of cost to sales. The following ratios can be useful to highlight an unexpected change in a period or to indicate a difference between the company and another in a similar industry:

- Ratio of (Cost of sales/Sales) × 100%
- Ratio of (Administration costs/Sales) × 100%
- Ratio of (Selling and distribution costs/Sales) × 100%

► Example 05:

Using the data given in Example 01 for year 2024, cost / sales ratios can be calculated as follows:

Cost of sales ratio

$$= \frac{\text{Cost of sales}}{\text{Sales}} = \frac{3,020}{4,315} = 70\%$$

Administrative expense ratio

$$= \frac{\text{Administrative expenses}}{\text{Sales}} = \frac{296}{4,315} = 6.86\%$$

Distribution costs ratio

$$= \frac{\text{Distribution costs}}{\text{Sales}} = \frac{800}{4,315} = 18.54\%$$

Comments:

Costs ratios represent what extent of sales is an individual expense or a group of expenses. The lower the ratio the better is the profitability status of the organisation. Care must be taken in dealing with the variable expenses as they vary with the change in the sales volume. This ratio doesn't normally change significantly with the rise or decline in the sales volume. Whereas the ratios for fixed expenses change significantly with the increase or decrease in the sales volume.

In the given scenario the cost of sales/sales ratio states that every Rs. 70 out of 100 rupees of sales represent cost of sales. These are the direct costs that vary with the level of sales.

Looking at the other two ratios we find that in this particular period every 6.86 rupees out of every 100 rupees of sales were spent on the administration costs and 18.54 rupees were expensed on selling and distribution costs.

These ratios help the management in controlling and estimating future expenses.

2.3 Sales/capital employed ratio or assets turnover ratio

This measures the amount of sales achieved during the period for each Rs. 1 of long-term capital invested in the business. This ratio is expressed in number of times rather than in terms of percentage.

The capital employed is aggregate of equity and long-term debts including preference shares. The capital employed can also be calculated as total assets minus current liabilities. Where possible, use the average capital employed during the year. This is usually the average of the capital employed at the beginning of the year and end of the year.

► **Example 06:**

Using the data given in Example 01 for year 2024, sales/capital employed ratio can be calculated as follows:

Sales to capital employed (or asset turnover) ratio

$$= \frac{\text{Sales}}{\text{Average capital employed}} = \frac{4,315}{1,272.5} = 3.39 \text{ times}$$

Capital employed

at end of year 2024: Rs. 1,160 m + 125 m = Rs. 1,285 m

at beginning of year 2024 Rs. 1,110 m + 150 m = Rs. 1,260 m

Average [Rs. 1,285 m + 1,260 m] / 2 = Rs. 1,272.5 m

Comment:

The Sales/Capital employed ratio measures how efficiently an organisation's assets generate revenues. Here, every single rupee of the capital employed in the business is generating revenue of Rs. 3.39. It must also be taken into account that the age of a company's assets can heavily impact hence result in different asset turnover ratios for similar companies. For example a company having older assets with lower book values might have a higher asset turnover ratio than the one with the similar revenues but newer, higher net book value assets.

A constantly declining assets turnover ratio or a lower ratio as compared to the industry averages might indicate towards the issues related to the excess production capacity, poor inventory management, and sloppy collection methods etc. The higher the ratio the better it is considered yet capital investment for purchasing assets in anticipation of future growth or sale of existing unnecessary assets for an anticipated decline in future can suddenly and may be artificially change the company's assets turnover ratio. Besides companies in the capital-intensive industries tend to have a lower assets turnover ratio than the ones operating with fewer assets. Therefore for a more meaningful analysis, the companies should be compared within the same industry.

It can be useful to measure the annual growth (or decline) in sales, measured as a percentage of sales in the previous year, as already covered in horizontal analysis.

2.4 Investors' profitability ratios

Profit-making companies should try to make a profit that is large enough in relation to the amount of money invested in the business. Therefore, investors are particularly interested in following profitability ratios:

- Return on capital employed (ROCE)
- Return on equity (ROE)
- Return on assets (ROA)

2.4.1 Return on capital employed (ROCE)

This ratio measures profit before interest and tax as a percentage of capital employed in the business.

Interest on long term debt is added back to determine the profit that will be available as return to providers of long-term capital resources. The capital employed is the share capital and reserves, plus long-term debt capital such as bank loans, bonds and loan stock. Where possible, use the average capital employed during the year. This is usually the average of the capital employed at the beginning of the year and end of the year.

A higher ROCE indicates more efficient use of capital. ROCE should be higher than the company's capital cost; otherwise it indicates that the company is not employing its capital effectively and is not generating shareholder value.

► **Example 07:**

Using the data given in Example 01 for year 2024, ROCE can be calculated as follows:

Return on capital employed

$$= \frac{\text{PBIT}}{\text{Average capital employed}} = \frac{214}{1,272.5} = 16.8\%$$

Capital employed

at end of year 2024: Rs. 1,160 m + 125 m = Rs. 1,285 m

at beginning of year 2024 Rs. 1,110 m + 150 m = Rs. 1,260 m

Average [Rs. 1,285 m + 1,260 m] / 2 = Rs. 1,272.5 m

Comments:

The 16.8% return on the capital employed indicates a return of Rs. 16.8 on every 100 rupees invested in the business. The ratio shows how efficiently the entity's long-term funds are being employed. The investors are interested to invest in the company that has a higher ROCE than the other available option(s). Besides the company's return should always be higher than the cost at which the funds were acquired. For example if a company borrows at 20% and achieves a return of only 16.8%, that indicates they are actually losing money.

The return on capital employed depends on two factors:

- The profitability of the goods or services that the entity has sold (i.e. profit to sales ratio).
- The volume of sales that the entity has achieved with the capital and assets it has employed (i.e. asset turnover ratio).

► **Example 08:**

A company has profit / sales ratio of 4.96% and asset turnover ratio of 3.39 times, its ROCE may be calculated as follows:

Return on capital employed = Profit to sales ratio x asset turnover

Return on capital employed = 4.96% x 3.39 = 16.8%

ROCE is a useful measure of comparing profitability across competing entities based on the amount of capital they use. It becomes more useful when the comparison is between capital-intensive entities. Moreover, for a single company, the ROCE trend over the years is a significant performance indicator. Generally speaking, the investors are more inclined to invest in the companies that have stable and rising ROCE figures as compared to those where the ROCE is volatile and inconsistent.

► **Example 09:**

The two companies A and B operating in the similar lines of business for the year ended 31st December 2016. The following data is available:

	Company A	Company B
	Rs.	Rs.
Profit before interest and tax	539,900	2,616,100
Average capital employed	3,659,000	12,193,400

Required:

Calculate and comment on ROCE of both companies.

► *Answer:***Company A – ROCE**

$$= \frac{\text{PBIT}}{\text{Average capital employed}} = \frac{539,900}{3,659,000} = 14.8\%$$

Company B – ROCE

$$= \frac{\text{PBIT}}{\text{Average capital employed}} = \frac{2,616,100}{12,193,400} = 21.5\%$$

Comments:

The company B appears to be utilising its capital better than company A. Company B can reinvest a greater portion of its profits back into the business operations to the benefit of the shareholders. While we see that Company B's ROCE is higher than that of Company A yet there is not a lot to be attained from using data from one angle and at a single point of time. Greater insight can be achieved if trends over time are analysed. As Company B though is performing better than A yet it might have been facing a constant decline in the ROCE that may indicate a potential loss of competitive advantage.

2.4.2 Return on equity (ROE)

This ratio is also called return on shareholders capital (ROSC) and return on investment (ROI).

It measures the return on investment that the shareholders of the company have made. This ratio normally uses the values of the shareholders' equity as shown in the statement of financial position (rather than market values of the shares).

The average value of equity should be used if possible. This is the average of the equity at the beginning and the end of the year. Profit after tax and preference dividend is used as this is the amount attributable to equity shareholders.

► *Example 10:*

Using the data given in Example 01 for year 2024, ROE can be calculated as follows:

Return on equity

$$= \frac{\text{PAT – preference dividend}}{\text{Average equity}} = \frac{166 - 0}{1,135} = 14.2\%$$

Average shareholders' equity [Rs. 1,110 m + 1,160 m] / 2 = Rs. 1,135 m

Comments:

The ROE measures the ability of the entity to generate profits from the investments made by its shareholders. The figure above shows a percentage of 14.2% meaning that the entity generates a return of Rs. 14.2 for every 100 rupees invested by the shareholder into the business. A good ROE is the indicator of effective management of equity financing.

2.4.3 Return on assets (ROA)

The normal convention is to use profit before interest and tax and 'total assets' which includes both current and non-current assets. However, other variations are sometimes used such as non-current assets only.

The return on assets ratio is a profitability ratio and measures the return produced by the total assets. It helps both, the management and the investors, to know how well the entity can convert its investment in assets into profits. The figures of ROA depend highly on the industry and hence can vary substantially. This suggests that when ROA has to be used as a comparative measure then the best practice is to compare it against a company's previous ROA figures or the ROA of a company in the similar business line.

► *Example 11:*

Using the data given in Example 01 for year 2024, ROA based on total assets as well as on non-current assets only can be calculated as follows:

Return on (total) assets

$$= \frac{\text{PBIT}}{\text{Total assets}} = \frac{214}{1,441} = 14.85\%$$

Return on (non-current) assets

$$= \frac{\text{PBIT}}{\text{Non-current assets}} = \frac{214}{989} = 21.63\%$$

Comments:

This means that on average every 100-rupees invested in business's assets generated 14.85 in profit. If taken from the perspective of non-current assets only, 21.63 rupees are generated in profit.

The analysis would be more useful and meaningful when compared with the entity's own performance over the years and against the figures of the firm(s) competing in the similar industry.

3. WORKING CAPITAL EFFICIENCY RATIOS

3.1 Purpose of working capital efficiency ratios

Working capital efficiency ratios measure the efficiency with which the entity has managed its receivables, inventory and trade payables. The ratios are usually measured in terms of an average number of days and sometimes expressed in number of times of turnover during a period.

The cash cycle, also called the operating cycle and the working capital cycle, can be calculated on the basis of working capital efficiency ratios as well. Cash cycle is the time between purchasing the raw materials used to make a product and collecting the money from selling the product.

The working capital ratios are a useful measure of whether the entity has too much or too little invested in working capital:

- Excessive investment in working capital** is indicated by a long cash cycle that appears to be getting even longer. When too much is invested in working capital, the ROCE and ROE will be lower than they should be.
- Under-investment in working capital** is an indication of possible liquidity difficulties. When working capital is low in comparison with the industry average, this might indicate that current assets are being financed to an excessive extent by current liabilities, particularly trade payables and a bank overdraft.

3.2 Average time to collect (receivables days) or receivables turnover

This ratio estimates the time that it takes on average to collect the payment from customers after the sale has been made. It could be described as the average credit period allowed to customers or the 'average collection period'.

Sales are usually taken as total sales for the year. However, if sales are analysed into credit sales and cash sales, it is probably more appropriate to use the figure for credit sales only. Average receivables should be used in calculation when comparable data for calculation is available, otherwise, receivables at the end of year is used.

The average time to collect money from credit customers should not be too long. A long average time to collect suggests inefficient collection of amounts due from receivables.

► Example 12:

Using the data given in Example 01, average days to collect receivables and receivable turnover in times can be calculated as follows:

Average days to collect

$$= \frac{\text{Average trade receivables}}{\text{Sales}} \times 365 = \frac{170.5}{4,315} \times 365 = 14.4 \text{ days}$$

Average trade receivables [Rs. 168 m + 173 m] / 2 = Rs. 171 m

Receivables turnover

$$= \frac{\text{Sales}}{\text{Average trade receivables}} = \frac{4,315}{171} = 25.2 \text{ times}$$

3.3 Average time for holding inventory (inventory days) or inventory turnover

This ratio is an estimate of the average time that inventory is held before it is used or sold. A longer than inventory average period indicates inefficient production process. Average inventory should be used in calculation when comparable data for calculation is available, otherwise, inventory at the end of year is used.

► **Example 13:**

Using the data given in Example 01, average holding days of inventory and inventory turnover in times can be calculated as follows:

Average holding days

$$= \frac{\text{Average inventory}}{\text{Cost of sales}} \times 365 = \frac{276}{3,020} \times 365 = 33.4 \text{ days}$$

Average inventory [Rs. 272 m + 280 m] / 2 = Rs. 276 m

Inventory turnover

$$= \frac{\text{Cost of sales}}{\text{Average inventory}} = \frac{3,020}{276} = 10.9 \text{ times}$$

In a manufacturing organization there are usually three types of inventories i.e. raw materials, work in process and finished goods. Holding period for each type of inventory may be calculated separately using the following formulas:

Raw material inventory holding period

$$= \frac{\text{Average raw material inventory}}{\text{Cost of material consumed}} \times 365 = \text{___ days}$$

Work in process inventory holding period

$$= \frac{\text{Average WIP inventory}}{\text{Cost of good manufactured}} \times 365 = \text{___ days}$$

Finished goods inventory holding period

$$= \frac{\text{Average finished goods inventory}}{\text{Cost of goods sold}} \times 365 = \text{___ days}$$

3.4 Average time to pay suppliers (payables days) or payables turnover

Average payment period measures the number of days it usually takes a business to pay its suppliers for purchases made on credit. When the cost of purchases is not available, the cost of sales may be used instead.

Average payables should be used in calculation when comparable data for calculation is available, otherwise, payables at the end of year is used.

► **Example 14:**

Using the data given in Example 01, average days to pay suppliers and payables turnover in times can be calculated as follows:

Average days to pay suppliers

$$= \frac{\text{Average trade payables}}{\text{Purchases}} \times 365 = \frac{158}{3,012} \times 365 = 19.1 \text{ days}$$

Average trade payables [Rs. 153 m + 162 m] / 2 = Rs. 158 m

Purchases = Cost of sales – Opening inventory + closing inventory

Purchases = Rs. 3,020 m – Rs. 280 m + Rs. 272 m = Rs. 3,012 m

Payables turnover

$$= \frac{\text{Purchases}}{\text{Average trade payables}} = \frac{3,012}{158} = 19.1 \text{ times}$$

► **Example 15:**

The following information is available for Broom Limited (BL) for Year 1.

	1 January Year 1	31 December Year 1
	Rs.	Rs.
Inventory	300,000	360,000
Trade receivables	400,000	470,000
Trade payables	150,000	180,000

Sales in Year 1 totalled Rs.3,000,000, purchases totalled Rs. 1,860,000 and the cost of sales was Rs.1, 800,000

Required: Calculate and comment on working capital efficiency ratios.

► **Answer:****Working capital efficiency ratios**

Average days to collect = $[435,000 \text{ W1} / 3,000,000] \times 365 \text{ days} = 52.9 \text{ days}$

Inventory turnover period = $[330,000 \text{ W2} / 1,800,000] \times 365 \text{ days} = 66.9 \text{ days}$

Average time to pay = $[165,000 \text{ W3} / 1,860,000] \times 365 \text{ days} = 32.4 \text{ days.}$

W1: Average trade receivables = $[\text{Rs.}400,000 + \text{Rs.}470,000] / 2 = \text{Rs.}435,000$

W2: Average inventory = $[\text{Rs.}300,000 + \text{Rs.}360,000] / 2 = \text{Rs.}330,000$

W3: Average trade payables = $[\text{Rs.}150,000 + \text{Rs.}180,000] / 2 = \text{Rs.}165,000.$

Comment:

The relationship among the three ratios given above is quite critical. The sale of inventory generates receivables, that when collected are used to settle creditors and the cycle goes on. The firm's ability to get the cycle repeated continuously depends heavily on the entity's short-term liquidity and the cash generating ability. In the given scenario the firm is responsible to settle its payables at least around 20 days before it receives payments from its customers. The working capital need then would be financed through some bank operating line and that would bring a cost which in turn would reduce the profitability of the organisation. The credit policy therefore needs to get revised and improved and sloppy collections to be gotten rid of. Also the agreement with the supplier might be refreshed for the purpose of extending the credit period.

3.5 Cash cycle / operating cycle/working capital cycle

This is average cycle of business operations:

- From the time that suppliers are paid for the resources they supply;
- To the time that cash is received from customers for the goods or services sold or provided to them.

The working capital ratios and the length of the cash cycle should be monitored over time. The cycle should not be allowed to become unreasonable in length, with a risk of over-investment or under-investment in working capital.

A positive working capital cycle balances incoming and outgoing payments to minimise net working capital and maximise free cash flow. For example, a company that pays its suppliers in 30 days but takes 60 days to collect

its receivables has a working capital cycle of 30 days. This 30-day cycle usually needs to be funded through a bank operating line, and the interest on this financing is a carrying cost that reduces the company's profitability.

Growing businesses require cash and being able to free up cash by shortening the working capital cycle is the most inexpensive way to grow. Sophisticated buyers review closely a target's working capital cycle because it provides them with an idea of the management's effectiveness at managing their financial position and generating free cash flow.

A cash cycle can be calculated as inventory holding period plus receivables collection period minus payables payment period.

► *Example 16:*

Using the data given in Example 15, cash cycle can be calculated as follows:

	Days
Inventory holding period	66.9
Receivables collection period	52.9
Payables payment period	(32.4)
Cash cycle	87.4

It indicates that on average BL needs working capital financing for 87 days.

4. LIQUIDITY AND SOLVENCY RATIOS

4.1 Liquidity ratios

Liquidity means having cash or access to readily available cash to make payments for settling the short term obligations of the entity.

For the purpose of ratio analysis, liquidity is measured on the assumption that the only sources of cash available are cash in hand or in the bank, and other current assets that will soon be converted into cash during the normal cycle of trade. Similarly, it is also assumed that the only immediate payment obligations to be settled by the entity are its current liabilities.

There are two ratios for measuring liquidity:

- Current ratio (i.e. ratio of current assets to current liabilities).
- Quick ratio [i.e. ratio of current assets excluding inventory and prepayments to current liabilities].

Current ratio is also called safe margin of solvency as it reflects ability to settle current liabilities.

Quick ratio is also called acid-test ratio that acknowledges that prepayments will not be available to settle obligations and inventory might take long time to be available for settling the obligations.

It is sometimes suggested that there is an 'ideal' current ratio of 2.0 times (2:1) and an 'ideal' quick ratio of 1.0 times (1:1). However, this is not necessarily true and, in some industries, much lower current ratios are normal. It is important to assess the liquidity ratios by considering:

- Changes in the ratio over time
- The liquidity ratios of other companies in the same period
- The industry average ratios.

► **Example 17:**

Using the data given in Example 01, for year 2024, current ratio and quick ratio can be calculated as follows:

Current ratio

$$= \frac{\text{Current assets}}{\text{Current liabilities}} = \frac{452}{156} = 2.9 : 1$$

Quick ratio

$$= \frac{\text{Current assets} - \text{inventory}}{\text{Current liabilities}} = \frac{452 - 272}{156} = 1.15 : 1$$

Comments:

A current ratio of 2.9:1 or higher is considered satisfactory. However, A higher current ratio might not indicate the ability to pay off the entity's current obligations efficiently as a huge portion of current assets may comprise of needless, obsolete and/or slow-moving inventory items. A deeper analysis into the individual items of current assets and liabilities would add value to the results.

The quick ratio of 1.15 times that says company can pay off all his current liabilities with liquid assets and can still have some quick assets left over. The acid-test ratio gives a more rigorous assessment of the company's ability to pay off its current liabilities as it considers only highly liquid assets. Had it been below 1 it would have indicated that company may be struggling to maintain or increase sales, settling its creditors quickly and/or collecting receivables on time.

4.2 Solvency ratios

Solvency means having enough assets to pay off the liabilities of the business in the long term. Solvency ratios include gearing ratio and interest coverage ratio.

Gearing, also called leverage, measures the total long-term debt of a company as a percentage of either:

- The equity capital in the company, or
- The total capital of the company

A company is said to be high-g geared or highly leveraged when its debt capital exceeds its equity capital. This means that a company is high geared when:

- the gearing ratio (long term debts / total capital employed) is above 50%; or
- the gearing ratio (long term debts / equity capital) is above 100%.

A high level of gearing may indicate the following:

- The entity has a high level of debt, which means that it might be difficult for the entity to borrow more when it needs to raise new capital.
- High gearing can indicate a risk that the entity will be unable to meet its payment obligations to lenders when these obligations are due for payment.

The gearing ratio can be used to monitor changes in the amount of debt of a company over time. It can also be used to make comparisons with the gearing levels of other, similar companies, to judge whether the company has too much debt, or perhaps too little, in its capital structure.

The interest coverage ratio is a debt and profitability ratio used to determine how easily a company can pay interest on its outstanding debt. The interest coverage ratio is calculated by dividing a company's profit before interest and taxes (PBIT) by its interest expense during a given period, expressed in number of times.

► Example 18:

Using the data given in Example 01, for year 2024, gearing ratio and interest coverage ratio can be calculated as follows:

Gearing ratio (as percentage of equity capital)

$$= \frac{\text{Long term debts}}{\text{Equity capital}} = \frac{125}{1,160} = 10.8\%$$

Gearing ratio (as percentage of total capital employed)

$$= \frac{\text{Long term debts}}{\text{Equity capital} + \text{long term debts}} = \frac{125}{1,160 + 125} = 9.7\%$$

Interest coverage ratio

$$= \frac{\text{PBIT}}{\text{Interest expense}} = \frac{214}{13} = 16.5 \text{ times}$$

Comments:

The company has very low gearing and a strong interest coverage ratio and it is likely that the company can easily obtain more long-term financing if so required.

5. OTHER ASPECTS

5.1 Impact of specific transactions on ratios

It is important to understand how certain future transactions or events might affect already calculated ratios, for example, an entity may be required to certain current ratio of at least 1.75 as part of its running finance agreement with the bank.

The following mathematical rules are useful in most circumstances:

- Increase in numerator will increase the measure of ratio and decrease in numerator will decrease the measure of ratio
- Increase in denominator will decrease the measure of ratio and decrease in denominator will increase the measure of ratio
- Increase in numerator and denominator by equal amount will increase the lower side of fraction bar, more proportionately. Similarly, decrease in numerator and denominator by equal amount will decrease the lower side of fraction bar, more proportionately.

► **Example 19:**

Epivac Limited is considering to take some of the following measures during the last week of the year ending 31 March 2021 in order to show better financial performance:

- Pay balance of a major supplier from bank overdraft facility and avail 5% discount.
- Sell slow moving stock items at a price equal to cost.
- Recover debtors' balances by offering cash discounts of 10%.
- Offer extended credit terms of 90 days which would increase sales at existing margins.
- Dispose-off some non-current assets at gain.

Required: State the effect (increase, decrease, no effect) of each of the above measure on the following financial ratios:

(a) Gross profit %	(b) Net profit %
(c) Current ratio	(d) Stock turnover (times)
(e) Return on non-current assets	(f) Quick ratio

► **Answer:**

S. No.	Ratios	Measures				
		(i)	(ii)	(iii)	(iv)	(v)
(a)	Gross profit %	Increase*	Decrease	Decrease*	No effect	No effect
	Gross Profit / Sales					
(b)	Net profit %	Increase	Decrease	Decrease	Increase	Increase
	PAT / Sales					
(c)	Current ratio	Increase	No effect	Decrease	Increase	Increase
	Current assets / Current liab.					
(d)	Stock turnover (times)	Decrease*	Increase	No effect	Increase	No effect
	Cost of Sales / Inventory					
(e)	Return on non-current assets	Increase	No effect	Decrease	Increase	Increase
	PBIT / Non-current assets					
(f)	Quick ratio	Increase	Increase	Decrease	Increase	Increase
	(RA + Cash) / Current liab.					

*The settlement discount is deducted from revenue or cost of purchases.

5.2 Limitations of financial statements and ratio analysis

Financial statements are time and cost producing. Ratio analysis can be used to compare information taken from the financial statements to gain an analytical understanding of the results, financial position and cash flows of a business. This analysis is a useful tool, especially for an outsider such as a supplier, lender or an investor.

However, there are a number of limitations of ratio analysis which are given below:

1. Historical

All of the information used in ratio analysis is derived from actual historical results. This does not mean that the same results will carry forward into the future. However, you can use ratio analysis on pro forma information and compare it to historical results for consistency.

2. Historical versus current cost

The information on the income statement is stated in current costs (or close to it), whereas many elements of the statement of financial position are stated at historical cost (which could vary substantially from current costs). This disparity can result in unusual ratio results.

3. Inflationary effect

If the rate of inflation has changed in any of the periods under review, this can mean that the numbers are not comparable across periods. For example, if the inflation rate was 100% in one year, sales would appear to have doubled over the preceding year, when in fact sales did not change at all.

4. Aggregation

The information in a financial statement line item that you are using for a ratio analysis may have been aggregated differently in the past, so that running the ratio analysis on a trend line does not compare the same information through the entire trend period.

5. Accounting policies and estimates

Different companies in a similar industry may have different policies for recording the same accounting transaction. This means that comparing the ratio results of different companies may be like comparing apples and oranges. For example, one company might use reducing balance method while another company uses straight-line depreciation.

6. Business conditions

You need to place ratio analysis in the context of the general business environment. For example, 60 days of sales outstanding for receivables might be considered poor in a period of rapidly growing sales but might be excellent during an economic contraction when customers are in severe financial condition and unable to pay their bills.

7. Interpretation

It can be quite difficult to ascertain the reason for the results of a ratio. For example, an acid test ratio of 2:1 might appear to be excellent, until you realize that the company just sold a large amount of its stock to bolster its cash position. A more detailed analysis might reveal that the acid test ratio will only temporarily be at that level and will probably decline in the near future.

8. Company strategy

It can be difficult to interpret a ratio analysis comparison between two companies that are pursuing different strategies. For example, one company may be following a low-cost strategy, and so is willing to accept a lower gross margin in exchange for more market share. Conversely, a company in the same industry is focusing on a high customer service strategy where its prices are higher and gross margins are higher, but it will never attain the revenue levels of the first company.

5.3 Window dressing

One should also be careful of unethical practices like window dressing while interpreting the financial statements. Window dressing is the adaptation of the rules and practices to present financial statements in a way that business situation appears better than it actually is. This manipulates the financial information and misleads the users of financial statements.

Some of the ways in financial statements may be manipulated include:

- Delay in paying suppliers, so that the period-end cash balance appears higher.
- Using lower estimate for allowance for doubtful debts.
- Capitalize smaller expenditures that would normally be charged to expense, to increase reported profits.
- Offer customers an early shipment discount, thereby accelerating revenues from a future period into the current period.
- Lower depreciation expense by using higher useful lives or residual values, etc.

► **Example 20:**

Ratios are computed by using numerical values from financial statements to gain meaningful information about an entity. However, due to inherent limitations of ratio analysis, it may not reflect the correct financial situation.

Required: Briefly explain any four limitations of ratio analysis.

► **Answer:**

(i) Historical

All information used in ratio analysis is derived from actual historical results. This does not mean that the same results will carry forward into the future. However, ratio analysis can be used on pro forma information and compare it to historical results for consistency.

(ii) Historical versus current cost

The information on the income statement is stated in current costs (or close to it), whereas many elements of the statement of financial position are stated at historical cost (which could vary substantially from current costs). This disparity can result in unusual ratio results.

(iii) Inflationary effect

If the rate of inflation has changed in any of the periods under review, this can mean that the numbers are not comparable across periods. For example, if the inflation rate was 100% in one year, sales would appear to have doubled over the preceding year, when in fact sales did not change at all.

(iv) Aggregation

The information in a financial statement line item that is used for a ratio analysis may have been aggregated differently in the past, so that running the ratio analysis on a trend line does not compare the same information through the entire trend period.

6. COMPREHENSIVE EXAMPLES

► Example 21:

Wasim Limited is an importer and retailer of vegetable oils. Extracts from the financial statements for this year and last are set out below:

Income statements for the years ended 30 September

	Year 7	Year 6
	Rs. 000	Rs. 000
Revenue	2,160	1,806
Cost of sales	(1,755)	(1,444)
Gross profit	405	362
Distribution costs	(130)	(108)
Administrative expenses	(260)	(198)
Profit before tax	15	56
Income tax expense	(6)	(3)
Profit for the period	9	53

Statements of financial position as at 30 September

	Year 7	Year 6
	Rs. 000	Rs. 000
Non-current assets		
Property, plant and equipment	78	72
Current assets		
Inventories	106	61
Trade receivables	316	198
Cash	-	6
	422	265
Total assets	500	337
Equity		
Ordinary shares	110	85
Preference shares	23	11
Share premium	15	-
Revaluation reserve	20	20
Retained earnings	78	74
	246	190
Current liabilities		
Bank overdraft	49	-
Trade payables	198	142
Current tax payable	7	5
	254	147
Total equity and liabilities	500	337

Required: Calculate profitability ratios, liquidity ratios and working capital ratios for Wasim Limited for two years.

► Answer:

Profitability ratios	Year 7		Year 6
Gross profit margin			
$\frac{405}{2,160}$	= 19%	$\frac{362}{1,806}$	= 20%
Net profit ratio			
$\frac{9}{2,160}$	= 0.4%	$\frac{53}{1,806}$	= 2.9%
Return on capital employed			
$\frac{15}{246}$	= 6%	$\frac{56}{190}$	= 29%
Asset turnover			
$\frac{2,160}{246}$	= 8.8 times	$\frac{1,806}{190}$	= 9.5 times

Liquidity ratios	Year 7		Year 6
Current ratio			
$\frac{422}{254}$	= 1.7 times	$\frac{265}{147}$	= 1.8 times
Quick ratio			
$\frac{422 - 106}{254}$	= 1.2 times	$\frac{265 - 61}{147}$	= 1.4 times

Working capital ratios	Year 7		Year 6
Average time to collect			
$\frac{316 \times 365}{2,160}$	= 53 days	$\frac{198 \times 365}{1,806}$	= 40 days
Average time to pay			
$\frac{198 \times 365}{1,755}$	= 41 days	$\frac{142 \times 365}{1,444}$	= 36 days
Average inventory holding period			
$\frac{106 \times 365}{1,755}$	= 22 days	$\frac{61 \times 365}{1,444}$	= 15 days

► *Example 22:*

The income statements and statements of financial position of two manufacturing companies in the same sector are set out below.

	Amir	Mo
	Rs.	Rs.
Revenue	150,000	700,000
Cost of sales	(60,000)	(210,000)
Gross profit	90,000	490,000
Interest expense	(500)	(12,000)
Distribution costs	(13,000)	(72,000)
Administrative expenses	(15,000)	(35,000)
Profit before tax	61,500	371,000
Income tax expense	(16,605)	(100,170)
Profit for the period	44,895	270,830

	Amir	Mo
	Rs.	Rs.
Non-current assets		
Property	-	500,000
Plant and equipment	190,000	280,000
	190,000	780,000
Current assets		
Inventories	12,000	26,250
Trade receivables	37,500	105,000
Cash at bank	500	22,000
	50,000	153,250
Total assets	240,000	933,250
Equity		
Share capital	156,000	174,750
Retained earnings	51,395	390,830
	207,395	565,580
Non-current liabilities		
Long term debt	10,000	250,000
Current liabilities		
Trade payables	22,605	117,670
Total equity and liabilities	240,000	933,250

Required: Calculate profitability ratios, liquidity ratios and working capital ratios for Amir and Mo.

► Answer:

Profitability ratios	Amir		Mo
Gross profit margin			
$\frac{90,000}{150,000}$	= 60%	$\frac{490,000}{700,000}$	= 70%
Net profit ratio			
$\frac{44,895}{150,000}$	= 30%	$\frac{270,830}{700,000}$	= 39%
Return on capital employed			
$\frac{61,500 + 500}{207,395 + 10,000}$	= 28.5%	$\frac{371,000 + 12,000}{565,580 + 250,000}$	= 47%
Asset turnover			
$\frac{150,000}{207,395 + 10,000}$	= 0.7 times	$\frac{700,000}{565,580 + 250,000}$	= 0.85 times

Liquidity ratios	Amir		Mo
Current ratio			
$\frac{50,000}{22,605}$	= 2.2 times	$\frac{153,250}{117,670}$	= 1.3 times
Quick ratio			
$\frac{50,000 - 12,000}{22,605}$	= 1.7 times	$\frac{153,250 - 26,250}{117,670}$	= 1.1 times

Working capital ratios	Amir		Mo
Average time to collect			
$\frac{37,500 \times 365}{150,000}$	= 91 days	$\frac{105,000 \times 365}{700,000}$	= 55 days
Average time to pay			
$\frac{22,605 \times 365}{60,000}$	= 137 days	$\frac{117,670 \times 365}{210,000}$	= 204 days
Average inventory holding period			
$\frac{12,000 \times 365}{60,000}$	= 73 days	$\frac{26,250 \times 365}{210,000}$	= 46 days

► *Example 23:*

Alpha Limited and Omega Limited are in the same trade but operate in different areas. Their financial statements for the year ended 31 December 2016 are as follows:

Statement of profit or loss	Alpha Limited	Omega Limited
	Rs.'000	Rs.'000
Sales	1,440	1,720
Cost of sales	(1,120)	(1,342)
Gross profit	320	378
Operating expenses	(220)	(300)
Profit before tax	100	78
Taxation	(40)	(30)
Profit after tax	60	48

Statement of financial position	Alpha Limited	Omega Limited
	Rs.'000	Rs.'000
Capital employed		
Share capital of Rs. 1 each	600	200
Reserves	240	104
	840	304
8% Debentures	-	120
	840	424
Represented by:		
Non-current assets at cost	660	520
Less: Depreciation	200	160
	460	360
Current assets:		
Inventory	280	172
Receivables	310	300
Cash	30	32
	620	504
Current liabilities:		
Taxation	40	30
Creditors	180	344
Bank overdraft	-	42
Dividend payable	20	24
	240	440
Net current assets	380	64
	840	424

Required: Compute the current ratio, acid test ratio, average payment period and average collection period for Alpha Limited and Omega Limited and carry out the comparative analysis based on the computed ratios.

► Answer:

	Alpha Limited		Omega Limited
Current ratio			
$\frac{620,000}{240,000}$	= 2.58 times	$\frac{504,000}{440,000}$	= 1.15 times
Quick ratio			
$\frac{620,000 - 280,000}{240,000}$	= 1.42 times	$\frac{504,000 - 172,000}{440,000}$	= 0.75 times
Average time to pay			
$\frac{180,000 \times 365}{1,120,000}$	= 59 days	$\frac{344,000 \times 365}{1,342,000}$	= 94 days
Average time to collect			
$\frac{310,000 \times 365}{1,440,000}$	= 79 days	$\frac{300,000 \times 365}{1,720,000}$	= 64 days

Comparative analysis commentary:

- In terms of working capital and liquidity, Alpha Limited is in a better position to honour its obligations as they fall due because its current ratio and acid test ratio are higher than those of Omega Limited.
- Omega Limited's payment period is better than that of Alpha Limited's because Omega Limited can supplier's funds for longer period to finance its operation.
- Omega Limited's collection period is also better than that of Alpha Limited. It extends shorter credit period to its customers than Alpha Limited.
- Omega Limited's credit policy is better than that of Alpha Limited. This is because there is 30 days difference between its payments period and collection periods compared with Alpha Limited that had a longer collection period than its payment period.

► Example 24:

Boom Limited (BL) is a manufacturer of sports goods. Following financial statements for the year ended 31 December 2017 have been submitted to the Chief Executive Officer (CEO):

Statement of profit or loss

	Rs. in '000
Revenues	21,000
Cost of sales	(17,500)
Gross profit	3,500
Operating expenses	(1,900)
Finance cost	(450)
Profit before tax	1,150
Taxation	(345)
Profit after tax	805

Statement of financial position

	Rs. in '000
Property, plant and equipment	7,500
Current assets	1,500
	9,000
Share capital	4,000
Reserves	1,000
Non-current liabilities	3,000
Current liabilities	1,000
	9,000

Although performance of BL has improved from the last year, CEO wants to compare the results with other companies operating in sports manufacturing industry. In this respect, following industry data has been gathered:

Gross profit margin	23.5%
Net profit margin	7.7%
Current ratio	2.75
Gearing ratio	50:50
Return on non-current asset	32.9%
Return on capital employed	27.4%
Return on equity	31.3%

Required:

- Compute BL's ratios for comparison with the industry.
- For each ratio, give one possible reason for variation from the industry.

► **Answer:**

Part (a) BL's ratios for comparison with the industry

Ratio		Boom Limited	Industry
Gross profit margin	[3,500 / 21,000]	16.7%	23.5%
Net profit margin	[805 / 21,000]	3.8%	7.7%
Current ratio	[1,500 / 1,000]	1.5	2.75
Gearing ratio	[3,000 / (3,000 + 5,000)]	37.5 : 62.5	50 : 50
Return on non-current asset	[(1,150 + 450) / 7,500]	21.3%	32.9%
Return on capital employed	[(1,150 + 450) / 8,000]	20.0%	27.4%
Return on equity	[805 / 5,000]	16.1%	31.3%

Part (b) Possible reasons for variation from the industry

Ratio	Reasons for variation from industry
Gross profit margin	Lower than industry • Purchase of raw material at higher prices as compared to its competitors • Inability to obtain economies of scale in production as compared to its competitors • Higher production costs due to inefficiencies • Deliberately keeping selling prices lower to gain the market share
Net profit margin	Lower than industry • BL's gross profit margin is 6.8% lower than industry (16.6% Vs 23.5%) whereas net profit margin is only 3.9% lower which indicates that BL's operating expenses as a percentage of sales are approximately 2.9% lower than the industry
Current ratio	Lower than industry • Since gearing ratio is lower than the industry so BL might have obtained running finances as compared to long-term financing by the industry availed extended credit terms from suppliers • Low inventory levels are maintained by BL • Shorter credit terms are given to debtors
Gearing ratio	Lower than industry • Difficulty in raising long-term finance from banks due to low profits • Running finance or extended credit terms from suppliers are available for BL
Return on non-current asset	Lower than industry • Lower profit margins • Relatively newer non-current assets have higher carrying value
Return on capital employed	Lower than industry • Lower profit margins • High shareholder's equity
Return on equity	Lower than industry • Lower profit margins • Higher shareholder's equity/low gearing ratio

► *Example 25:*

Progressive Steel Limited (PSL) commenced business in 2015. The following comparative data pertains to the year ended 30 June 2017:

Description	PSL		Industry
	2017	2016	2017
Gross profit margin	13%	13%	16%
Net profit margin	8%	7%	10%
Return on shareholders' equity	22%	18%	25%
Current ratio	1.2	1.6	1.5
Debt to equity ratio	40:60	30:70	50:50
Cash operating cycle in days	119	135	118

Required: For each ratio/data give possible reasons for variation from comparative and industry data.

► *Answer:*

Ratios	Reasons for fluctuation with previous year	Reason for fluctuation with Industry
Gross profit margin	In line with previous year. No variation.	Lower than industry ▪ The company is in an initial phase and may have kept the selling prices lower than the industry to gain market share. ▪ The company may not have been able to purchase raw material at prices which is available to its competitors. ▪ The company may not have been able to obtain economies of scale in its production which may have been obtained by its competitors. ▪ Possibility of higher production costs.
Net profit margin	Higher than previous year: ▪ Tight control over operating costs. ▪ Increase in other income. Decrease in fixed cost per unit due to increase in sale.	Lower than industry however, the difference is mainly attributed to lower gross profit margin.
Return on shareholder's equity	Higher than previous year: ▪ Reduction in tax rates. ▪ Reduction in interest rates. ▪ The decrease in equity might be due to buyback of shares. ▪ Distribution of profits from the previous year which resulted in a decrease in equity.	Lower than industry ▪ Lower gross profit and net profit margins. ▪ Lower leverage. ▪ Higher net assets resulting in higher equity.

Ratios	Reasons for fluctuation with previous year	Reason for fluctuation with Industry
Current ratio	Lower than previous year: ▪ The company might have obtained a running finance facility to fund its operations in the current year. ▪ Long term loan payments might have become due in the next 12 months, which decreases the current ratio. ▪ Decrease in current assets due to better inventory management/ reduction in credit period of debtors.	Lower than industry ▪ Since the debt equity ratio is lower than the industry, company might have obtained running finance or might have availed extended credit terms from suppliers.
Debt to equity ratio	Higher than previous year ▪ Decrease in reserves due to dividend pay-out. ▪ Further debt obtained during the period. ▪ The decrease in equity might be due to buyback of shares.	Lower than industry ▪ Being a new entrant, the company may be in the phase of expansion thereby raising debt accordingly.
Cash operating cycle	Lower than previous year ▪ The increase in current liabilities might be due to an increase in the credit period. ▪ Decrease in current assets which might be due to greater stock turnover or better inventory management. ▪ By giving lower credit days to debtors.	In line with industry.

► **Example 26:**

The following information has been gathered by an analyst, in respect of Dairy Foods Limited (DFL) which specializes in various dairy products.

Ratio	2016	2015	2014	Industry average
Profit margin %	11%	10%	8%	10.45%
Quick ratio	1.38	1.40	1.42	1.52
Current ratio	1.84	1.67	1.59	1.73
Days purchases in payables	80	91	89	82

In the latest annual report to the shareholders, Directors of DFL have claimed that liquidity position of the Company has improved significantly.

Required: Critically analyse and discuss whether you agree with the claim.

► *Answer:*

While analysing liquidity positions of DFL, it is noted that current ratio has steadily increased over the years and is better than industry average. However, the quick ratio has steadily declined and is even lower than industry average. This is a clear evidence that the increase in liquidity is caused by an increase in inventory.

Further, by considering the nature of highly perishable inventories kept by a dairy food company, it is a possibility that DFL may bear high inventory losses due to short expiry. Based on the above, I do not agree with the claim of DFL's directors.

► *Example 27:*

Extracts from latest financial statements of two companies are as follows;

Extracts from statements of financial position

Equity & Liabilities	A	B	Assets	A	B
	Rs. in millions			Rs. in millions	
Equity & reserves	51,690	72,114	Fixed assets	34,460	48,076
Long term loan	-	36,057	Stock in trade	21,700	20,000
Trade creditors	35,790	45,135	Trade debtors	24,470	44,030
Other payables	12,000	8,500	Cash and bank	18,850	49,700
	99,480	161,806		99,480	161,806

Extract from Statement of Comprehensive Income

	A	B
	Rs. m	Rs. m
Revenue	161,600	220,150
Cost of sales	(135,160)	(180,520)
Gross profit	26,440	39,630
Operating expenses	(9,840)	(13,870)
Interest expense	(720)	(2,313)
Profit before tax	15,880	23,447
Income tax	(333)	(409)
Profit after tax	15,547	23,038

Required: Analyse the profitability, liquidity and working capital ratios of both the companies.

► *Answer:*

Profitability ratios	A	B
Gross profit ratio (GP ÷ sales)	16.36%	18.00%
Profit to sales (Profit after tax ÷ sales)	9.62%	10.46%
Return on capital employed (Profit before interest and tax ÷ capital employed)	32.11%	23.81%
Return on asset employed (Profit before interest and tax ÷ assets)	16.69%	15.92%

Company B's gross profit and net profit ratio is slightly higher as compared to Company A. The difference is not significant and may be on account of higher level of sales resulting in lesser fixed costs per unit.

Company A's return on capital employed ratio and return on asset employed ratio are better than Company B, because Company B has accumulated large balances of cash despite of availing long-term loan. Had Company B had used its cash balances to pay off the long-term loan; it would have both of these ratio better than Company A.

Liquidity Ratios	A	B
Current ratio (current assets ÷ current liabilities)	1.36	2.12
Quick ratio (current asset-inventory ÷ liabilities)	0.91	1.75

Company B has better current and quick ratio. However, it appears that these ratios are better than Company A due to substantially high amount of trade debts in term of percentage of sales as sales days. It also represents a risk that these trade debts may prove irrecoverable. Moreover, they may be indicative of inefficient in debt collection as well.

Working capital turnover ratios	A	B
Stock turnover days (Stock ÷ Cost of goods sold × 365)	58.60	40.44
Debtor turnover days (Debtor ÷ Revenue × 365)	55.27	73.00
Creditor turnover days (Creditor ÷ Cost of goods sold × 365)	(96.65)	(91.26)
Cash operating cycle (days)	17.22	22.18

Stock turnover of Company B is better than that of Company A. Company B is turning over its stock 9 times whereas company A is doing it 6 times a year.

Company A is more effectively collecting its debtors than Company B. This could also be due to the fact that Company B is following a lenient credit policy to attract more revenue. This fact is also supported from higher stock turnover ratio of Company B.

Company A have availed better credit facility from its creditors but it may have forgone some settlement discounts which might have resulted in lower gross profit ratio than that of Company B.

Overall cash operating cycle of Company A is better than Company B. Furthermore, Company B has accumulated large balances of cash despite the fact that it has also availed long term loan. Excess cash balance should have been used to pay off the long-term loan to reduce the finance cost.

► **Example 28:**

Following are the summarised financial statements of Shispare Limited (SL) and its competitor Trivor Limited (TL) for the year ended 31 December 2019:

Statement of financial position

Assets	SL	TL	Equity & liabilities	SL	TL
	Rs. in million			Rs. in million	
Fixed assets	5,400	7,800	Capital and reserves	8,400	9,450
Current assets:			Long-term loan	1,900	4,600
Inventory	4,800	7,100	Current liabilities:		
Debtors	2,700	3,200	Creditors	2,900	4,500
Cash	1,200	800	Accrued expenses	900	350
	8,700	11,100		3,800	4,850
	14,100	18,900		14,100	18,900

(iv) Gross profit margin

$$\frac{5,300}{16,700} = 31.74\% \quad \frac{7,600}{35,400} = 21.47\%$$

TL is deliberately keeping selling prices lower to gain the market share.

(v) Current ratio

$$\frac{8,700}{3,800} = 2.29 : 1 \quad \frac{11,100}{4,850} = 2.29 : 1$$

Quick ratio

$$\frac{8,700 - 4,800}{3,800} = 1.03 : 1 \quad \frac{11,100 - 7,100}{4,850} = 0.82 : 1$$

SL has better liquidity position.

(vi) Return on assets

$$\frac{1,550 + 250}{14,100} = 12.77\% \quad \frac{2,100 + 600}{18,900} = 14.29\%$$

TL has higher ability to convert its assets into profit.

(vii) Operating expenses ratio

$$\frac{3,500}{16,700} = 20.95\% \quad \frac{4,900}{35,400} = 13.84\%$$

TL is efficiently controlling the operating expenses.

(vii) Gearing ratio (as %age of capital employed)

$$\frac{1,900}{8,400 + 1,900} = 18\% \quad \frac{4,600}{9,450 + 4,600} = 33\%$$

SL is going to raise a bank loan relatively easily in future.

► **Example 29:**

Ali and Bashir are chartered accountants and have been working as Managing Director (MD) and Chief Financial Officer (CFO) in a listed company. In a recent meeting of the Board, the directors have decided to expand the business within six months by opening 20 retail outlets. This expansion would require financing of Rs. 300 million which may be arranged through bank loan.

The following information has been extracted from latest draft financial statements of the company:

	Rs. m
Sales	1,700
Gross profit	545
Tax expense	23
Profit after tax	40
Total assets	2,500
Non-current assets	900
Inventories	850
Trade receivables	600
Share capital	800
Reserves	152
Long term debt @ 9%	750

Following additional information is also available:

- 80% of the sales are on credit.
- Opening inventory was Rs. 100 million.
- 40% of current liabilities comprise of trade payables.

Required: Compute liquidity, working capital and debt ratios of the company.

► **Answer:****Liquidity ratios****(i) Current ratio**

$$\frac{\text{Current assets}}{\text{Current liabilities}} = \frac{2500 - 900}{2,500 - 800 - 152 - 750} = 2.01 \text{ times}$$

(ii) Quick ratio

$$\frac{\text{Current assets} - \text{inventories}}{\text{Current liabilities}} = \frac{1,600 - 850}{2,500 - 800 - 152 - 750} = 0.94 \text{ times}$$

Working capital ratios**(iii) Inventory holding period**

$$\frac{\text{Average inventories} \times 365}{\text{Cost of sales}} = \frac{[(850 + 100)/2] \times 365}{1,700 - 545} = 150 \text{ days}$$

(iv) Receivables collection period

$$\frac{\text{Trade receivables} \times 365}{\text{Sales}} = \frac{600 \times 365}{(1,700 \times 80\%)} = 161 \text{ days}$$

(v) Payables payment period

$$\frac{\text{Trade payables} \times 365}{\text{Purchases}} = \frac{[798 \times 40\%] \times 365}{1,905^*} = 61 \text{ days}$$

*Purchases = [1,700 – 545] – 100 + 850 = Rs. 1905

Debt ratios**(vi) Gearing ratio**

$$\frac{\text{Long term debt}}{\text{Capital employed}} = \frac{750}{800 + 152 + 750} = 44\%$$

(vii) Interest cover

$$\frac{\text{PBIT}}{\text{Interest expense}} = \frac{40 + 23 + 67.5^*}{67.5^*} = 1.93 \text{ times}$$

*Interest expense = Rs. 750 loan x 9% = Rs. 67.5

► **Example 30:**

Following amounts have been determined from the records of Hassan Limited.

Description	2014	2015	2016
	----- Rs. in million -----		
Sales	100.00	120.00	135.00
Cost of sales	75.00	90.00	101.25
Profit before interest and tax	6.00	5.50	5.60
Account receivable	16.50	25.00	35.00
Account payable	13.00	14.70	15.00
Inventory	18.75	26.00	30.40
Cash at bank / (overdraft)	5.00	(0.50)	(2.00)

Required: Calculate liquidity ratios and working capital cycle for 2015 and 2016 and comment on the results of your calculation, assuming that all sales and purchases are made on credit.

► *Answer:***Liquidity ratios**

2016	2015
Current ratio	
$\frac{35 + 30.4}{15 + 2} = 3.85 : 1$	$\frac{25 + 26}{14.7 + 0.5} = 3.36 : 1$

Quick ratio

$\frac{35}{15 + 2} = 2.06 : 1$	$\frac{25}{14.7 + 0.5} = 1.64 : 1$

Working capital cycle

		2016	2015
		Days	Days
Inventory holding period	(i)	102	91
Receivables collection period	(ii)	81	63
Payables payment period	(iii)	(51)	(52)
		132	102

Relevant ratios

2016	2015
(i) Inventory holding period	
$\frac{[(26 + 30.4)/2] \times 365}{101.25} = 102 \text{ days}$	$\frac{[(18.75 + 26)/2] \times 365}{90} = 91 \text{ days}$
(ii) Receivables collection period	
$\frac{[(25 + 35)/2] \times 365}{135} = 81 \text{ days}$	$\frac{[(16.25 + 25)/2] \times 365}{120} = 63 \text{ days}$
(iii) Payables payment period	
$\frac{[(14.7 + 15)/2] \times 365}{105.65^*} = 51 \text{ days}$	$\frac{[(13 + 14.7)/2] \times 365}{97.25^{**}} = 52 \text{ days}$

*Purchases (2016) = Rs. 101.25 – 26 + 30.4 = Rs. 105.65

**Purchases (2015) = Rs. 90 – 18.75 + 26 = Rs. 97.25

Comments

- The company's liquidity position, as evidenced from the current ratio and the quick ratio, appears to be growing stronger. However, the working capital cycle of the company is getting longer in 2016 as compared to 2015.
- The company may face liquidity problem in future, as debtors days are increasing and a large cash is blocked in inventory.
- Higher investment in working capital would result in decrease in ROCE and Return on shareholders' equity.
- The increase in debtors days may suggest inefficient collection of amounts due from debtors.

► **Example 31:**

Following amounts have been extracted from the financial statements of Lithops Limited:

	2020	2019
	----- Rs. in million -----	
Sales	500	450
Cost of sales	378	300
Trade receivables	95	80
Trade payables	72	60
Inventory	93	75
Cash at bank	12	16

All sales and purchases are made on credit.

Required:

- Calculate working capital cycle days for 2020. **(Assume a 360-day year)**
- Suggest **four** possible measures that can be taken to reduce working capital cycle days.

► **Answer:****Part (a) Working capital cycle**

	Days
Inventory holding period (i)	80
Receivables collection period (ii)	63
Payables payment period (iii)	(60)
Working capital cycle	83

Relevant ratios**(i) Inventory holding period**

$$\frac{\text{Average inventory} \times 360}{\text{Cost of sales}} = \frac{[(93+75)/2] \times 360}{378} = 80 \text{ days}$$

(ii) Receivables collection period

$$\frac{\text{Average receivables} \times 360}{\text{Sales}} = \frac{[(95+80)/2] \times 360}{500} = 63 \text{ days}$$

(ii) Payables payment period

$$\frac{\text{Average payables} \times 360}{\text{Purchases}} = \frac{[(72+60)/2] \times 360}{396^*} = 59.1 \text{ days}$$

*Purchases = Cost of sales 378 – 75 opening inventory + 93 closing inventory = Rs. 396

Part (b) Measures to improve working capital cycle days:

- Give incentives to customers to pay on time
- Do not transact with customers who have a history of defaulting/late payments
- Automate the monitoring of accounts receivables
- Resolve disputes with customer as early as possible

► **Example 32:**

SK Limited (SKL) deals in a single product. Following are the summarized financial statements of SKL for the year ended 31 December 2017:

Statement of financial position

	2017	2016
	Rs. in million	
Fixed assets	410	240
Current assets	90	200
	500	440
Capital	280	260
Long-term loan	170	100
Current liabilities	50	80
	500	440

Statement of profit or loss

	2017	2016
Units sold in million	39	30
	Rs. in million	
Sales	371	300
Cost of goods sold	(273)	(210)
Gross profit	98	90
Selling and administrative	(55)	(60)
Finance cost	(13)	(8)
Net profit	30	22

Additional information:

- (i) With effect from 1 January 2017, selling price was decreased by 5% to boost sales volume.
- (ii) During the year 2017, suppliers demanded price increase of 4%. SKL resisted the price increase. However, both parties agreed to reduce the credit period.
- (iii) SKL had been running its business in a rented building whose annual rent was Rs. 15 million. During the year, SKL purchased this building for Rs. 200 million. Funds were arranged partially through a long-term loan. Useful life of the building is estimated at 40 years.
- (iv) 75% of the selling and administration cost incurred in 2016 was fixed cost.

Required:

a) Compute the following ratios for 2016 and 2017:

- Gross profit margin
- Return on assets
- Debt equity ratio
- Net profit margin
- Return on capital employed
- Current ratio

b) Keeping in view the above information, comment on profitability and liquidity position of SKL for 2017.

► **Answer:**

Part (a) Ratio computation

	2017	2016
Gross profit margin		
	$\frac{98}{371} = 26.42\%$	$\frac{90}{300} = 30\%$
Net profit margin		
	$\frac{30}{371} = 8.09\%$	$\frac{22}{300} = 7.33\%$
Return on assets		
	$\frac{30 + 13}{500} = 8.60\%$	$\frac{22 + 8}{440} = 6.82\%$
Return on capital employed		
	$\frac{30 + 13}{280 + 170} = 9.56\%$	$\frac{22 + 8}{260 + 100} = 8.33\%$
Debt equity ratio (% of total capital employed)		
	$\frac{170}{280 + 170} = 38\%$	$\frac{100}{260 + 100} = 28\%$

Current ratio

$$\frac{90}{50} = 1.8 : 1 \qquad \frac{200}{80} = 2.5 : 1$$

Part (b)

Profitability: In 2017, gross profit margin of SKL has reduce from 30% to 26.42%. however, gross and net profits amounts have been increased by Rs. 8 million mainly due to:

- Increase in sales volume as a result of 5% decrease in selling price. This resulted in increase in gross profit by 8.89%[(98-90)÷90×100].
- Acquisition of building has resulted in savings in expenses as rent saved (Rs. 15 million) is higher than the depreciation (Rs. 5 million) and increased in finance cost (Rs. 5 million).
- Since 75% of selling and administrative cost was fixed, expenses did not increase due to increase in sales volume (economies of scale).

Liquidity: The decrease in current ratio from 2.5 to 1.8 is net effect of the following:

- Cash payment for purchase of building which significantly decreased current assets.
- Prompt payment to suppliers which decreased the current liabilities.

► **Example 33:**

Following are the summarised financial statements of Keyboard Limited (KL):

Statement of financial position

	2018	2017	2016
	----- Rs. in '000 -----		
Fixed assets	12,500	10,800	11,800
Current assets:			
Inventory	4,000	4,500	3,000
Debtors	4,200	3,200	1,800
Cash	-	800	2,100
	8,200	8,500	6,900
	20,700	19,300	18,700
Equity and reserves	10,400	9,000	8,600
Long term loan	4,400	5,000	5,600
Current liabilities:			
Creditors	3,500	4,400	4,200
Bank overdraft	1,500	-	-
Accrued expense	900	900	300
	5,900	5,300	4,500
	20,700	19,300	18,700

Statement of profit or loss

	2018	2017	2016
	----- Rs. in '000 -----		
Sales	27,000	24,400	21,000
Cost of goods sold	(21,300)	(19,400)	(17,200)
Gross profit	5,700	5,000	3,800
Operating expenses	(3,400)	(3,000)	(2,400)
Finance cost	(300)	(350)	(400)
Net profit	2,000	1,650	1,000

Required:

- Compute working capital cycle in days and liquidity ratios for 2018 and 2017.
- Suggest three possible measures that can be taken by KL to improve working capital cycle days.

► *Answer:***Part (a)**

Working capital cycle		2018	2017
		Days	Days
Inventory holding period	(i)	73	71
Receivables collection period	(ii)	50	37
Payables payment period	(iii)	(69)	(75)
		54	33

Relevant ratios

	2018	2017
(i) Inventory holding period		
	$\frac{[(4,000 + 4,500)/2] \times 365}{21,300} = 73 \text{ days}$	$\frac{[(4,500 + 3,000)/2] \times 365}{19,400} = 71 \text{ days}$
(ii) Receivables collection period		
	$\frac{[(4,200 + 3,200)/2] \times 365}{27,000} = 50 \text{ days}$	$\frac{[(3,200 + 1,800)/2] \times 365}{24,400} = 37 \text{ days}$
(iii) Payables payment period		
	$\frac{[(3,500 + 4,400)/2] \times 365}{20,800^*} = 69 \text{ days}$	$\frac{[(4,400 + 4,200)/2] \times 365}{20,900^{**}} = 75 \text{ days}$

*Purchases (2018) = Rs. 21,300 – 4,500 + 4,000 = Rs. 20,800

**Purchases (2017) = Rs. 19,400 – 3,000 + 4,500 = Rs. 20,900

Liquidity ratios

	2018	2017
Current ratio		
	$\frac{8,200}{5,900} = 1.39 : 1$	$\frac{8,500}{5,300} = 1.60 : 1$
Quick ratio		
	$\frac{8,200 - 4,000}{5,900} = 0.71 : 1$	$\frac{8,500 - 4,500}{5,300} = 0.75 : 1$

Part (b) Measures to improve working capital cycle days:

- Give incentives to customers to pay on time
- Do not transact with customers who have a history of defaulting/late payments
- Automate the monitoring of accounts receivables

► **Example 34:**

Qamar Limited (QL) is in the business of consumer goods. Following are the summarized financial statements of QL for 2021:

Statement of financial position as at 31 December 2021

Assets	Rs. in million	Equity and liabilities	Rs. in million
Fixed assets	550	Share capital	600
		Retained earnings	319
Current assets:		Long-term loan	350
Inventory	440	Current liabilities:	
Trade debtors	350	Trade creditors	150
Short term investment	160	Other payables	70
Cash and bank balances	39	Current maturity of loan	50
	1,539		1,539

Statement of profit or loss for the year ended 31 December 2021

	Rs. in million
Sales	2,150
Cost of goods sold	(1,900)
Gross profit	250
Selling and administrative expenses	(93)
Other income	40
Finance cost	(35)
Net profit	162

Extracts from management reports submitted to the board of directors**Ratios for the year 2020:**

Gross profit margin	9.5%	Net profit margin	3.9%
Interest cover	2.4 times	Inventory holding period	90.4 days
Return on non-current assets	16.8%	Debtors turnover	7.3 times
Creditor payment period	55.1 days	Acid test	0.9 times

Important financial and operating decisions taken during the year 2021:

- QL renewed a large contract with a customer. In the renewed contract, extended credit terms were given to the customer.
- A major supplier agreed to reduce the prices by 10% on the condition of cash purchases only. This reduction helped QL to avoid increase in prices of its products despite increase in prices by competitors.
- Increasing working capital demands were met by making a share issue. A part of the proceeds from the issue were also used to prepay a significant portion of the long-term loan.
- QL disposed of its main warehouse in the last month of the year at a gain of Rs. 25 million. The sale proceeds are temporarily invested in a short-term investment.

Required:

- Compute QL's ratios for 2021 for comparison with 2020.
- Keeping in view the financial and operating decisions extracted from management reports, provide reasons for variation in the ratios computed in (a) above.

► **Answer:****Part (a) QL's ratios for 2021 for comparison with 2020**

Ratio		2021	2020
Gross profit margin	$[250 / 2,150]$	11.6%	9.5%
Net profit margin	$[162 / 2,150]$	7.5%	3.9%
Interest cover	$[(162 + 35) / 35]$	5.6 times	2.4 times
Inventory holding period	$[(440 \times 365) / 1,900]$	84.5 days	90.4 days
Return on non-current assets	$[(162 + 35) / 550]$	35.8%	16.8%
Debtors turnover	$[2,150 / 350]$	6.1 times	7.3 times
Creditors payment period	$[(150 \times 365) / 1,900]$	28.8 days	55.1 days
Acid test	$[(350 + 160 + 39) / (150 + 70 + 50)]$	2.03 times	0.9 times

Part (b) Reasons for variation in the ratios

Ratio	Reasons for variation in the ratios
Gross profit margin	Reduction in cost due to discount by major supplier
Net profit margin	• Increase in gross profit margin / Reduction in cost due to discount by major supplier • Increase in sales volume achieved by not increasing prices. • Profit from disposal of warehouse • Reduced interest expense due to repayment of loan
Interest cover	• Reduction in finance cost due to repayment of loan • Increase in overall profitability
Inventory holding period	Due to increase in sales volume achieved by not increasing prices.
Return on non-current assets	• Increase in overall profitability • Disposal of main warehouse
Debtors turnover	Due to extended credit period offered to new customer
Creditors payment period	Cash purchases from a major supplier to avail discount
Acid test	• Due to funds generated from sale of warehouse placed in short term investments • Decrease in payables due to cash purchases

► **Example 35:**

You are working as the finance manager of Hittite Limited (HL). A new CFO has joined HL and has recommended changes to accounting policies related to assets to improve HL's financial ratios in the next financial statements. The CFO has suggested the following changes to the policies:

- Subsequent measurement of investment property from cost model to fair value model.
- Subsequent measurement of property, plant and equipment from cost model to revaluation model.
- Cost formula for inventory from weighted average to FIFO method.

You may assume that:

- fair values / cost / prices of all assets would increase over the time.
- the maximum possible amount from the revaluation surplus to retained earnings would be transferred on an annual basis.
- periodic inventory system is followed by HL.

Required: State the effect (increase, decrease, no effect) of each of the above changes on the ratios in the next financial statements. **(Note: Use the following format)**

Ratios	Change in policy of		
	investment property	property, plant and equipment	inventory
Net profit to sales ratio			
Return on assets			
Return on capital employed			
Debt equity ratio			
Current ratio			

► Answer:

Ratios	Change in policy of		
	investment property	property, plant and equipment	inventory
Net profit to sales ratio	Increase	Decrease	Increase
Return on assets	Increase	Decrease	Increase
Return on capital employed	Increase	Decrease	Increase
Debt equity ratio	Decrease	Decrease	Decrease
Current ratio	No effect	No effect	Increase

► Example 36:

Whale Limited (WL) is a growing business in the electronic items industry and operates two owned outlets. Below are the summarized financial statements of WL for 2023:

Statement of financial position as at 31 March 2023

Assets	Rs. in '000	Equity and liabilities	Rs. in '000
Fixed assets	52,514	Share capital	11,000
Inventory	11,528	Retained earnings	25,535
Trade receivables	6,874	Long-term loan	21,625
Cash	2,658	Trade payables	9,874
		Accrued expenses	5,540
	73,574		73,574

Statement of profit or loss for the year ended 31 March 2023

	Rs. in '000
Sales	67,851
Cost of sales	(47,528)
Gross profit	20,323
Selling and administrative expenses	(7,584)
Interest expenses	(5,147)
Net profit	7,592

Extracts from management reports:

(i) Ratios for the year ended 31 March 2022:

Gross profit margin	36.2%	Quick ratio	1.1 times
Operating profit margin	30.0%	Interest cover	17.5 times
Return on capital employed	51.7%	Asset turnover	1.7 times
Average time to pay	35 days	Inventory turnover	9.0 times

(ii) Key events during the year:

- A new outlet was inaugurated. The cost of purchasing the outlet was financed through another long-term loan from a bank. The sales prices at the new outlet are kept lower to attract customers.
- Despite an increase in sales promotional activities, the sales at the new outlet were below expectation but are expected to increase from next year.
- Inventory at the new outlet was build-up by utilising liquid funds available with WL and the extended credit facility from suppliers.
- The interest rate on existing bank loans has increased due to rise in the market interest rate.

Required:

- (a) Compute WL's ratios for 2023 in comparison with 2022.
- (b) Keeping in view the key events during the year, provide possible reasons for the variation(s) in the ratios computed in (a) above.

► **Answer:**

Part (a) WL's ratios for 2023 for comparison with 2022

Ratio		2023	2022
Gross profit margin	[20,323 / 67,851]	30.0%	36.2%
Operating profit margin	[(20,323-7,584) / 67,851]	18.8%	30.0%
Return on capital employed	[(20,323-7,584) / 58,160*]	21.9%	51.7%
Average time to pay	[9,874/47,528 x 365]	76 days	35 days
Quick ratio	[(6,874+2,658)/(9,874+5,540)]	0.6 times	1.1 times
Interest cover	[(20,323-7,584) / 5,147]	2.5 times	17.5 times
Asset turnover	[67,851 / 58,160*]	1.2 times	1.7 times
Inventory turnover	[47,528 / 11,528]	4.1 times	9.0 times

*11,000 + 25,535 + 21,625 = 58,160

Part (b) Reasons for variation in the ratios

Ratio	Reasons for variation in the ratios
Gross profit margin	Reduced sale prices at new outlet to attract customers.
Operating profit margin	• Increase in selling expenses due to sales promotion activities to boost the sales at new outlet. • Reduced sale prices at new outlet to attract customers. • Increase in depreciation expense due to inauguration of new outlet. • Increase in sales due to new outlet. • Decrease in gross profit margin.
Return on capital employed	• Increase in borrowings due to additional loan borrowed to refinance the new outlet. • Decrease in the operating profit.

Ratio	Reasons for variation in the ratios
Average time to pay	Increase in payables due to extended credit period offered by supplier.
Quick ratio	- Increase in payables due to extended credit offered by the supplier. - Decrease in liquid funds utilised for inventory build-up.
Interest cover	- Increase in interest expense due to additional loan borrowed to refinance the new outlet. - Increase in interest rates on existing loan due to increase in discount rates. - Decrease in the operating profit.
Asset turnover	- Increase in borrowings due to additional loan borrowed to refinance the new outlet. OR Increase in assets due to new outlet. - Less than expected sales at new outlet.
Inventory turnover	- Increase in inventory for availability of stock at new outlet. - Less than expected sales at new outlet.

► **Example 37:**

The following information pertains to Dall-E Limited (DL) for the year ended 31 December 2023:

Sales during the year (25% mark up on cost)	Rs. 100 million
Average current assets	Rs. 49 million
Average quick assets	Rs. 21 million
Receivables turnover	7 times
Payables turnover	9 times
Credit period usually allowed to customers	30 days
Credit period usually allowed by suppliers	60 days

Required:

- Compute operating cycle days of DL for 2023. (Assume 365 days a year)
- Suggest one potential action for each component of the operating cycle to assist DL in decreasing its operating cycle days.

► **Answer:**

Part (a) Operating cycle

	Days
Inventory holding period (i)	127.8
Receivables collection period (ii)	52.1
Payables payment period (iii)	(40.6)
Operating cycle	139.3

Relevant ratios**(i) Inventory holding period**

$$\frac{\text{Average inventory} \times 365}{\text{Cost of sales}} = \frac{28 \times 365}{80} = 127.8 \text{ days}$$

Average current assets 49m – Average quick assets 21m = Average inventory Rs. 28m

Cost of sales = Sales Rs. 100m x 100/125 = Rs. 80m

(ii) Receivables collection period

$$\frac{365}{\text{Receivable turnover}} = \frac{365}{7} = 52.1 \text{ days}$$

(ii) Payables payment period

$$\frac{365}{\text{Payable turnover}} = \frac{365}{9} = 40.6 \text{ days}$$

Part (b)

Trade receivable collection period:

- (i) Give incentives to the customers to pay on time e.g. early payment discounts.
- (ii) Do not transact with customers who have a history of defaulting/late payments.
- (iii) Automate the monitoring of accounts receivable.
- (iv) Resolve disputes with customer as early as possible.

Inventory holding period:

- (i) Establish relationships with reliable suppliers for timely replenishment so that stock level could be reduced.
- (ii) Identify and address obsolete or slow moving inventory.

Trade payable payment period:

- (i) DL should fully utilize credit period given by supplier.
- (ii) Find suppliers, who are offering higher credit period.
- (iii) Negotiate extended terms with existing suppliers.

► *Example 38:*

Preshapur Limited (PL), a growing company in the home appliances industry, has provided the following summarized financial statements:

Statement of financial position as at 30 June 2024

Assets	Rs. m	Equity and liabilities	Rs. m
Property, plant and equipment	467	Share capital (Rs. 10 each)	215
Inventory	190	Share premium	95
Trade receivables	75	Retained earnings	35
Cash and bank balances	10	Cumulative preference shares:	
		- 20% redeemable (Rs. 100 each)	130
		- 10% irredeemable (Rs. 50 each)	140
		Long term loans	45
		Current liabilities	82
	742		742

Statement of profit or loss for the year ended 30 June 2024

	Rs. in million
Sales	725
Cost of goods sold	(544)
Gross profit	181
Selling and administrative expenses	(102)
Finance cost	(38)
Net profit	41

Additional information:

- (i) Details of ordinary shares issued during the year are as follows:
- On 1 December 2023, PL issued 20% right shares at par value. The share price immediately before the issue was Rs. 32.
 - On 1 May 2024, PL issued 3.5 million shares at market value.
- (ii) PL did not declare dividend to preference shareholders during the year.
- (iii) A potential buyer has expressed interest in acquiring 100% shareholding of PL, contingent upon PL achieving the following benchmark ratios based on financial statements for the year ending 30 June 2025:

Gross profit margin	30%	Gearing ratio	40:60
Net profit margin	10%	Asset turnover (in times)	1.3
Return on assets	15%	Basic earnings per share	Rs. 2
Return on equity	10%		

Recent management decisions:

To achieve the benchmark ratios, the management of PL has made the following decisions in July 2024:

- (i) Purchases from a major supplier will now be made on a cash basis to avail discounts not available on credit purchases. The increased working capital demand will be met by acquiring a bank overdraft facility. The savings from the discount are expected to exceed the interest on the overdraft.
- (ii) A further issue of redeemable preference shares will be made to finance the installation of a solar system at the office premises. The savings in electricity costs are expected to exceed the dividend payments on these preference shares and depreciation on the solar system.
- (iii) A revaluation policy for property, plant and equipment will be adopted to reflect the increase in their fair value in the financial statements.

Required:

- (a) Based on the financial statements for the year ended 30 June 2024 provided above, calculate the PL's ratios in comparison with benchmark ratios.
- (b) Briefly describe the effects of each management decision on the PL's ratios, indicating whether these actions help or adversely affect the attainment of the benchmarks.

► **Answer:**

Part (a) Ratios

			PL	Benchmark
Gross profit margin	=	$\frac{\text{GP 181}}{\text{Sales 725}}$	= 25%	30%
Net profit margin	=	$\frac{\text{Net profit 41}}{\text{Sales 725}}$	= 5.7%	10%
Return on assets	=	$\frac{\text{PBIT [41 + 38]}}{\text{Total assets 742}}$	= 10.6%	15%
Return on equity	=	$\frac{\text{Profit 41 - Pref div 14}}{\text{Equity [215 + 95 + 35]}}$	= 7.8%	10%
Gearing ratio	=	$\frac{\text{Debt [130 + 45]}}{\text{Capital employed [742 - 82]}}$	= 27:73	40:60
Asset turnover	=	$\frac{\text{Sales 725}}{\text{Capital employed [742 - 82]}}$	= 1.1 times	1.3 times
Basic EPS	=	$\frac{\text{Profit 41 - Pref div 14}}{\text{W. Avg Shares 18.13 W1}}$	= Rs. 1.48	Rs. 2

W1: Weighted average number of shares (for basic EPS)

Date	Number of shares (m)	Time factor	Adjustment factor(s)	Weighted average (m)
1 Jul to 30 Nov	15	5/12	x 32/28.33	7.05
Right issue @20%	3			
1 Dec to 30 Apr	18	5/12		7.50
At market value	3.5			
1 May to 30 Jun	21.5	2/12		3.58
				18.13

Shares on 1 July = 21.5m – 3.5m at market value = 18m x 100/120 = 15m shares

Right adjustment factor = 32 /28.33

$$\text{Theoretical ex-rights price} = \frac{(100 \text{ shares} \times \text{Rs. } 32) + (20 \text{ share} \times \text{Rs. } 10)}{100 \text{ shares} + 20 \text{ share}} = \text{Rs. } 28.33 \text{ per share}$$

Part (b) Effects of management decisions

- (i) The reduction in the cost of goods sold will increase profit, leading to an improvement in basic EPS, gross profit margin, net profit margin, return on assets and return on equity. Currently, these ratios are below the benchmark, so the resulting increase will support the attainment of the benchmark.
- (ii) This reduction in electricity cost will increase profit, resulting in an increase in non-current liabilities. The increase in profit will improve basic EPS, net profit margin and return on equity, contributing to the attainment of the benchmark. However, the increase in gearing ratio may hinder the attainment of the benchmark if it exceeds the 40% cut-off.
- (iii) The adoption of revaluation will decrease profit due to higher depreciation and increase in assets and equity balances. This will lead to a decrease in basic EPS, net profit margin, return on assets, return on equity and asset turnover, which may hinder the attainment of the benchmark. However, the decrease in gearing ratio will support the attainment of the benchmark.

7. OBJECTIVE BASED Q&A

- 01.** The acid test also known as quick ratio should include which of the following?
- (1) Inventory
 - (2) Accounts receivables
 - (3) Bank overdraft
 - (4) Accruals
- (a) (1), (2), (3) and (4)
 (b) (1), (2) and (3) only
 (c) (1), (2) and (4) only
 (d) (2), (3) and (4) only
- 02.** Salik has net current liabilities in its statement of financial position. He has decided to pay off its accounts payables using surplus cash.
 What will be the effect of the above transaction on the current ratio?
- (a) Decrease
 (b) Increase
 (c) No effect
 (d) The ratio could either increase or decrease

- 03.** Extracts from the statement of Comprehensive Income and statement of financial position of the Huda Limited are shown below:

	Rs.
Revenue from sales (all on credit)	900,000
Cost of goods sold	756,000
Purchases (all on credit)	504,000
Receivables	112,500
Trade payables	75,600
Inventory	333,000

What is the length of the working capital cycle (also known as the operating or cash cycle) to the nearest day?

- (a) 170 days
 (b) 152 days
 (c) 261days
 (d) 60 days
- 04.** Which of the following should be included in acid test or quick ratio?
- (a) Finished goods inventory
 (b) raw materials and consumables
 (c) long-term loans
 (d) Accounts payable

05. Given below are included in the financial statements of Haris Limited for the year ending 30 June:

	2015	2016
	Rs. 000	Rs. 000
Receivables for disposal of PPE	36	54
Accounts receivables	108	72
	144	126

Sales for the year amounted to Rs. 630,000, of which Rs. 90,000 were cash sales.

The average receivables turnover (in times) during the year ended 30 June 2016 was?

- (a) 7
- (b) 6
- (c) 5
- (d) 4

06. Dawn Limited has provided following information:

	31st December 2014	31st December 2015
	Rs. 000	Rs. 000
Non -current assets	36	61.2
Inventory	18	23.4
Accounts receivable	25.2	19.8
Bank balance	5.4	3.6
Accounts payable	19.8	16.2
Sales on credit	252	216
Purchases on credit	144	108

Which TWO of the following statements are correct?

- (a) Net current assets have increased between the two years
- (b) The quick (acid test) ratio has improved between the two years
- (c) Customers are paying more quickly in 2015 than in 2014
- (d) Dawn Limited is paying its suppliers more quickly in 2015 than in 2014

07. Amir sells fish and Abid sells books. Both operate on a 50% mark-up on cost.

However, their gross profit ratios are as follows.

Amir 25%

Abid 33%

The highest gross profit ratio of the bookseller may be because?

- (a) There is more wastage with fish stocks than with book stocks
- (b) Amir has a substantial bank loan whereas the Abid's business is entirely financed by her family
- (c) Amir has expensive high street premises whereas Abid has cheaper back street premises
- (d) Amir's turnover is declining whereas that of the Abid is increasing

08. Maira Limited has a current ratio of 2:1.
This ratio will decrease if Maira Limited
- will receive cash in respect of a long-term loan
 - will receive cash in respect of a short-term loan
 - pays an existing trade payable
 - writes off an existing receivable against the provision for doubtful debts
09. Haris Limited has positive working capital.
What effect will the payment of a declared (payable) dividend using cash balances have upon the current ratio and working capital?
- Increase in current ratio and increase in working capital
 - Increase in current ratio and no effect on working capital
 - No effect on current ratio and working capital
 - Decrease in current ratio and decrease in working capital
10. After declaring a final dividend, Kashan Limited has a current ratio of 2.0 and a quick asset ratio of 0.8.
If the company now uses its positive cash balance to pay that final dividend, what will be the effect upon the two ratios?
- Increase in current ratio and increase in quick asset ratio
 - Increase in current ratio and decrease in quick asset ratio
 - Decrease in current ratio and increase in quick asset ratio
 - Decrease in current ratio and decrease in quick asset ratio
11. The draft accounts of Super Star Limited for the year ended 31 December 2018 include the following:
- | | |
|--------------|-----------------|
| Revenue | Rs. 360 million |
| Gross profit | Rs. 90 million |
- It was subsequently discovered that the revenue was overstated by Rs. 45 million and the closing inventory understated by Rs. 15 million.
After correction of these errors the gross profit percentage will be?
- 9.5%
 - 19.0%
 - 23.8%
 - 33.3%

12. The following has been extracted from the financial statements of a business.

SOCI	Rs.	SOFP	Rs.
Profit from operations	86,400	7% debenture	117,000
Debenture interest	(8,190)	Ordinary share capital	171,000
Profit for the year	72,360	Share premium	13,500
		Retained earnings	63,000

What was the return on capital employed (ROCE)?

- (a) 19.9%
- (b) 23.7%
- (c) 29.2%
- (d) 34.9%

13. Waris Limited buys and sells a single product. The following is an extract from its statement of financial position at 31 December 2018.

	2018	2017
	Rs. 000	Rs. 000
Inventory	75	60
Receivables	24	36

Sales and purchases during 2018 were Rs. 300,000 and Rs. 180,000 respectively. 20% of sales were for cash.

Which TWO of the following are correct?

- (a) Average receivables collection period is 37 days
 - (b) Average receivables collection period is 46 days
 - (c) Gross profit % is 35%
 - (d) Gross profit % is 45%
14. A company's gearing ratio (Debt/Equity) is 60%. This would rise if
- (a) The decrease in shareholders' equity is equal in amount to decrease in long term loans
 - (b) The increase in shareholders' equity is equal in amount to increase in long term loans
 - (c) The part of long term loans are repaid
 - (d) Right issue of shares of 1 for 5 is made
15. A business has the following trading account for the year ending 31 May 2018:

	Rs.	Rs.
Sales		450,000
Opening inventory	40,000	
Purchases	260,500	
	300,500	
Less: closing inventory	(60,000)	(240,500)
Gross profit		209,500

Its rate of inventory turnover for the year is?

- (a) 4.9 times
- (b) 5.3 times
- (c) 7.5 times
- (d) 9 times

16. Tara Ltd produces a single product with a margin on sales of 25%.

Total sales for the year	Rs. 400,000
Receivables collection period	64 days
Average receivables	Rs. 32,000

The value of inventory held during the year was constant.

The cost of credit sales was?

- (a) Rs. 136,875
 (b) Rs. 182,500
 (c) Rs. 192,000
 (d) Rs. 197,325
17. The following are extracts from the financial statements of Laiba Ltd for the year ended 31 December 2018.

Statement of financial position		Statement of Comprehensive Income	
	Rs. 000		Rs. 000
Issued share capital	3,600	Operating profit	1,431
Reserves	1,800	Debt interest	(216)
	5,400		1,215
12% debenture 2018	1,800		
	7,200		

What is the return (%) on long-term funds?

- (a) 16.88%
 (b) 19.88%
 (c) 22.50%
 (d) 26.50%
18. The opening inventory for a business was Rs. 108,000. The closing inventory was Rs. 144,000. Inventory turnover for the year was 10 times. The gross margin was 30%. What were the sales for the year?
- (a) Rs. 1,200,000
 (b) Rs. 1,260,000
 (c) Rs. 1,800,000
 (d) Rs. 1,860,000
19. Adeel Limited has trade payables (creditors) of Rs. 12,000 and a bank overdraft of Rs. 3,000. Its current ratio is 2.5: 1 and its quick (acid test) ratio is 1.5:1. What is the value of its inventory (stock)?
- (a) Rs. 12,500
 (b) Rs. 15,000
 (c) Rs. 22,500
 (d) Rs. 37,500

20. Extracts from statement of financial position of Turab Limited at 31 March 2019 are presented below:

	Rs. 000
Loans due in more than one year	32
5% loan notes	24
Ordinary shares - Rs. 1 each fully paid	80
6% redeemable preferred shares, Rs. 1 each fully paid	16
Retained profits	104
Revaluation reserve	40

The gearing ratio is (to one decimal place)?

- (a) 24.3%
 (b) 25.0%
 (c) 35.3%
 (d) 39.1%
21. Which ratio is considered as safe margin of solvency?
 (a) Liquid ratio
 (b) Quick ratio
 (c) Current ratio
 (d) Net profit ratio
22. Liquid ratio is also known as
 i. Quick ratio
 ii. Acid test ratio
 iii. Working capital ratio
 iv. Stock turnover ratio
 (a) i. and ii.
 (b) i. and iii.
 (c) iii. and iii.
 (d) iii. and iv.
23. Care pharmacy Ltd. has a current ratio equal to 1.6 and a quick ratio equal to 1.2. The company has Rs.200 million in sales and its current liabilities are Rs.10 million. what is the value of company's current assets?
 (a) Rs.14 million
 (b) Rs.16 million
 (c) Rs.18 million
 (d) Rs.20 million

24. Determine working capital turnover ratio if, current assets is Rs.150 million, current liabilities is Rs.100 million and Sales during the year are Rs.500 million.
- (a) 5 times
 - (b) 10 times
 - (c) 15 times
 - (d) 20 times
25. A debtor turnover ratio of 12 times means that:
- (a) one-twelfth of debtors will turn out to be bad debts
 - (b) debtors are about twelve times as big as creditors
 - (c) in any given month, twelve debtors are expected to pay in full
 - (d) the average debtor takes about one month to pay.
26. What is the impact of collection of debtors on the current ratio;
- (a) Increase
 - (b) Decrease
 - (c) No impact
 - (d) None of the above
27. Which of the following is not included in the computation of acid test ratio?
- (a) Debtors
 - (b) Cash at bank
 - (c) Short-term investments
 - (d) Stock
28. Determine inventory turnover ratio if, opening inventory is Rs.31 million, closing inventory is Rs.29 million, sales are Rs.320 million and gross profit margin is 25%.
- (a) 6 times
 - (b) 8 times
 - (c) 11 times
 - (d) 16 times
29. Debt-equity ratio is a sub-part of
- (a) Short-term solvency ratios
 - (b) Long-term solvency ratios
 - (c) Debtors turnover ratios
 - (d) None of the above
30. Night Limited has a current ratio of 1.8. This ratio will increase if Night Limited:
- (a) receives cash in respect of a short-term loan
 - (b) receives cash from an existing receivable
 - (c) pays an existing trade payable
 - (d) purchases inventory on credit

31. A debtor turnover of 6 times means that:
- (a) one-sixth of the debtors are collected in one month
 - (b) average debtors are collected in 6 months
 - (c) average debtors are collected in 2 months
 - (d) average debtors are collected 2 times in a year
32. Which of the following companies is most likely to face cash flow problems?
- (a) A loss-making government organisation
 - (b) A company which has recently sold part of its operations so as to concentrate on its core areas
 - (c) A reasonably profitable and long-established company with no expansion plans
 - (d) A profitable retailer about to embark on ambitious expansion plans
33. A company has current ratio and quick ratio of 2.0 and 0.8 respectively. If the company uses its positive cash balance to pay a creditor, it will:
- (a) increase current ratio as well as quick ratio
 - (b) increase current ratio and decrease quick ratio
 - (c) have no effect on current ratio as well as quick ratio
 - (d) decrease current ratio as well as quick ratio
34. Which of the following would increase gearing ratio?
- (a) Issuance of shares at premium
 - (b) Issuance of shares at discount
 - (c) Issuance of bonus shares
 - (d) Declaration and payment of cash dividend
35. Which two of the following factors could cause a company's gross profit percentage on sales to be above the expected level?
- (a) Over-statement of closing inventories
 - (b) Sales were higher than expected
 - (c) Inclusion of disposal proceeds of non-current assets in sales
 - (d) Decrease in carriage charges borne by the company on goods sent to customers
36. Which of the following is NOT a limitation of ratio analysis?
- (a) Use of different accounting policies and estimates
 - (b) Use of different formulas for calculating ratios
 - (c) Different inflation rates in different years
 - (d) Companies pursuing different strategies
37. If the existing current ratio of a company is more than 1, what would be the impact of a credit purchase of inventory on the current ratio?
- (a) Current ratio would increase
 - (b) Current ratio would decrease
 - (c) Current ratio would decrease but would remain higher than 1
 - (d) Current ratio would remain same

38. Which of the following statements are correct?
- (I) Giving incentives to customer to pay on time would result in decrease in debtor's turnover in times.
 - (II) If all debtors pay their debts within the credit period, the average collection period would be Nil.
- (a) Only (I) is correct
 - (b) Only (II) is correct
 - (c) Both are correct
 - (d) None is correct
39. Which TWO of the following would improve gearing ratio of a company?
- (a) Issuance of shares at discount
 - (b) Repayment of a bank loan
 - (c) Issuance of bonus shares
 - (d) Disposal of a land at its carrying value
40. Quick and current ratios of a business as on 31 December were 1:1 and 1.25:1. If inventories at that date amounted to Rs. 45 million, then current liabilities were:
- (a) Rs. 144 million
 - (b) Rs. 225 million
 - (c) Rs. 180 million
 - (d) Rs. 135 million

ANSWERS

01.	(d)	Acid test ratio is calculated as (current assets - inventory) / current liabilities																													
02.	(a)	Assume initially that Salik has assets of Rs. 100,000 and liabilities of Rs. 150,000 Its current ratio prior to the transaction will be: Rs. 100,000/Rs. 150 ,000= 0.67 If it then pays its trade payables by Rs. 50,000 the current assets will be Rs. 50,000 and the liabilities Rs. 100,000. Hence the new current ratio is 50,000/100,000 = 0.50, i.e. a decrease.																													
03.	(b)	<table><tr><td></td><td></td><td></td><td></td><td>days</td></tr><tr><td>Inventory turnover: 333/756× 365</td><td></td><td></td><td></td><td>160.8</td></tr><tr><td>Average collection period: 112.5/900 × 365</td><td></td><td></td><td></td><td>45.6</td></tr><tr><td>Average time to pay: 75.6/504× 365</td><td></td><td></td><td></td><td>(54.8)</td></tr><tr><td></td><td></td><td></td><td></td><td>151.6</td></tr></table>									days	Inventory turnover: 333/756× 365				160.8	Average collection period: 112.5/900 × 365				45.6	Average time to pay: 75.6/504× 365				(54.8)					151.6
				days																											
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				151.6																											
04.	(d)	The acid test ratio excludes all inventory balances and is based on short-term creditors only.																													
05.	(b)	Credit sales = 630,000 – 9,000 = Rs. 540,000 Average receivables = (72000 + 108000)/2 =90,000 Receivable turnover =540,000/ 90,000 = 6																													
06.	(a & c)	<table><tr><td></td><td>2014</td><td></td><td></td><td>2015</td></tr><tr><td>Net current assets</td><td>(18 + 25.2 + 5.4 – 19.8)</td><td>28.8</td><td>(23.4+ 19.8+ 3.6 – 16.2)</td><td>30.6</td></tr><tr><td>Quick ratio</td><td>(25.2 + 5.4)/19.8</td><td>1.55</td><td>(19.8 + 3.6)/16.2</td><td>1.44</td></tr><tr><td>Collection period</td><td>(25.2 /252) × 365</td><td>36.5 days</td><td>(19.8/216) × 365</td><td>33.5 days</td></tr><tr><td>Payment period</td><td>(19.8/144) × 365</td><td>50.2 days</td><td>(16.2/108) × 365</td><td>54.8 days</td></tr></table>						2014			2015	Net current assets	(18 + 25.2 + 5.4 – 19.8)	28.8	(23.4+ 19.8+ 3.6 – 16.2)	30.6	Quick ratio	(25.2 + 5.4)/19.8	1.55	(19.8 + 3.6)/16.2	1.44	Collection period	(25.2 /252) × 365	36.5 days	(19.8/216) × 365	33.5 days	Payment period	(19.8/144) × 365	50.2 days	(16.2/108) × 365	54.8 days
	2014			2015																											
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Payment period	(19.8/144) × 365	50.2 days	(16.2/108) × 365	54.8 days																											
07.	(a)	Cost plus 50% is equivalent to a gross profit ratio of 33%. Amir’s gross profit margin may be low because of wastage. The loan interest and rental would not affect gross profit (only affects net profit) and declining turnover would not directly affect the gross profit percentage.																													
08.	(b)	Receiving cash for a long-term loan increases current assets with no change in current liabilities, hence improves the ratio. Payment on an existing creditor improves the ratio. Writing off a receivable against a provision has no effect on current assets. Therefore receiving cash in respect of a short-term loan must be the correct choice. Thus, suppose current ratio is 2:1, that means assets 100,000 and current liabilities 50,000 Now say Maira Limited receives loan = Rs. 50,000 Current assets will be 100,000 + 50,000=150,000 Current liabilities 50,000 + 50,000 = 100,000 New Current ratio 1.5:1																													

09.	(b)	Before payment of proposed dividend														
				Rs.												
		Current assets		150,000												
		Current liabilities including proposed dividend Rs. 30,000		50,000												
		Current ratio		3:1												
		Working capital		100,000												
		After payment of proposed dividend														
				Rs.												
		Current assets		120,000												
		Current liabilities		20,000												
		Current ratio		6:1												
		Working capital		100,000												
10.	(b)	Suppose that inventories are Rs. 120,000, cash plus receivables are Rs. 80,000 and creditors (including a Rs. 10,000 dividend) are Rs. 100,000. Payment of the dividend will cause cash plus receivables to fall to Rs. 70,000 and creditors to fall to Rs. 90,000. The current ratio will increase to 2.11 (190 ÷ 90). The quick ratio will decrease to 0.77 (70 ÷ 90).														
11.	(b)	<table><tr><td></td><td>Rs. m</td><td>Rs. m</td></tr><tr><td>Turnover</td><td>360-45</td><td>315</td></tr><tr><td>Cost of sales</td><td>270-15</td><td>(255)</td></tr><tr><td>Gross profit</td><td></td><td>60</td></tr></table> Gross profit % =60/315= 19.0%		Rs. m	Rs. m	Turnover	360-45	315	Cost of sales	270-15	(255)	Gross profit		60		
	Rs. m	Rs. m														
Turnover	360-45	315														
Cost of sales	270-15	(255)														
Gross profit		60														
12.	(b)	ROCE = 86,400/364,500= 23.7%														
13.	(b) & (d)	Credit sales = Rs. 300,000 x 80%= Rs. 240,000 Average receivables =Rs. (24,000+ 36,000)/2 = Rs. 30,000 Receivables’ turnover =Rs. 240,000/Rs. 30,000 = 8 Collection period =365/8 = 46 days <table><tr><td></td><td>Rs. 000</td><td>%</td></tr><tr><td>Sales</td><td>300</td><td>100</td></tr><tr><td>Cost of sales (60+180-75)</td><td>(165)</td><td>55</td></tr><tr><td>Gross profit</td><td>135</td><td>45</td></tr></table>				Rs. 000	%	Sales	300	100	Cost of sales (60+180-75)	(165)	55	Gross profit	135	45
	Rs. 000	%														
Sales	300	100														
Cost of sales (60+180-75)	(165)	55														
Gross profit	135	45														
14.	(b)	Since long term loans being numerator are lower amount (i.e. 60% of equity), the equal amount increase would result in higher ratio than before. Equal amount decrease would result in lower ratio and repayment of long term loan or issue of shares would also result in lower gearing ratio.														

15.	(a)	Inventory turnover = $\text{COS} / \text{average inventory}$ = $240,500 / [(40,000 + 60,000) / 2] = 4.9$ times
16.	(a)	Receivables of Rs. 32,000 represent 64 days' credit sales. Therefore, receivables of Rs. 182,500 would represent 365 days' credit sales. $[32,000 \times 365 / 64]$ Cost of credit sales = Rs. 182,500 x 75% = Rs. 136,875
17.	(b)	Return on long-term funds = $\text{Operating profit (before debenture interest)} / (\text{Share capital} + \text{Reserves} + \text{Debentures})$ = $1,431 / 7,200$ = 19.88%
18.	(c)	Inventory turnover = $\text{CGS} / \text{average inventory}$ CGS = average inventory x inventory turnover = $[(108,000 + 144,000) / 2] \times 10$ = $126,000 \times 10 = \text{Rs. } 1,260,000$ Sales = $\text{Rs. } 1,260,000 / 0.7 = \text{Rs. } 1,800,000$
19.	(b)	Current ratio = $\text{Current assets} / \text{current liabilities}$ Current assets = Current ratio x Current liabilities = $2.5 \times (\text{Rs. } 12,000 + \text{Rs. } 3,000) = \text{Rs. } 37,500$ Quick ratio = $(\text{C.A} - \text{inventory}) / \text{C.L}$ C.A - inventory = Quick ratio x C.L $\text{Rs. } 37,500 - \text{inventory} = 1.5 \times 15,000$ $\text{Rs. } 37,500 - \text{inventory} = \text{Rs. } 22,500$ Inventory = Rs. 15,000
20.	(a)	Debt = $32 + 24 + 16 = 72$ Equity = $80 + 104 + 40 = 224$ Gearing = $72 / (72 + 224) = 24.3 \%$
21.	(c)	Current ratio
22.	(a)	Quick ratio or acid-test ratio
23.	(b)	Rs. 10 million x 1.6 current ratio = Rs. 16 million current assets
24.	(b)	$\text{Rs. } 500\text{m} / (150\text{m} - 100\text{m}) = 10$ times
25.	(d)	The average debtor pays 12 times in a year i.e. on average after one month.
26.	(c)	No impact
27.	(d)	Stock (inventories) are excluded.
28.	(b)	Average inventory $[31+29] / 2 = \text{Rs. } 30\text{m}$ Cost of sales $320 \times 75\% = \text{Rs. } 240\text{m}$ Inventory turnover $240 / 30 = 8$ times
29.	(b)	Long term solvency ratios
30.	(c)	Pays an existing trade payable
31.	(c)	Average debtors are collected in 2 months

32.	(d)	A profitable retailer about to embark on ambitious expansion plans
33.	(b)	increase current ratio and decrease quick ratio
34.	(d)	Declaration and payment of cash dividend
35.	(a) & (c)	Over-statement of closing inventories Inclusion of disposal proceeds of non-current assets in sales
36.	(b)	Use of different formulas for calculating ratios
37.	(c)	Current ratio would decrease but would remain higher than 1
38.	(d)	None is correct
39.	(a) & (b)	Issuance of shares at discount Repayment of a bank loan
40.	(c)	Current assets – Inventory = Quick assets $1.25 \text{ CL} - \text{Rs. } 45\text{m} = 1 \text{ CL}$ $\text{CL} = \text{Rs. } 180 \text{ million}$

STICKY NOTES

Profitability ratios

Gross profit ratio	=	$\frac{\text{Gross profit}}{\text{Sales}}$	=	___%
Operating profit ratio	=	$\frac{\text{Profit before interest and tax (PBIT)}}{\text{Sales}}$	=	___%
Net profit ratio	=	$\frac{\text{Profit after tax (PAT)}}{\text{Sales}}$	=	___%
Cost of sales ratio	=	$\frac{\text{Cost of sales}}{\text{Sales}}$	=	___%
Operating cost ratio	=	$\frac{\text{Operating expenses}}{\text{Sales}}$	=	___%
Asset turnover ratio	=	$\frac{\text{Sales}}{\text{Average capital employed}}$	=	___times

Investors' profitability ratios

Return on capital employed	=	$\frac{\text{PBIT}}{\text{Average capital employed}}$	=	___%
Return on equity	=	$\frac{\text{PAT} - \text{preference dividend}}{\text{Average equity}}$	=	___%
Return on total assets	=	$\frac{\text{PBIT}}{\text{Total assets}}$	=	___%
Return on non-current assets	=	$\frac{\text{PBIT}}{\text{Non-current assets}}$	=	___%

Working capital efficiency ratios (days)

$$\text{Average holding days} = \frac{\text{Average inventory} \times 365}{\text{Cost of sales}} = \text{___ days}$$

$$\text{Average days to collect} = \frac{\text{Average trade receivables} \times 365}{\text{Sales}} = \text{___ days}$$

$$\text{Average time to pay} = \frac{\text{Average trade payables} \times 365}{\text{Purchases}} = \text{___ days}$$

$$\text{Cash cycle} = \text{Inventory days} + \text{Receivable days} - \text{Payable days} = \text{___ days}$$

Working capital efficiency ratios (turnover)

$$\text{Inventory turnover} = \frac{\text{Cost of sales}}{\text{Average inventory}} = \text{___ times}$$

$$\text{Receivables turnover} = \frac{\text{Sales}}{\text{Average trade receivables}} = \text{___ times}$$

$$\text{Payables turnover} = \frac{\text{Purchases}}{\text{Average trade payables}} = \text{___ times}$$

Liquidity ratios

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}} = \text{___} : 1$$

$$\text{Quick ratio (acid test)} = \frac{\text{Current assets} - \text{inventory} - \text{prepayments}}{\text{Current liabilities}} = \text{___} : 1$$

Note: Liquidity ratios may also be expressed in 'times'.

Debt (Solvency) ratios

$$\text{Gearing ratio} = \frac{\text{Long term debts}}{\text{Equity capital}} = \text{___} \%$$

$$\text{Gearing ratio} = \frac{\text{Long term debts}}{\text{Equity capital} + \text{Long term debts}} = \text{___} \%$$

$$\text{Interest cover} = \frac{\text{PBIT}}{\text{Interest expense}} = \text{___ times}$$

AT A GLANCE

SPOTLIGHT

STICKY NOTES

ETHICAL ISSUES IN FINANCIAL REPORTING

IN THIS CHAPTER:

AT A GLANCE

SPOTLIGHT

1. Fundamental principles and potential threats thereto
2. Preparation and presentation of information
3. Comprehensive Examples
4. Objective Based Q&A

STICKY NOTES

AT A GLANCE

Most people are inherently honest and have integrity and will try to behave in the right way in a given set of circumstances.

Chartered accountants might face situations where it is not easy to see the most ethical course of action. ICAP Code of Ethics (the Code) provides guidance in such situations. The Code applies to members, students, affiliates, employees of member firms and, where applicable, member firms, in all of their professional and business activities, whether remunerated or voluntary.

The Code is applicable to chartered accountants in business and chartered accountant in practice, both.

The Code expresses its guidance in term of five fundamental principles namely Integrity, Objectivity, Professional competence and due care, Confidentiality and Professional behaviour.

The compliance with the fundamental principles may potentially be threatened by broad range of circumstances. Many threats can be categorised as Self-interest, Self-review, Advocacy, Familiarity and Intimidation threats.

Chartered accountant in business at all levels are often involved in the preparation and presentation of information that may either be made public or used by others inside or outside the employing organisation. The Code specifically provides guidance on issues that may arise in such circumstances.

1. FUNDAMENTAL PRINCIPLES AND POTENTIAL THREATS THERETO

1.1 Introduction [Section 100]

Ethics can be difficult to define but it is principally concerned with moral principles, character and conduct. Ethical behaviour is more than obeying laws, rules and regulations. It is about doing 'the right thing'. A distinguishing mark of accountancy profession is its acceptance of the responsibility to act ethically and in the public interest.

Confidence in the accountancy profession is a reason why businesses, governments and other organizations involve chartered accountants in a broad range of areas, including financial and corporate reporting, assurance and other professional activities. Accountants understand and acknowledge that such confidence is based on the skills and values that accountants bring to the professional activities they undertake, including:

- (a) Adherence to ethical principles and professional standards;
- (b) Use of business acumen;
- (c) Application of expertise on technical and other matters; and
- (d) Exercise of professional judgment.

The application of these skills and values enables accountants to provide advice or other output that meets the purpose for which it was provided, and which can be relied upon by the intended users of such output.

Professional accountants may find themselves in situations where values are in conflict with one another due to responsibilities to employers, clients and the public. ICAP has a code of conduct which members, students, affiliates, employees of member firms and, where applicable, member firms must follow. The Code is called 'Code of Ethics for Chartered Accountants (Revised 2024)' and it provides guidance in situations where ethical issues arise.

1.2 Impact on members [Section 120]

All members of ICAP are required to comply with the code of ethics. The code applies to both accountants in practice and in business.

ICAP-Code of ethics has been bifurcated into following parts:

Part 1:	Complying with the Code, Fundamental Principles and Conceptual Framework (All Chartered Accountants)
Part 2:	Chartered Accountants in Business
Part 3:	Chartered Accountants in Practice
Part 4A:	Independence for Audit and Review Engagements
Part 4B:	Independence for Assurance Engagements other than Audit and Review

1.3 The fundamental principles [Section 110]

ICAP's Code of Ethics expresses its guidance in terms of five fundamental principles. These are:

- integrity;
- objectivity;
- professional competence and due care;
- confidentiality; and
- professional behaviour

A chartered accountant shall comply with each of the fundamental principles. A chartered accountant might face a situation in which complying with one fundamental principle conflicts with complying with one or more other fundamental principles. In such a situation, the accountant might consider consulting, on an anonymous basis if necessary, with others within organisation, those charged with governance, a professional body, a regulatory body or legal counsel.

1.3.1 Integrity [Sub Section 111]

An accountant is required to be straightforward and honest in all professional and business relationships. Integrity implies fair dealing and truthfulness.

A chartered accountant should not be knowingly associated with reports, returns, communications or other information where they believe that the information:

- Contains a materially false or misleading statement;
- Contains statements or information furnished recklessly; or
- Omits or obscures information required to be included where such omission or obscurity would be misleading.

When a chartered accountant becomes aware of having been associated with misleading or false information, the accountant shall take steps to be disassociated from that information.

1.3.2 Objectivity [Sub Section 112]

Objectivity requires an accountant not to compromise professional or business judgment because of bias, conflict of interest or undue influence of, or undue reliance on, individuals, organisations, technology or other factors.

A chartered accountant shall not undertake a professional activity if a circumstance or relationship unduly influences the accountant's professional judgment regarding that activity.

1.3.3 Professional competence and due care [Sub Section 113]

Being a chartered accountant involves a commitment to learning over one's entire working life. The principle of professional competence and due care requires an accountant to:

- Attain and maintain professional knowledge and skill at the level required to ensure that a client or employing organization receives competent professional service, based on current technical and professional standards and relevant legislation; and
- Act diligently and in accordance with applicable technical and professional standards.

Serving employers with professional competence requires the exercise of sound judgment in applying professional knowledge and skill when undertaking professional activities.

Maintaining professional competence requires a continuing awareness and an understanding of relevant technical, professional and business developments. Continuing professional development enables a chartered accountant to develop and maintain the capabilities to perform competently within the professional environment.

Diligence encompasses the responsibility to act in accordance with the requirements of an assignment, carefully, thoroughly and on a timely basis.

A chartered accountant shall take reasonable steps to ensure that those working in a professional capacity under the accountant's authority have appropriate training and supervision.

Where appropriate, a chartered accountant shall make employers or other users of the accountant's professional services or activities, aware of the limitations inherent in the services or activities.

1.3.4 Confidentiality [Sub Section 114]

The principle of confidentiality requires an accountant to respect the confidentiality of information acquired as a result of professional and business relationships. Confidentiality serves the public interest because it facilitates the free flow of information from the chartered accountant's client or employing organization to the accountant in the knowledge that the information will not be disclosed to a third party.

A chartered accountant shall continue to comply with the principle of confidentiality even after the end of the relationship between the accountant and a client or employing organization. An accountant might use his experience while respecting the confidentiality of information.

An accountant shall:

- (a) Be alert to the possibility of inadvertent disclosure, including in a social environment, and particularly to a close business associate or an immediate or a close family member;
- (b) Maintain confidentiality of information within the firm or employing organization;
- (c) Maintain confidentiality of information disclosed by a prospective client or employing organization;
- (d) Not disclose confidential information acquired as a result of professional and business relationships outside the firm or employing organization without proper and specific authority, unless there is a legal or professional duty or right to disclose;
- (e) Not use confidential information acquired as a result of professional and business relationships for the personal advantage of the accountant or for the advantage of a third party;
- (f) Not use or disclose any confidential information, either acquired or received as a result of a professional or business relationship, after that relationship has ended; and
- (g) Take reasonable steps to ensure that personnel under the accountant's control, and individuals from whom advice and assistance are obtained, respect the accountant's duty of confidentiality.

The following are circumstances where chartered accountants are or might be required to disclose confidential information or when such disclosure might be appropriate:

- Disclosure is required by law.
- Disclosure is permitted by law and authorized by the client or employing organisation.
- Disclosure is not prohibited by law and there is professional duty or right to disclose.

1.3.5 Professional behaviour [Sub Section 115]

A chartered accountant shall comply with the principle of professional behaviour, which requires an accountant to:

- (a) Comply with relevant laws and regulations;
- (b) Behave in a manner consistent with the profession's responsibility to act in the public interest in all professional activities and business relationships; and
- (c) Avoid any conduct that the accountant knows or should know might discredit the profession.

A chartered accountant shall not knowingly engage in any business, occupation or activity that impairs or might impair the integrity, objectivity or good reputation of the profession, and as a result would be incompatible with the fundamental principles.

Conduct that might discredit the profession includes conduct that a reasonable and informed third party would be likely to conclude adversely affects the good reputation of the profession.

1.4 Threats to the fundamental principles [Section 120]

Compliance with the fundamental principles may potentially be threatened by a broad range of circumstances. Many threats fall into the following categories:

- Self-interest;
- Self-review;
- Advocacy;
- Familiarity; and
- Intimidation.

The chartered accountant shall:

- Identify threats to compliance;
- Evaluate whether such a threat is at an acceptable level; and
- If not, then address the threats by eliminating them or reducing them to an acceptable level.

Unless any threat is clearly insignificant, members must implement safeguards to eliminate the threats or reduce them to an acceptable level so that compliance with the fundamental principles is not compromised. The accountant shall do so by:

- Eliminating the circumstances, including interests or relationships, that are creating the threats;
- Applying safeguards, where available and capable of being applied, to reduce the threats to an acceptable level; or
- Declining or ending the specific professional activity.

A circumstance might create more than one threat, and a threat might affect compliance with more than one fundamental principle.

1.4.1 Self-interest threats

This is the threat that a financial or other interest will inappropriately influence a chartered accountant's judgment or behaviour. Such financial interests might cause an accountant to be reluctant to take actions that would be against their own interests.

The following examples indicate the circumstances where

Examples of circumstances include:

- An accountant receives large bonus based on financial targets and is tempted to manipulate financial records to meet the financial targets.
- A CFO owns shares in the company is feeling tempted to push for accounting treatment that would result in higher profits and boost share prices in stock market.
- A CFO avoids reporting financial loss to protect his/her reputation.

► Example 01:

Ibrahim is member of ICAP working as a unit accountant. He is a member of a bonus scheme under which, staff receive a bonus of 10% of their annual salary if profit for the year exceeds a trigger level.

Ibrahim has been reviewing working papers prepared to support this year's financial statements. He has found a logic error in a spreadsheet used as a measurement tool for provisions. Correction of this error would lead to an increase in provisions. This would decrease profit below the trigger level for the bonus.

Required: Analyse the above situation and briefly comment on it.

► ANSWER:

Ibrahim faces a self-interest threat which might distort his objectivity.

Ibrahim has a professional responsibility to ensure that financial information is prepared and presented fairly, honestly and in accordance with relevant professional standards. He has further obligations to ensure that financial information is prepared in accordance with applicable accounting standards and that records maintained represent the facts accurately and completely in all material respects.

Ibrahim must make the necessary adjustment even though it would lead to a loss to himself.

1.4.2 Self-review threats

The threat that a chartered accountant will not appropriately evaluate the results of a previous judgment made; or an activity performed by the accountant, or by another individual within the accountant's firm or employing organization, on which the accountant will rely when forming a judgment as part of performing a current activity.

Examples include:

- An accountant finds errors in her own past calculations but hesitates to report these errors to avoid embarrassment.
- A CFO approves a financial decision that he originally recommended, without critically analysing the effect of such decision.

1.4.3 Advocacy threats

A chartered accountant in business may often need to promote the organisation's position by providing financial information. Advocacy threat is that a chartered accountant will promote a client's or employing organization's position to the point that the accountant's objectivity is compromised.

For example, a CFO defends (potentially incorrect) information to protect interest of employing organisation. As long as information provided is neither false nor misleading such actions would not create an advocacy threat.

1.4.4 Familiarity threats

The threat that due to a long or close relationship with a client, or employing organization, a chartered accountant will be too sympathetic to their interests or too accepting of their work.

Examples of circumstances that may create familiarity threats include:

- A chartered accountant in business in a position to influence financial or non-financial reporting or business decisions having an immediate or close family member who is in a position to benefit from that influence.
- Long association with business contacts influencing business decisions.
- An accountant overlooks mistakes in vendor payments because he personally knew the vendor.

1.4.5 Intimidation threats

The threat that a chartered accountant will be deterred from acting objectively because of actual or perceived pressures, including attempts to exercise undue influence over the accountant (for example, when he encounters an aggressive and dominating individual at a client or at his employer).

Examples of circumstances that may create intimidation threats include:

- Threat of dismissal or replacement over a disagreement about the application of an accounting principle or the way in which financial information is to be reported.
- A dominant personality attempting to influence decisions of the chartered accountant.
- A CFO is being pressured by board of directors to approve financial statements that he believes are misleading.

1.5 Applicability of the Code [Section 100]

A chartered accountant is required to comply with the Code unless law or regulations preclude from compliance and in such case, those law and regulations shall prevail and the CA shall comply other parts of the Code.

A chartered accountant might encounter unusual circumstances in which the accountant believes that the result of applying a specific requirement of the Code would be disproportionate or might not be in the public interest. In those circumstances, the accountant is encouraged to consult with a professional or regulatory body.

A chartered accountant identifies the breach of the Code:

- Take whatever actions available to address the consequences of breach
- Determine whether to report the breach to users/professional or regulatory body.

► Example 02:

Zia is a Chartered Accountant and works as a financial controller in Unique Engineering Limited (UEL). UEL is currently considering the acquisition of Top Storage Limited (TSL) and Zia is a member of the team which is currently negotiating the acquisition with the management of TSL.

After becoming aware of the prospective acquisition, Zia purchased 1,000,000 shares of TSL in the name of his wife and son.

Required:

Briefly explain how Zia is in breach of the fundamental principles of ICAP's code of ethics. Also explain the potential threats that might be involved in the above situation.

► **ANSWER:****Breach of Fundamental Principles of Code of Ethics:**

Mr. Zia breached the following fundamental principles of ICAP code of ethics:

Confidentiality: Under the Code of Ethics, member must respect the confidentiality of information acquired as a result of professional and business relationship. Confidential information acquired should not be used for the personal advantage by a member.

In the above scenario, Mr Zia has breached the principle of confidentiality by using the confidential information for the personal advantage since the information was not publicly available.

Professional behaviour: Under the Code of Ethics, member must comply with relevant laws and regulations and should avoid any action which discredits the profession.

Since it can be a non-compliance of laws and regulation, he may be in breach of the principle of professional behaviour.

Potential Self-Interest threat involved in the circumstances:

Since Mr. Zia is part of a team which is negotiating the price of the shares and he has purchased shares in the name of his wife and son, it creates self-interest threat and he would be reluctant to take any decision that would be against his own interest.

2. PREPARATION AND PRESENTATION OF INFORMATION

2.1 Introduction [Section 220]

Chartered accountants at all levels in an employing organization are involved in the preparation or presentation of information both within and outside the organization.

Stakeholders to whom, or for whom, such information is prepared or presented, include:

- Management and those charged with governance.
- Investors and lenders or other creditors.
- Regulatory bodies.

Information can include financial and non-financial information that might be made public or used for internal purposes. Examples include:

- Operating and performance reports.
- Decision support analyses.
- Budgets and forecasts.
- Information provided to the internal/external auditors.
- Risk analyses.
- General and special purpose financial statements.
- Tax returns.
- Reports filed with regulatory bodies for legal and compliance purposes.

This information might assist stakeholders in understanding and evaluating aspects of the employing organization's state of affairs and in making decisions concerning the organization.

Preparing or presenting information includes:

- recording,
- maintaining and
- approving information.

2.2 General requirements [Section 220]

When preparing or presenting information, a chartered accountant shall:

- Prepare or present the information in accordance with a relevant reporting framework (e.g. IFRSs), where applicable;
- Prepare or present the information in a manner that is intended neither to mislead nor to influence contractual or regulatory outcomes inappropriately;
- Exercise professional judgment to:
 - Represent the facts accurately and completely in all material respects;
 - Describe clearly the true nature of business transactions or activities; and
 - Classify and record information in a timely and proper manner;
- Not omit anything with the intention of rendering the information misleading or of influencing contractual or regulatory outcomes inappropriately.
- Avoid undue influence of, or undue reliance on, individuals, organisations or technology; and
- Be aware of risk of bias.

2.3 Use of Discretion in Preparing or Presenting Information [Section 220]

Preparing or presenting information might require the exercise of discretion in making professional judgments. The chartered accountant shall not exercise such discretion with the intention of misleading others or influencing contractual or regulatory outcomes inappropriately.

Examples of ways in which discretion might be misused to achieve inappropriate outcomes include:

- Determining estimates, for example, determining fair value estimates in order to misrepresent profit or loss.
- Selecting or changing an accounting policy or method among two or more alternatives permitted under the applicable financial reporting framework, for example, selecting a policy for accounting for long term contracts in order to misrepresent profit or loss.
- Determining the timing of transactions, for example, timing the sale of an asset near the end of the fiscal year in order to mislead.
- Determining the structuring of transactions, for example, structuring financing transactions in order to misrepresent assets and liabilities or classification of cash flows.
- Selecting disclosures, for example, omitting or obscuring information relating to financial or operating risk in order to mislead.

When performing professional activities, especially those that do not require compliance with a relevant reporting framework, the chartered accountant shall exercise professional judgment to identify and consider:

- The purpose for which the information is to be used;
- The context within which it is given; and
- The audience to whom it is addressed.

For example, when preparing or presenting pro forma reports, budgets or forecasts, the inclusion of relevant estimates, approximations and assumptions, where appropriate, would enable those who might rely on such information to form their own judgments. The chartered accountant might also consider clarifying the intended audience, context and purpose of the information to be presented.

2.4 Relying on the Work of Others [Section 220]

A chartered accountant who intends to rely on the work of others, either internal or external to the employing organization, shall exercise professional judgment to determine what steps to take, if any, in order to fulfil the responsibilities as discussed previously.

Factors to consider in determining whether reliance on others is reasonable include:

- The reputation and expertise of, and resources available to, the other individual or organization.
- Whether the other individual is subject to applicable professional and ethics standards.

Such information might be gained from prior association with, or from consulting others about, the other individual or organization.

2.5 Addressing Information that is or might be Misleading [Section 220]

When the chartered accountant knows or has reason to believe that the information with which the accountant is associated is misleading, the accountant shall take appropriate actions to seek to resolve the matter.

Actions that might be appropriate include:

- Discussing concerns that the information is misleading with the chartered accountant's superior and/or the appropriate level(s) of management within the accountant's employing organization or those charged with governance, and requesting such individuals to take appropriate action to resolve the matter. Such action might include:
- Having the information corrected.
- If the information has already been disclosed to the intended users, informing them of the correct information.

- Consulting the policies and procedures of the employing organization (for example, an ethics or whistle-blowing policy) regarding how to address such matters internally.

The chartered accountant might determine that the employing organization has not taken appropriate action. If the accountant continues to have reason to believe that the information is misleading, the following further actions might be appropriate provided that the accountant remains alert to the principle of confidentiality:

- Consulting with:
 - A relevant professional body.
 - The internal or external auditor of the employing organization.
 - Legal counsel.
- Determining whether any requirements exist to communicate to:
 - Third parties, including users of the information.
 - Regulatory and oversight authorities.

If after exhausting all feasible options, the chartered accountant determines that appropriate action has not been taken and there is reason to believe that the information is still misleading, the accountant shall refuse to be or to remain associated with the information.

In such circumstances, it might be appropriate for a chartered accountant to resign from the employing organization.

2.6 Documentation [Section 220]

The chartered accountant is encouraged to document:

- The facts.
- The accounting principles or other relevant professional standards involved.
- The communications and parties with whom matters were discussed.
- The courses of action considered.
- How the accountant attempted to address the matter(s).

► Example 03:

Ali is a chartered accountant recruited on a short-term contract to assist the finance director, Bashir (who is not a chartered accountant) in finalising the draft financial statements.

The decision on whether to employ Ali on a permanent basis rests with Bashir.

Ali has been instructed to prepare information on leases to be included in the financial statements. He has identified a number of large leases which are being accounted for as rental arrangements even though the terms of the contract contain clear indicators that the risks and benefits have passed to the company and applying IFRS 16, right of use asset and lease liability should have been recorded. Changing the accounting treatment for the leases would have a material impact on asset and liability figures.

Ali has explained this to Bashir. Bashir responded that Ali should ignore this information as the company need to maintain a certain ratio between the assets and liabilities in the statement of financial position.

Required: Discuss the responsibility of Ali and suggest course of action.

► ANSWER:

Ali faces a self-interest threat which might distort his objectivity.

The current accounting treatment is incorrect.

Ali has a professional responsibility to ensure that financial information is prepared and presented fairly, honestly and in accordance with relevant professional standards. He has further obligations to ensure that financial information is prepared in accordance with applicable accounting standards and that records maintained represent the facts accurately and completely in all material respects.

Possible course of action

Ali must explain his professional obligations to Bashir in particular that he cannot be party to the preparation and presentation of knowingly misleading information.

Ali should refuse to remain associated with information that is misleading.

If Bashir refuses to allow the necessary changes to the information, Ali should take following appropriate actions to resolve the matter:

- should report the matter to the audit committee or the other directors;
- consult the policies and procedures of the company with respect to ethics or whistle blowing policy
- consider consulting with the relevant professional body, internal or external auditor, legal counsel or informing third parties or appropriate authorities in line with the ICAP guidance on confidentiality.

As a last resort if the company refuses to change the information Ali should resign from his post.

► Example 04:

Etishad is a chartered accountant who works in a team that reports to Fahad, the finance director of Kohat Holdings.

Fahad is also a chartered accountant. He has a domineering personality.

Kohat Holdings revalue commercial properties as allowed by IAS 16. Valuation information received last year showed that the fair value of the property portfolio was 2% less than the carrying amount of the properties (with no single property being more than 4% different). A downward revaluation was not recognised on the grounds that the carrying amount was not materially different from the fair value.

This year's valuation shows a continued decline in the fair value of the property portfolio. It is now 5% less than the carrying amount of the properties with some properties now being 15% below the carrying amount.

Etishad submitted workings to Fahad in which he had recognised the downward revaluations in accordance with IAS 16.

Fahad has sent him an email in response in which he wrote "Stop bothering me with this rubbish. There is no need to write the properties down. The fair value of the portfolio is only 5% different from its carrying amount. Restate the numbers immediately".

Required:

Discuss the issue, responsibility and course of action from the perspective of Etishad.

► ANSWER:

Etishad faces an intimidation threat which might distort his objectivity.

The current accounting treatment might be incorrect. The value of the properties as a group is irrelevant in applying IAS 16's revaluation model. IAS 16 allows the use of a revaluation model but requires that the carrying amount of a property should not be materially different from its fair value. This applies to individual properties not the whole class taken together.

(It could be that Fahad is correct because there is insufficient information to judge materiality in this circumstance. However, a 15% discrepancy does sound significant).

Etishad has a professional responsibility to ensure that financial information is prepared and presented fairly, honestly and in accordance with relevant professional standards. He has further obligations to ensure that financial information is prepared in accordance with applicable accounting standards and that records maintained represent the facts accurately and completely in all material respects.

Possible course of action

Etishad should arrange a meeting with Fahad to try to explain Fahad's misapplication of the IAS 16 guidance and to try to persuade Fahad that a change might be necessary.

Fahad should be reminded that he too is bound by the same guidance that applies to Etishad. Indeed he has a greater responsibility as the more senior person to show leadership in this area.

Etishad cannot be party to the preparation and presentation of knowingly misleading information. He should explain that he cannot remain associated with information that is misleading. If Fahad refuses to allow the necessary changes to the information Etishad should take following appropriate actions to resolve the matter:

- should report the matter to the audit committee or the other directors;
- consult the policies and procedures of the company with respect to ethics or whistle blowing policy to address the matter internally;
- consider consulting with the relevant professional body, internal or external auditor, legal counsel or informing third parties or appropriate authorities in line with the ICAP guidance on confidentiality.

As a last resort, Etishad should resign from his post.

► **Example 05:**

Waheed is a chartered accountant, recently employed by AA plc as deputy to the finance director, Arif (also a chartered accountant). AA plc is listed on the Pakistan stock exchange.

On Waheed's first day on the job he met with Arif who said "Look, keep it to yourself but I'm having a second interview next week for a new job. The first thing that I need you to do is to review the financial statements before the auditors arrive. I qualified a few years ago and am not up to date on all of the little technicalities in IFRS. You should know these better than me and you'll know more about what the auditors might focus on. We must do our best to present the financial statements in the most favourable light as the bonus paid to employees (including me) depends on profit being more than 10% bigger than last year's and remember that you qualify for this too. Keep this in mind when you carry out the review as we do not really want to find anything. Do well at this and I might put in a good word for you when I leave as I'm sure you'll be a great replacement for me."

Required: Explain the ethical issues inherent in the above conversation and what Waheed should do about them.

► **ANSWER:**

The range of comments made by Arif raises questions over his ethical behaviour and professional standards.

A chartered accountant should be unbiased when involved in preparing and reviewing financial information. A chartered accountant should prepare financial statements fairly, honestly, and in accordance with relevant professional standards and must not be influenced by considerations of the impact of reported results.

Arif's failings

Arif appears to be influenced by the need to achieve a specified level of profit. This is not appropriate and calls his integrity into question.

In addition, Arif's professional competence seems to be suspect. His comment on not being up to date on all of the little technicalities in IFRS suggests that he has not maintained a level of professional competence appropriate to his professional role.

ICAP members have a responsibility to engage in continuing professional development in order to ensure that their technical knowledge and professional skills are kept up to date. Arif should seek continuing professional development activities and improve his knowledge on ethical standards. Furthermore, it might be expected that as Waheed's superior he should set an example to Waheed and guide him in his responsibilities. Clearly this is not happening.

As a member of ICAP Arif should be aware of the ICAP code of ethics. Arif should know of the danger of self-interest threats and intimidation threats to himself and to others. His attempt to influence the outcome of a fellow professional by applying such a threat to that individual is very unprofessional.

Waheed's ethical issues

Waheed faces a self-interest threat, in that there is the possibility of a bonus provided the earnings per share figure remains the same as last year. Arif has also suggested that he can influence the Board's decision over employing him as a replacement finance director – another self-interest threat to Waheed. Both of these threats must be ignored and Waheed must do 'the right thing'.

Arif's comments imply that his application of professional responsibility is lacking. This may extend into the way in which the current financial statements have been prepared. Waheed must be very careful (as always) to carry out the review with all due care.

Waheed should first discuss his recommendations with Arif and remind him of his professional responsibilities to ensure that the accounting standards are correctly followed. If the financial statements are found to contain errors or incorrect accounting treatment, then they must be amended. If Arif refuses to amend the draft financial statements, if necessary, Waheed should take appropriate actions to resolve the matter including:

- should report the matter to the audit committee or the other directors;
- consult the policies and procedures of the company with respect to ethics or whistle blowing policy to address the matter internally;
- consider consulting with the relevant professional body, internal or external auditor, legal counsel or informing third parties or appropriate authorities in line with the ICAP guidance on confidentiality.

3. COMPREHENSIVE EXAMPLES

► *Example 06:*

Umer Sheikh, ACA is Manager Finance at Charming Limited (CL) and reports to Abid, FCA who is the Chief Financial Officer of CL. Abid is also a close relative of the major shareholder of CL.

CL is negotiating an important financing arrangement with Union Standard Bank (USB) in order to expand its business in foreign markets. The rate quoted by USB is comparatively higher than existing rates being paid by CL.

During a meeting with the Executive Vice President (EVP) of USB, where Umer Sheikh was also present, Abid revealed that his son has applied for a house financing in USB last month but has not received any response from USB so far. Abid requested EVP to consider his application. EVP agreed to look into the matter. On conclusion of the meeting, Abid asked Umer Sheikh to prepare a note for the board of directors proposing the acceptance of the rate offered by USB.

Required: Briefly explain how Abid may be in breach of the fundamental principles of ICAP's code of ethics. Also state the potential threats that Umer Sheikh may face in the above circumstances and how he should respond.

► *ANSWER:*

In the given situation, CFO may be in breach of:

Principle of professional behaviour: All chartered accountants are obligated to avoid any action that the chartered accountant knows or should know may discredit the profession. CFO should have avoided discussing his personal interest in official meeting.

Principle of objectivity: Chartered Accountant should not compromise their professional or business judgment because of bias, conflict of interest or the undue influence of others. In this circumstance, he has compromised his professional and business judgment due to his personal interest as he requested the EVP to consider application of his son who has applied for house financing in USB.

Principle of integrity: Chartered Accountant should be straight forward and honest in all professional and business relationship. It seems that CFO may be inclined to accept higher mark-up rate as compared to existing rate being paid by CL, resulting breach of integrity.

Intimidation threat faced by Mr. Umer

Umer may face intimidation threat from his superior if he would raise his objection on acceptance of higher mark-up rate offered by the Bank specially where his superior i.e. Abid is a relative of principal shareholder too.

Available safeguards

If this threat is significant Umer should consult with superiors within the organization in order to eliminate or reduce it to an acceptable level.

Where it is not possible to reduce the threats to an acceptable level, Umer should refuse to associate with this financing arrangement and take the following appropriate steps:

- should consider informing appropriate authorities like Audit Committee / CEO;
- consult the policies and procedures of the company with respect to ethics or whistle blowing policy to address the matter internally;
- consider consulting with the relevant professional body, internal or external auditor, legal counsel or informing third parties or appropriate authorities in line with the ICAP guidance on confidentiality;
- should resign.

► *Example 07:*

Usman is a Chartered Accountant and has been working as Finance Director in Mehran Limited (ML) for the past one year. He reports to the CEO who is also a Chartered Accountant.

Recently, Usman has received a bill issued by an advertising agency which is duly approved for payment by the Director Marketing. Usman believes that the amounts agreed to be paid under the contract far exceed the value of services to be provided by the advertising agency and that the payment would be redirected to obtain a sales contract. He has discussed the matter with CEO who has advised him to process the payment in ML's business interest. The CEO also informed Usman that if the said contract is secured, the management staff will be entitled to a handsome bonus.

Required: Briefly explain how CEO is in breach of the fundamental principles of ICAP's code of ethics. Also state the potential threats which Usman may face under the circumstances, along with available safeguards (if any).

► *ANSWER:*

Chartered Accountants should be straight forward and honest in all professional and business relationships. Since the CEO advised Usman to process the payment about which Usman believes that the said payment is unreasonable and would be made to obtain a sales contract, therefore he is in breach of **principle of integrity and professional behaviour**.

In the given circumstances, the decision of CEO may also induce **lack of objectivity** due to the expected bonuses to the management.

Self-interest threat faced by Usman

Usman might get influenced by the CEO due to the expected bonus therefore he might process the payment in his own self-interest.

Intimidation threat faced by Usman

Usman may have to leave this job if the disagreement continues.

Available safeguards

Where it is not possible to reduce the threats to an acceptable level, Usman:

- should refuse to sign the cheque / refuse to associate with the transaction.
- should consider informing appropriate authorities like Audit Committee.
- consult the policies and procedures of the company with respect to ethics or whistle blowing policy to address the matter internally
- Consider consulting with the relevant professional body, internal or external auditor, legal counsel or informing third parties or appropriate authorities in line with the ICAP guidance on confidentiality.
- should resign.

► *Example 08:*

Atif is a chartered accountant and has been working as Manager – Accounts in an unlisted public company MNZ Limited.

While preparing the financial statements for the year ended 31 December 2016, CFO of MNZ who is also a chartered accountant informed Atif that the directors are considering to have the company listed on Pakistan Stock Exchange.

Consequently, CFO wants to show higher profit and has asked Atif to identify areas where book adjustments can be made. He has also informed that if MNZ is able to list the shares at a price of Rs. 35 or more, all managerial staff would be given an additional bonus this year.

Required: Briefly explain how the CFO is in breach of the fundamental principles of ICAP's code of ethics. Also state the potential threats that Atif may face under the above circumstances and how he should respond.

► **ANSWER:**

In given situation, CFO is in breach of:

Principle of integrity: Chartered Accountant should be straight forward and honest in all professional and business relationship. Since he asked Accounts manager to identify the areas where through adjustments, profit may be reported on higher side, he has breached the principle of integrity.

Principle of professional behaviour: This principle imposes an obligation on all chartered accountants to avoid any action that the chartered accountant knows or should know may discredit the profession. Since CFO asked Accounts Manager for booking the adjustments to increase the current year profit, which have a negative effect on the reputation of the profession.

Principle of objectivity: Chartered Accountant should not compromise their professional or business judgment because of bias, conflict of interest or the undue influence of others. In this circumstance, he has compromised his professional and business judgment due to biasness.

Self-interest threat faced by Mr. Atif

Self-interest threat occurs as a result of financial or other interest of members or their immediate family member. In this case, he has been told by the CFO that he would be given an additional bonus this year so he faces self-interest threat.

Available safeguards

If this threat is significant Atif should consult with superiors within the organisation in order to eliminate or reduce it to an acceptable level.

Where it is not possible to reduce the threats to an acceptable level, Atif:

- should refuse to remain associated with information which is or may be misleading;
- should consider informing directors;
- consult the policies and procedures of the company with respect to ethics or whistle blowing policy to address the matter internally;
- consider consulting with the relevant professional body, internal or external auditor, legal counsel or informing third parties or appropriate authorities in line with the ICAP guidance on confidentiality;
- should resign.

► **Example 09:**

Ali and Bashir are chartered accountants and have been working as Managing Director (MD) and Chief Financial Officer (CFO) in a listed company. In a recent meeting of the Board, the directors have decided to expand the business within six months by opening 20 retail outlets. This expansion would require financing of Rs. 300 million which may be arranged through bank loan.

MD has advised the CFO to arrange the loan from MN Bank. He has also informed that the President of the bank is his good friend and the loan can be arranged on a fast track basis at a mark-up of 15% per annum, subject to the following conditions:

- current ratio and quick ratio should be at least 2:1 and 1:1 respectively;
- gearing ratio should not exceed 40%; and
- interest cover should be at least 3.

CFO is not comfortable with this deal as the mark-up offered by the bank is much higher than the rate on the existing loan and it is difficult for the company to meet the gearing requirements of the bank. However, MD has asked him to make certain changes in the draft financial statements before submission to the bank; which according to the CFO are not in accordance with the IFRSs.

Required: Briefly explain how the MD may be in breach of the fundamental principles of ICAP's code of ethics. Also state the potential threats that CFO may face under the circumstances, along with available safeguards (if any).

► **ANSWER:**

In this situation, the existence of threats to fundamental principles will depend on following factors:

- Whether financing from other banks is available at lower mark up;
- Whether it is feasible to borrow @15% for the expansion.

If financing from other banks is available or it may not be feasible to finance the project at the rate of 15%, and still MD is pressurizing the CFO to obtain financing at higher rate of mark-up the MD may be in breach of:

Principle of objectivity: It can be a bias decision on part of MD, as he may be favouring his friend who is the president of the bank or may have any other interest in taking loan from that particular bank.

Principle of integrity: MD may be in breach of principle of integrity because he is asking CFO to manipulate the financial information.

Potential threat to CFO along with safeguards:

Preparation of financial information as per the instructions of MD, will result in intimidation threat to integrity and objectivity.

Identified threat is significant as the CFO is being instructed from the highest level of management. In order to reduce the threat to an acceptable level, the following safeguards should be applied:

- Consult with superiors such as audit committee or those charged with governance.
- Consult the policies and procedures of the company with respect to ethics or whistle blowing policy to address the matter internally.
- Consider consulting with the relevant professional body, internal or external auditor, legal counsel or informing third parties or appropriate authorities in line with the ICAP guidance on confidentiality.
- Where it is not possible to reduce the threat to an acceptable level, CFO shall refuse to be remain associated with the financial information and consider resigning from the post of CFO.

► **Example 10:**

On receiving the revised financial statements, the CEO called Faraz and briefed him in the following manner:

“Since the position of the CFO is vacant, I intend to promote you as CFO. GL has been through a rough year and has some disappointing results but a reasonable profit needs to be reported for the mutual benefit of all stakeholders. Moreover, the financial statements would also be scrutinized by the bank to ensure that the loan covenants are met which include maintaining total assets at 1.5 times the total liabilities.

Therefore, I want you to confirm the draft financial statements without making any adjustment for presentation before the Board and submission to the bank.”

Required: Briefly explain the potential threats that Faraz may face under the circumstances, along with available safeguards (if any).

► **ANSWER:**

In the given situation, Faraz may face following threats:

Self-interest threat: Self-interest threat occurs as Faraz has been told by the CEO that he would be promoted to CFO.

Intimidation threat: Faraz may quit this job if he would not confirm the draft financial statement as per CEO's instructions.

Available safeguards:

Where it is not possible to reduce the threats to an acceptable level, Faraz:

- should refuse to remain associated with information which is or may be misleading;
- should consider to consult with superiors such as audit committee or those charged with governance;

- consult the policies and procedures of the company with respect to ethics or whistle blowing policy to address the matter internally;
- consider consulting with the relevant professional body, internal or external auditor, legal counsel or informing third parties or appropriate authorities in line with the ICAP guidance on confidentiality;
- may resign.

► **Example 11:**

Baqir, ACA is working as Finance Manager at Kiwi Limited (KL), a listed company, and reports to Shahid, FCA who is the Chief Financial Officer of the company.

Before the date of authorization for issuance of KL's financial statements for the year ended 30 June 2018, Zahoor (a mutual friend of Baqir and Shahid) informed Baqir that Shahid has recommended him to purchase KL's shares as higher EPS is expected this year. Zahoor also sought Baqir's advice on this matter.

Required: Briefly explain how Shahid may be in breach of the fundamental principles of ICAP's code of ethics. Also state the potential threats that Baqir may face in the above circumstances and how he should respond.

► **ANSWER:**

Breach by CFO Mr. Shahid

In the given situation, CFO may be in breach of:

Principle of Professional behaviour: This principle imposes an obligation on all chartered accountants to comply with relevant laws and regulations and avoid any action that discredits the profession. According to Zahoor, Shahid revealed inside information to him which is non-compliance of regulations pertaining to inside information and his act may discredit the profession as well. As a result Shahid has breached this principle.

Principle of confidentiality: This principle imposes an obligation on all chartered accountants to refrain from using confidential information acquired as a result of professional and business relationships to their personal advantage or the advantage of third parties. In given scenario, Shahid misused the confidential information for the advantage of his friend so Shahid has breached this principle.

Threats faced by Baqir

Intimidation threat: Baqir may face intimidation threat from his superior if he raises objection on non-compliance of regulations by Shahid.

Self-interest threat: Baqir may also face self-interest threat as his interest towards friendship with Zahoor may be at stake if he refuses to disclose (confirm or deny) the confidential information to him.

Responding to above issues

- He should refrain himself from disclosing any confidential information to his friend.
- He should discuss the issue with Shahid and ask him to take remedial action and disclose the non-compliance.
- He should consider informing appropriate authorities like Audit Committee/CEO or informing authorities considering the guidance on confidentiality.
- He may seek legal advice to deal with the situation.

► **Example 12:**

Fortune Limited (FL) is quoted on the stock exchange, with revenue of over Rs. 5 billion per annum. During the year ended 30 June 2015, FL has incurred a loss of Rs. 26 million.

The Chief Executive is of the view that declaration of loss may result in the bankers' refusal to renew the credit facility. Therefore, he wants to incorporate certain adjustments in the books of account that will result in a net profit of Rs. 100 million. However, the Chief Financial Officer (CFO), who is a chartered accountant, is of the view that all possible adjustments allowable under the applicable accounting regulations have already been considered and incorporated.

Required: Identify the categories of threats to the fundamental principles of objectivity or professional competence and due care, that may be created in the above situation and discuss the safeguards available to the CFO in this respect, under the ICAP's Code of Ethics.

► **ANSWER:**

Threats to fundamental principles

The situation may create following threats to the fundamental principles of **objectivity or professional competence and due care**:

- Self-interest (employment)
- Intimidation (actual or perceived pressure from CEO)

Safeguards available to the CFO:

In order to reduce the threat to an acceptable level, the following safeguards should be applied:

- Consult with superiors such as audit committee.
- Consult the policies and procedures of the company with respect to ethics or whistle blowing policy to address the matter internally.
- Consider consulting with the relevant professional body, internal or external auditor, legal counsel or informing third parties or appropriate authorities in line with the ICAP guidance on confidentiality.
- Where it is not possible to reduce the threat to an acceptable level, CFO shall refuse to be remain associated with the financial information and consider resigning from the post of CFO.

► *Example 13:*

Amir Ali, ACA is CFO at Circle Limited (CL) and reports to Junaid, FCA who is the CEO.

The financial year of CL ends on 30 April and its profit for the nine months ended 31 January 2019 was below target. In a management meeting held in February 2019, Junaid has proposed the following measures to improve the results.

- (i) Annual maintenance of the manufacturing plant which is due in March 2019 should be deferred to May 2019. Production manager has warned that the deferral may affect the safety of the plant. However, Junaid is of the view that the maintenance was delayed two years ago as well and nothing adverse happened at that time.
- (ii) Incorporation of the new revaluation report of CL's buildings should be deferred to the next year as the resulting increase in valuation is substantial and would result in increase in the depreciation for the year. Amir had initiated the revaluation during the year since the fair values of the buildings had increased materially. Junaid is of the view that the buildings were revalued last year and there is no need of such frequent revaluations.

Due to the dominant nature of Junaid, none of the participants opposed his views. The summary to implement the above actions has been received by Amir.

Amir has recently applied for an interest free car loan from CL which is expected to be approved in few days.

Required: Briefly explain how Junaid may be in breach of the fundamental principles of Code of Ethics for Chartered Accountants. Also state the potential threats that Amir may face in the above circumstances and how he should respond.

► *ANSWER:***Breach by CEO Mr. Junaid**

In the given situation, Junaid may be in breach of the following fundamental principles of Code of Ethics for Chartered Accountants:

Professional behaviour: This principle imposes an obligation on all chartered accountants to comply with relevant laws and regulations and avoid any action that discredits the profession. Junaid has breached this principle as his proposed suggestion in respect of incorporation of the new revaluation report is not in accordance with IAS 16. Under IAS 16, carrying amount of property carried at revaluation model should not be materially different from its fair value so his proposal is against the requirement of IAS 16.

Integrity: Chartered Accountant should be straight forward and honest in all professional and business relationship. It seems that Junaid's decision to defer the maintenance of plant despite warning of production manager in terms of safety of plant and non-incorporation of new annual report in financial statement would make them misleading.

Objectivity: Chartered Accountant should not compromise his professional or business judgment because of bias, conflict of interest or the undue influence of others. In this circumstance, he has compromised his professional and business judgment by proposing unethical/unlawful measures to just improve the falling profit of the company.

Potential threats faced by Amir:

Amir may face following threats:

Self-interest threat: Amir may face self-interest threat as the disbursement of his car loan may be at stake if he refuses to obey the instructions.

Intimidation threat: Amir may face intimidation threat from Junaid as refusal to obey instruction may risk his job.

Identified threats are significant as the CFO is being instructed from the highest level of management.

Response / Actions:

In order to reduce the threat to an acceptable level, Amir should:

- Discuss the matter with CEO and persuade him to follow code of ethics.
- Refuse to implement the given proposals.

If Junaid does not follow code of ethics and forces him to implement the proposal, Amir should refuse to associate with these proposals and take the following appropriate steps:

- should consider informing superiors like Audit Committee / directors;
- consult the policies and procedures of the company with respect to ethics or whistle blowing policy to address the matter internally;
- consider consulting with the relevant professional body, internal or external auditor, legal counsel or informing third parties or appropriate authorities in line with the ICAP guidance on confidentiality;
- should resign.

► **Example 14:**

Atif Anwar, ACA is Finance Manager at Hot Coffee Limited (HCL) and reports to Jamal Ahmed, FCA who is the CFO.

On returning from leaves, Atif noted that draft financial statements for the year ended 31 December 2019 have been prepared. He found that financial statements have not been updated for the revision in decommissioning cost related to a plant, as advised by the engineering department at the start of 2019. Atif discussed the matter with Jamal who advised him to finalize the financial statements without revising the decommissioning cost as HCL's profit would be decreased if revised cost would be taken into account.

Decommissioning cost related to the plant has increased from initial estimate of Rs. 50 million to Rs. 88 million. Applicable discount rate is 12%. This plant had a useful life of 6 years when it was purchased on 1 July 2017 at a purchase price of Rs. 860 million. HCL uses cost model for subsequent measurement of its property, plant and equipment and follows straight line method for charging depreciation.

Required:

- Compute the change in net profit, assets and liabilities if revised decommissioning cost is included in the financial statements for the year ended 31 December 2019.
- Briefly explain how Jamal may be in breach of the fundamental principles of ICAP's Code of Ethics for Chartered Accountants.

► **ANSWER:****Part (a)**

	Net profit	Assets	Liabilities
	Rs. in million		
Increase in decommissioning liability [Rs. (88m – 50m) x (1.12 ^{4.5})]		22.82	22.82
Depreciation [Rs. 22.82m / 4.5 years]	(5.07)	(5.07)	
Interest on liability [Rs. 22.82m x 12%]	(2.74)		2.74
Net change	(7.81)	17.75	25.56

Part (b)

In the given scenario, Jamal may be in breach of the following fundamental principles of Code of Ethics for Chartered Accountants:

Principle of integrity: Chartered Accountant should be straight forward and honest in all professional and business relationships. It seems that the decision to defer incorporation of new decommissioning cost would make financial statements misleading.

Principle of professional behaviour: This principle imposes an obligation on all chartered accountants to comply with the relevant laws and regulation and avoid any action that discredits the profession. Jamal has breached this principle as his decision to defer incorporation of new decommissioning cost is not in accordance with IFRSs.

► **Example 16:**

You have recently joined as Finance Manager of Mercury Limited (ML) and have been asked by the CFO to prepare a power point presentation on ML's financial statements for the half-year ended 31 December 2022 for the board of directors' meeting. These financial statements were finalised by the CFO who is a chartered accountant.

While preparing the presentation, you have noted that a five storey building purchased in July 2022 by ML was entirely classified as an investment property. ML uses the ground and first floors for its administrative purposes while remaining three floors were rented out to different tenants and will be sold in future. Further, on 31 December 2022, the fair value increase of Rs. 150 million for the entire building has been taken to the statement of profit or loss which has ensured that the required interest cover as per bank loan covenants has been met.

The CFO is of the view that IFRSs allow such application as ML only uses less than 50% of the building for its own use. He further explained that non-compliance of loan covenants should be avoided at any cost as the bank loan would become immediately payable upon non-compliance. This would create significant financial difficulties for ML which may even result in closure of business.

Required: Briefly explain how CFO may be in breach of the fundamental principles of ICAP's Code of Ethics for Chartered Accountants. Also state the potential threats that you may face in the above circumstances and how you should respond.

► **Answer:**

In the given situation, CFO might be in breach of the following fundamental principles of the Code of Ethics for Chartered Accountants:

(i) Professional competence and due care:

A chartered accountant (CA) should act diligently and in accordance with the applicable technical and professional standards. Applying incorrect application of standard raises questions on his professional competence and due care. Under IAS 40, each portion that can be sold separately should be accounted for separately. Therefore, ground and first floors should be recorded as 'Property, plant and equipment' and remaining floors should be recorded as 'Investment property'.

(ii) Objectivity:

CA should not compromise professional or business judgements because of bias, conflict of interest or undue influence of others. Incorrect application of IFRSs by CFO to avoid the non-compliance of loan covenant is affecting the objectivity of CFO.

(iii) Professional behaviour:

CA should comply with the relevant laws and regulations and avoid any conduct that might discredit the profession. Pressurizing or threatening subordinates with an intention to influence them is the non-compliance of ICAP's code of ethics and is reflective of non-professional behaviour of CFO.

In the given situation, following threats to compliance with the fundamental principles arises for me:

(i) Intimidation threat:

CA will be deterred from acting objectively because of pressures or exercise of undue influence over him. I may feel intimidation threat due to perceived pressure exerted by the CFO on raising objection over his finalized financial statements.

(ii) Self-interest threat:

CA's judgement or behaviour may be inappropriately influenced by financial or other interest. I may feel self-interest threat due to fear of losing job in case of financial difficulties of ML.

In order to reduce the threat to an acceptable level, one or more of the following safeguards should be applied:

- (i) Discuss and persuade CFO to follow the correct application of standard and adjust the financial statements.
- (ii) If CFO refuses to adjust the financial statements, consider informing appropriate authorities such as CEO or the audit committee.
- (iii) Consult the policies or procedures (i.e. ethics or whistleblowing policies) of ML.
- (iv) Refuse to present or disassociate with the presentation of misleading financial statements.
- (v) Resign from the job.

► **Example 15:**

On 1 November 2021, Excitement Limited (EL) entered into a contract with Pride Limited (PL) to manufacture and sell 100 units of a specialized machine at a total consideration of Rs. 300 million. The machines will be delivered in lots of 20 units at the end of each quarter. PL has paid 10% non-refundable consideration in advance while the remaining consideration will be paid in five equal instalments, only after delivery of each lot and not before.

The sales team of EL worked hard and spent 1600 hours costing Rs. 4 million for preparing proposal for the contract. The team was also rewarded with a bonus of Rs. 6 million upon obtaining the contract. Upto year ended 31 December 2021, EL had manufactured 15 units of the machine to be delivered on 31 January 2022.

EL's CFO, a chartered accountant, has suggested that revenue for 15 units should be recognized in 2021 as the machines are of specialized nature and have no alternate use for EL. Further, the sales team cost of Rs. 10 million should be taken to statement of profit or loss in 2021 as this has been fully recovered through 10% advance received from PL.

Required:

- (a) Analyse the treatments suggested by the CFO in respect of the above contract.
- (b) Briefly explain how CFO may be in breach of the fundamental principles of Code of Ethics for Chartered Accountants and how he should respond.

► **Answer:****Part (a)****Revenue recognition**

As per IFRS 15, in cases where entity's performance does not create an asset with alternative use, the entity can recognize revenue over time if the entity also has an enforceable right to payment for performance completed to date. As per agreement, EL is entitled for remaining consideration only after delivery of each lot so revenue should not be recognized over time as suggested by CFO. Proportionate revenue should be recognized upon transferring control i.e. delivery of each lot consisting of 20 machines to PL. Goods manufactured till year-end should be included in EL's closing inventory and the advance received from PL should be shown as contract liability.

Contract cost

The cost of Rs. 4 million for 1600 hours spent is correctly expensed out as such cost would have been incurred whether contract was obtained or not. However, Rs. 6 million paid for bonus should be capitalized as contract cost being an incremental cost of obtaining a contract and should be amortized over contract period on a systematic basis. This contract costs should not be amortized in year 2021 as no related revenue has been recognized in 2021.

Part (b)

In given situation, CFO is in breach of principle of professional competence and due care as CFO has a duty to maintain his professional knowledge and skill at such a level that employer receives a competent service in accordance with applicable technical and professional standards.

CFO should involve in continuing professional development activities which will develop and maintain his capabilities enabling him to perform competently within the professional environment.

4. OBJECTIVE BASED Q&A

- 01.** Which of the following are true about “Ethics”?
- (i) Ethical behaviour is more than obeying laws, rules and regulations.
 - (ii) Ethics is about doing ‘the right thing’.
 - (iii) The accountancy profession is committed to acting ethically and in the public interest.
- (a)** (i) and (ii) only
 - (b)** (i) and (iii) only
 - (c)** (ii) and (iii) only
 - (d)** (i), (ii) and (iii) all
- 02.** ICAP code of ethics is applicable to:
- (i) Members: Accountants in practice
 - (ii) Students
 - (iii) Members: Accountants in business
- (a)** (i) and (ii) only
 - (b)** (i) and (iii) only
 - (c)** (ii) and (iii) only
 - (d)** (i), (ii) and (iii) all
- 03.** Ibrahim is member of ICAP working as a unit accountant. He is a member of a bonus scheme under which, staff receive a bonus of 10% of their annual salary if profit for the year exceeds a trigger level. Ibrahim has been reviewing working papers prepared to support this year’s financial statements. He has found a logic error in a spreadsheet used as a measurement tool for provisions. Correction of this error would lead to an increase in provisions. This would decrease profit below the trigger level for the bonus.
- Which threat to fundamental principle Ibrahim is facing?
- (a)** Self-interest threat
 - (b)** Intimidation threat
 - (c)** Familiarity threat
 - (d)** Advocacy threat
- 04.** Ibrahim is member of ICAP working as a unit accountant. He is a member of a bonus scheme under which, staff receive a bonus of 10% of their annual salary if profit for the year exceeds a trigger level. Ibrahim has been reviewing working papers prepared to support this year’s financial statements. He has found a logic error in a spreadsheet used as a measurement tool for provisions. Correction of this error would lead to an increase in provisions. This would decrease profit below the trigger level for the bonus.
- Which fundamental principle is mainly affected in above situation?
- (a)** Integrity
 - (b)** Objectivity
 - (c)** Professional behaviour
 - (d)** Confidentiality
- 05.** Fortune Limited (FL) is quoted on the stock exchange, with revenue of over Rs. 5 billion per Annum. During the year ended 30 June 2015, FL has incurred a loss of Rs.26 million.
- The Chief Executive is of the view that declaration of loss may result in the bankers’ refusal to renew the credit facility. Therefore, he wants to incorporate certain adjustments in the books of account that will result in a net profit of Rs.100 million. However, the Chief Financial Officer (CFO), who is a chartered accountant, is of the view that all possible adjustments allowed under the applicable accounting regulations have already been considered and incorporated.

Identify TWO categories of threats to the fundamental principles of objectivity or professional competence and due care

- (a) Self-interest threat
- (b) Self-review threat
- (c) Advocacy threat
- (d) Intimidation threat

- 06.** Zia is a Chartered Accountant and works as a financial controller in Unique Engineering Limited (UEL). UEL is currently considering the acquisition of Top Storage Limited (TSL) and Zia is a member of the team which is currently negotiating the acquisition with the management of TSL. After becoming aware of the prospective acquisition, Zia purchased 1,000,000 shares of TSL in the name of his wife and son.

Which of the following fundamental principles of ICAP code of ethics, Zia has breached?

- (a) Objectivity and Confidentiality
- (b) Confidentiality and Professional behaviour
- (c) Objectivity and Professional behaviour
- (d) None of above

- 07.** Zia is a Chartered Accountant and works as a financial controller in Unique Engineering Limited (UEL). UEL is currently considering the acquisition of Top Storage Limited (TSL) and Zia is a member of the team which is currently negotiating the acquisition with the management of TSL. After becoming aware of the prospective acquisition, Zia purchased 1,000,000 shares of TSL in the name of his wife and son.

Which potential threat is involved in above circumstances?

- (a) Self-interest threat
- (b) Self-review threat
- (c) Advocacy threat
- (d) Intimidation threat

- 08.** Atif is a chartered accountant and has been working as Manager – Accounts in an unlisted public company MNZ Limited.

While preparing the financial statements for the year ended 31 December 2016, CFO of MNZ who is also a chartered accountant informed Atif that the directors are considering to have the company listed on Pakistan Stock Exchange.

Consequently, CFO wants to show higher profit and has asked Atif to identify areas where book adjustments can be made. He has also informed that if MNZ is able to list the shares at a price of Rs.35 or more, all managerial staff would be given an additional bonus this year.

Which fundamental principles of ICAP code of ethics have been breached by CFO?

- (a) Integrity
- (b) Objectivity
- (c) Professional behaviour
- (d) All of above

- 09.** Atif is a chartered accountant and has been working as Manager – Accounts in an unlisted public company MNZ Limited.

While preparing the financial statements for the year ended 31 December 2016, CFO of MNZ who is also a chartered accountant informed Atif that the directors are considering to have the company listed on Pakistan Stock Exchange.

Consequently, CFO wants to show higher profit and has asked Atif to identify areas where book adjustments can be made. He has also informed that if MNZ is able to list the shares at a price of Rs.35 or more, all managerial staff would be given an additional bonus this year.

Which threat to fundamental principles is being faced by Atif?

- (a) Self-interest threat
- (b) Self-review threat
- (c) Advocacy threat
- (d) Intimidation threat

10. Integrity means:

- (a) Members should be straightforward and honest in all professional and business relationships.
- (b) Members should not allow bias, conflicts of interest or undue influence of others to override their professional or business judgements.
- (c) Members have a duty to maintain their professional knowledge and skill at such a level that a client or employer receives a competent service, based on current developments in practice, legislation and techniques.
- (d) Members must comply with relevant laws and regulations and should avoid any action which discredits the profession.

11. Objectivity means:

- (a) Members should be straightforward and honest in all professional and business relationships.
- (b) Members should not allow bias, conflicts of interest or undue influence of others to override their professional or business judgements.
- (c) Members have a duty to maintain their professional knowledge and skill at such a level that a client or employer receives a competent service, based on current developments in practice, legislation and techniques.
- (d) Members must comply with relevant laws and regulations and should avoid any action which discredits the profession.

12. Professional competence and due care means:

- (a) Members should be straightforward and honest in all professional and business relationships.
- (b) Members should not allow bias, conflicts of interest or undue influence of others to override their professional or business judgements.
- (c) Members have a duty to maintain their professional knowledge and skill at such a level that a client or employer receives a competent service, based on current developments in practice, legislation and techniques.
- (d) Members must comply with relevant laws and regulations and should avoid any action which discredits the profession.

13. Professional behaviour means:

- (a) Members should be straightforward and honest in all professional and business relationships.
- (b) Members should not allow bias, conflicts of interest or undue influence of others to override their professional or business judgements.
- (c) Members have a duty to maintain their professional knowledge and skill at such a level that a client or employer receives a competent service, based on current developments in practice, legislation and techniques.
- (d) Members must comply with relevant laws and regulations and should avoid any action which discredits the profession.

14. Which of the following are correct responses, where it is not possible to reduce the threats to an acceptable level:
- (i) The member must refuse to remain associated with information which may be misleading
 - (ii) The member must report the matter to audit committee or other governance authority within organisation.
 - (iii) The member may seek legal advice if it seems necessary to report the matter to legal authorities.
- (a) (i) and (ii) only
 - (b) (i) and (iii) only
 - (c) (ii) and (iii) only
 - (d) (i), (ii) and (iii) all
15. Naveed is a chartered accountant, recently employed by KK Limited as deputy to the finance director, Harris (also a chartered accountant). KK Limited is listed on the Pakistan stock exchange.
- On Naveed's first day on the job he met with Harris who said 'Look, keep it to yourself but I am having a second interview next week for a new job. The first thing that I need you to do is to review the financial statements before the auditors arrive. I passed exams few years ago and I am not up to date on all of the little technicalities in IFRS. You should know these better than me and you will know more about what the auditors might focus on. Also keep in mind that you and I would be entitled to bonus if the profits are 10% higher than last year, so I hope you understand that you do not want to find any irregularity in the financial statements. Do well at this and your chances of promotion are quite high.'
- Which of the following fundamental principles, Harris is failing to comply with?
- (a) Integrity
 - (b) Professional competence
 - (c) Professional behaviour
 - (d) All of above
16. Members should be straightforward and honest in all professional and business relationships. Name the fundamental principle indicated by above statement:
- (a) Integrity
 - (b) Objectivity
 - (c) Professional behaviour
 - (d) Confidentiality
17. Members should not allow bias, conflicts of interest or undue influence of others to override their professional or business judgements. Name the fundamental principle indicated by above statement:
- (a) Integrity
 - (b) Objectivity
 - (c) Professional behaviour
 - (d) Confidentiality
18. Members should behave with courtesy and consideration towards all with whom they come into contact in a professional capacity. Name the fundamental principle indicated by above statement:
- (a) Integrity
 - (b) Objectivity
 - (c) Professional behaviour
 - (d) Confidentiality

19. A threat to fundamental principles occurs when a previous judgement needs to be re-evaluated by members responsible for that judgement. Name the type of threat:
- (a) Self-interest threat
 - (b) Self-review threat
 - (c) Advocacy threat
 - (d) Familiarity threat
20. A threat to fundamental principles occurs when, because of a close relationship, members become too sympathetic to the interests of others. Name the type of threat:
- (a) Self-interest threat
 - (b) Self-review threat
 - (c) Advocacy threat
 - (d) Familiarity threat
21. You are working in finance department of Kamyab Motors Limited (KML), a listed company. The draft results of KML for the year are encouraging and are likely to increase KML's share price upon public announcement. Your best friend is heavily in debt and has recently asked for your assistance. He has helped you on numerous occasions in the past. In the context of ICAP's Code of Ethics, you should:
- (a) keep confidentiality about KML's results; however, you can buy KML's shares to use the gain upon disposal to help your friend
 - (b) tell your friend about KML's results and let him decide whether he should buy KML's shares or not
 - (c) keep confidentiality about KML's results by all means
 - (d) keep confidentiality about KML's results but just tell your friend to buy the KML's shares
22. ICAP code of ethics applies to:
- (a) Members only
 - (b) Members and students only
 - (c) Members, students and affiliates only
 - (d) Members, students, affiliates and employees of member firms
23. Which TWO of the following situations might create a self-interest threat?
- (a) Profit/incentive based compensation
 - (b) Reviewing self-prepared reports
 - (c) Fear of losing job
 - (d) Accepting gift of significant value
24. Which of the following statements are correct?
- (I) Self-interest threat arise if a chartered accountant promotes a client's position to the point that the accountant's objectivity is compromised.
 - (II) Professional behaviour means members should not allow bias, conflicts of interest or undue influence of others to override their professional or business judgements.
- (a) Only (I) is correct
 - (b) Only (II) is correct
 - (c) Both are correct
 - (d) None is correct

25. Nasir is working as a director of Rectangle Limited (RL). He is aware of the profit in RL's draft financial statements which would increase share price of RL upon public announcement. He has suggested his friend to purchase shares of RL.

Which of the following fundamental principles of ICAP's code of ethics has been breached by Nasir?

- (a) Integrity
- (b) Confidentiality
- (c) Objectivity
- (d) Professional competence and due care

26. Which of the following statements is/are correct?

- (I) Acceptance of a significant gift would result in familiarity threat to fundamental principles.
- (II) Commercial pressure from outside the employing organization would result in self-review threat to fundamental principles.

- (a) Only (I) is correct
- (b) Only (II) is correct
- (c) Both are correct
- (d) None is correct

27. Asghar Limited (AL) is currently negotiating the acquisition of Basker Limited (BL). Mr. Karim ACA, besides being CFO of AL, is part of the team negotiating the acquisition of BL. After becoming aware of the potential acquisition, Karim purchased 2 million shares of BL in the name of his son.

Which TWO of the following fundamental principles of ICAP's code of ethics is Mr. Karim is in breach of?

- (a) Confidentiality
- (b) Objectivity
- (c) Professional behaviour
- (d) Professional competence

28. The CFO of the company has asked you to submit the quarterly report to the bank for the compliance with loan covenants. He has also instructed you to recognise revenue on orders not yet delivered for increasing profits, to comply with bank loan covenants. The CFO explained that non-compliance of loan covenants will create financial difficulties for the company, which may result in the lay-off of certain employees, including yourself. However, the compliance of loan covenants will ensure that all employees will receive a higher salary increment.

Which of the following potential threats is NOT involved in the above situation?

- (a) Self-interest threat
- (b) Self-review threat
- (c) Intimidation threat
- (d) Advocacy threat

29. Ibrahim is a member of ICAP working as a finance manager. During the preparation of monthly employees' salaries, he noted that last month, he had not included house rent allowance given to all employees in the taxable salary due to a spreadsheet formula error, resulting in lower tax deductions.

Which of the following potential threats are involved in the above situation?

- (a) Self-interest threat and self-review threat
- (b) Self-interest threat and advocacy threat
- (c) Advocacy threat and self-review threat
- (d) Familiarity threat and intimidation threat

30. The following are the examples of situations creating threats to compliance with ICAP's code of ethics:

- (I) Acceptance of a gift or preferential treatment
- (II) A dominant personality attempting to influence decisions of the chartered accountant.

Which threats arise out of above situations, respectively?

(I)	(II)
(a) Familiarity	Intimidation
(b) Advocacy	Advocacy
(c) Self-review	Intimidation
(d) Familiarity	Self-review

ANSWERS

01.	(d)	All three statements are correct.
02.	(d)	Applicable to all listed in the question.
03.	(a)	Ibrahim is facing self-interest threat.
04.	(b)	Objectivity is mainly affected as Ibrahim may not be able to make an independent judgment due to his self-interest threat.
05.	(a) & (d)	Self- interest threat & Intimidation threat
06.	(b)	Zia has breached confidentiality by using inside information for his persona advantage.
07.	(a)	He has not behaved professionally as he disregarded the law and regulations.
08.	(d)	Since Zia is part of a team which is negotiating the price of the shares and he has purchased shares in the name of his wife and son, it creates self-interest threat and he would be reluctant to take any decision that would be against his own interest.
09.	(a)	CFO is in breach of all three fundamental principles.
10.	(a)	Integrity means members should be straightforward and honest in all professional and business relationships.
11.	(b)	Objectivity means members should not allow bias, conflicts of interest or undue influence of others to override their professional or business judgements.
12.	(c)	Professional competence and due care means members have a duty to maintain their professional knowledge and skill at such a level that a client or employer receives a competent service, based on current developments in practice, legislation and techniques.
13.	(d)	Professional behaviour means members must comply with relevant laws and regulations and should avoid any action which discredits the profession.
14.	(d)	All three may be possible course of action.
15.	(d)	Harris is failing all three fundamental principles mentioned.
16.	(a)	Integrity
17.	(b)	Objectivity
18.	(c)	Professional behaviour
19.	(b)	Self-review threat
20.	(d)	Familiarity threat
21.	(c)	Keep confidentiality about KML's results by all means.
22.	(d)	The Code is applicable to members, students, affiliates and employees of member firms.
23.	(a) and (d)	Profit/incentive based compensation Accepting gift of significant value
24.	(d)	None is correct
25.	(b)	Confidentiality

26.	(a)	Only (I) is correct
27.	(a) and (c)	Confidentiality Professional behaviour
28.	(b)	Self-review threat
29.	(a)	Self-interest threat because his own tax was deducted lesser than required. Self-review threat as he would have to accept error in his work.
30.	(a)	(I) Familiarity (II) Intimidation

STICKY NOTES

Fundamental Principles

1.	Integrity
2.	Objectivity
3.	Professional competence and due care
4.	Confidentiality
5.	Professional behaviour

Threats to compliance with fundamental principles

1.	Self-interest threat
2.	Self-review threat
3.	Advocacy threat
4.	Familiarity threat
5.	Intimidation threat

Available safeguards

1.	Discuss the concerns that the information is misleading with superior (e.g. CFO/CEO/audit committee) for appropriate action.
2.	Consult the policies and procedures of the employing organisation (e.g. ethics policy, whistle blowing policy) regarding how to address such matters internally.
3.	Consider consulting with relevant professional body, internal/external auditor, legal counsel, etc.
4.	Consider communication with third parties and/or regulatory and oversight authorities.
5.	If after exhausting all feasible options, the chartered accountant determines that appropriate action has not been taken and he has reason to believe that information is misleading, it might be appropriate to resign from employing organisation.

ESG AND SUSTAINABILITY

IN THIS CHAPTER:

AT A GLANCE

SPOTLIGHT

1. Introduction
2. IFRS Sustainability Disclosure Standard S1
3. Comprehensive Examples
4. Objective Based Q&A

STICKY NOTES

AT A GLANCE

Environmental, Social, and Governance (ESG) factors have become crucial in financial reporting as businesses increasingly recognize their role in sustainable development. ESG encompasses how companies manage environmental impact, social responsibilities, and governance structures, ensuring ethical and responsible operations.

Sustainability reporting allows businesses to demonstrate accountability to stakeholders, highlighting their commitment to long-term value creation.

IFRS S1 provides a structured approach to disclosing sustainability-related financial information, helping companies present relevant, comparable, and reliable data. It emphasizes materiality, requiring companies to report only on sustainability factors that could significantly impact their financial performance and position. This ensures that sustainability disclosures are integrated into the overall financial reporting framework rather than treated as separate, less relevant reports. By aligning sustainability reporting with financial data, IFRS S1 encourages businesses to assess risks and opportunities arising from ESG factors more effectively.

Accountants play a key role in ensuring accurate ESG reporting, helping companies align their sustainability strategies with financial performance. As global regulations increasingly mandate sustainability disclosures, finance professionals must integrate ESG considerations into their assessments, contributing to responsible and informed decision-making in the corporate world.

1. INTRODUCTION

1.1 Environmental, Social and Governance (ESG) factors

The concept of Corporate Citizenship evolved further and took shape of a structured initiative in the corporate world and was termed 'sustainability'. The term smartly communicates the concept behind the process covering most important essence of organization's ability to show resilience and to contribute to the society for a long time or indefinitely. Therefore, information and disclosures in following areas are also important, in addition to reporting financial and economic performance:

- Environmental impacts
- Social responsibilities
- Governance structures

► Example 01:

Kashif Mills Limited (KML) is a manufacturing company is considering switching to renewable energy sources to power its factories. The CFO is hesitant, citing high initial costs. However, one of the director argued that the switch aligns with ESG goals and could enhance the KML's reputation.

Required: What ESG factors should be considered in making this decision, and how might they impact the business?

► ANSWER:

KML should evaluate several key ESG factors:

- (i) **Environmental Impact:** Switching to renewable energy reduces the KML's carbon footprint and dependence on fossil fuels, contributing to climate change mitigation. This aligns with regulatory trends and reduces the risk of future penalties related to emissions.
- (ii) **Social Responsibility:** Using clean energy demonstrates corporate responsibility, attracting environmentally conscious customers and investors. Employees and communities may also support the move, enhancing stakeholder engagement and brand loyalty.
- (iii) **Governance Considerations:** The board must assess the long-term financial implications and risk mitigation strategies. While upfront costs are high, potential savings from energy efficiency, tax incentives, and regulatory benefits could create financial advantages over time.

Ultimately, the decision should balance financial feasibility with ESG commitments. If managed well, shifting to renewable energy could strengthen KML's market position, ensure compliance with emerging sustainability regulations, and lead to long-term profitability.

1.2 Sustainability

The recognition governments and many organizations have given to the importance of sustainability and sustainable development is beginning to change business culture and society. The global challenge is to ensure that organizations develop sustainably to reverse the previous erosion of natural resources, and to improve their environmental, social, and financial performance. This requires radical changes in the way they do business and the way we live our lives.

From an environmental and social perspective, sustainability issues are transforming the competitive landscape, forcing organizations to change the way they think about products, technologies, processes, and business models. From a financial perspective, the primacy of shareholders as owners is giving way to a rational view of maximizing wealth creation that incorporates wider stakeholder perspectives and issues into decision making. Long-term sustainable value creation requires responsible organizations to direct their strategies and operations to achieving sustainable economic, social, and environmental performance.

1.3 Benefits of Sustainability Reporting

An effective sustainability reporting cycle should benefit all reporting organizations.

Internal benefits for companies and organizations can include:

- Increased understanding of risks and opportunities
- Emphasizing the link between financial and non-financial performance
- It provides supports in the development of long term management strategy and policy, and business plans
- It helps in streamlining processes, reducing costs and improving efficiency
- It helps benchmarking and assessing sustainability of performance with respect to laws, norms, codes, performance standards, and voluntary initiatives
- It helps avoiding being implicated in publicized environmental, social and governance failures
- It helps in comparing performance internally, and between organizations and sectors

External benefits of sustainability reporting can include:

- Mitigating – or reversing – negative environmental, social and governance impacts
- Improving reputation and brand loyalty
- Enabling external stakeholders to understand the organization's true value, and tangible and intangible assets
- Demonstrating how the organization influences, and is influenced by, expectations about sustainable development

1.4 Role of Professional accountants

Achieving a sustainable future is only possible if organizations recognize the role that they can and need to play. Effective action by the accountancy profession and professional accountants to better integrate, and account for sustainability is an essential part of that role. Professional accountants are well positioned to help organizations interpret sustainability issues in a relevant way for their organizations, and to integrate those issues into the way they do business.

Professional accountants in all types of organization have a significant role in:

- challenging conventional assumptions of doing business, identifying risks, and seizing opportunities;
- integrating sustainability issues into strategy, operations, and reporting;
- redefining success in the context of achieving sustainable value creation;
- establishing appropriate performance goals and targets;
- encouraging and rewarding the right behaviours; and
- ensuring that the necessary information, analysis, and insights are available to support decision making.

1.5 Regulatory requirements in Pakistan

The Securities and Exchange Commission of Pakistan (SECP) has issued a notification announcing the adoption of IFRS Sustainability Disclosure Standards (IFRS S1 & IFRS S2) for listed companies and SECP-licensed non-listed Public Interest Companies.

Implementation will follow a phase-wise approach requiring IFRS SDS from to be applicable from annual reporting periods beginning on or after July 1, 2025 (Phase – I) and July 1, 2026 (Phase – II) for certain listed companies with high turnover, number of employees and total assets. The remaining listed companies and non-listed Public-Interest Companies licensed or registered with the SECP shall comply from annual reporting periods beginning on or after July 1, 2027 (Phase – III).

Companies are encouraged to adopt these standards earlier. Further, SECP has also notified that sustainability reports shall be approved in the same manner as laid down for approval of financial statements in the Companies Act, 2017.

2. IFRS SUSTAINABILITY DISCLOSURE STANDARD S1

2.1 Objective [IFRS S1: 1 & 3]

IFRS S1 *General Requirements for Disclosure of Sustainability-related Financial Information* requires an entity to disclose information about its sustainability-related risks and opportunities to meet the needs of primary users of financial statements.

This means information about all sustainability-related risks and opportunities that could reasonably be expected to affect the entity's prospects – its cash flows, access to finance or cost of capital over the short, medium or long term.

An entity's ability to deliver financial value for investors is inextricably linked to:

- Stakeholders with whom it works and serves;
- Society in which it operates; and
- Natural resources upon which it draws.

2.2 Scope [IFRS S1: 5, 6 & 8]

An entity shall apply IFRS S1 in preparing and reporting sustainability-related financial disclosures in accordance with IFRS Sustainability Disclosure Standards.

IFRS S1 focuses only on risks and opportunities that could materially impact an entity's future prospects. Entities can apply these standards regardless of whether their financial statements follow IFRS Accounting Standards or other generally accepted accounting principles (GAAP).

2.3 Conceptual Foundations [IFRS S1: 10, 11, 13, 17, 18, 20, 21 & 22]

For sustainability-related financial information to be useful, it must be relevant and faithfully represent what it purports to represent. These are fundamental qualitative characteristics of useful sustainability-related financial information. The usefulness of sustainability-related financial information is enhanced if the information is comparable, verifiable, timely and understandable. These are enhancing qualitative characteristics of useful sustainability-related financial information.

Conceptual Foundation	Guidance in IFRS S1
Fair presentation	A complete set of sustainability-related financial disclosures shall present fairly all sustainability-related risks and opportunities that could reasonably be expected to affect an entity's prospects. To achieve faithful representation, an entity shall provide a complete, neutral and accurate depiction of those sustainability-related risks and opportunities.
Materiality	An entity shall disclose material information about the sustainability-related risks and opportunities that could reasonably be expected to affect the entity's prospects. Information is material if omitting, misstating or obscuring that information could reasonably be expected to influence decisions that primary users of general purpose financial reports make on the basis of those reports, which include financial statements and sustainability-related financial disclosures and which provide information about a specific reporting entity.
Reporting entity	An entity's sustainability-related financial disclosures shall be for the same reporting entity as the related financial statements.

Connected information	IFRS S1 requires to disclose information that enables understanding of connections between: • Sustainability-related risks and opportunities • Disclosure of core content • Sustainability-related financial disclosure and financial statements. These disclosure are: • Prepared for the same reporting entity and reporting period as the related financial statements • Provided at the same time as financial statements and as part of general purpose financial reports • Include data and assumptions that are consistent with the corresponding data and assumptions in the related financial statements, to the extent possible, considering accounting requirements.

► **Example 02:**

A company operates in multiple industries. How does IFRS S1 help determine which sustainability risks and opportunities to disclose?

► **ANSWER:**

IFRS S1 requires companies to disclose only sustainability-related risks and opportunities that could materially impact their financial performance. It emphasizes materiality, ensuring relevant disclosures without overwhelming reports with immaterial information.

► **Example 03:**

A manufacturing firm wants to align its sustainability disclosures with financial reporting. How does IFRS S1 support this?

► **ANSWER:**

IFRS S1 ensures sustainability-related disclosures integrate seamlessly with financial reports, allowing investors and stakeholders to assess ESG risks alongside financial data for informed decision-making.

► **Example 04:**

A conglomerate with diverse business units is unsure whether to aggregate sustainability disclosures. What does IFRS S1 suggest?

► **ANSWER:**

IFRS S1 advises aggregating information to maintain clarity, but disclosures should not obscure material details—especially where different industries face unique sustainability risks.

2.4 Core Content [IFRS S1: 25]

Unless another IFRS Sustainability Disclosure Standard permits or requires otherwise in specified circumstances, an entity shall provide disclosures about:

Core Content Area	Examples
Governance —the governance processes, controls and procedures the entity uses to monitor and manage	• The board of directors' responsibility in guiding and supervising sustainability initiatives, including environmental and social concerns. • The creation of a specialized sustainability committee or task force to enhance oversight and strategic planning.

Core Content Area	Examples
sustainability-related risks and opportunities;	• Management's accountability for sustainability outcomes, reinforced through performance metrics tied to executive compensation. • Frameworks and protocols designed to identify and mitigate sustainability-related risks effectively.
Strategy —the approach the entity uses to manage sustainability-related risks and opportunities;	• Description of how climate change risks, including physical risks such as fire, floods or regulatory changes like carbon pricing, may affect the entity's business activities, supply chain, and financial performance. • Strategies for transitioning to a low-carbon economy, such as investing in sustainable energy solutions or implementing emissions reduction initiatives. • Incorporating emerging sustainability trends—such as the circular economy and biodiversity conservation—into the organization's long-term strategic planning. • The entity's commitment to aligning with global sustainability frameworks, for example, UN Sustainable Development Goals, Paris Agreement, Net Zero Emissions Targets.
Risk management —the processes the entity uses to identify, assess, prioritise and monitor sustainability-related risks and opportunities; and	• Materiality assessment methodology for identifying and prioritising sustainability-related risks. • Use of structured approach to identifying, assessing, managing, and monitoring risks that could impact an organization's objectives, for example, enterprise risk management (ERM) framework. • Mechanisms for tracking emerging risks, such as regulatory changes and supply chain disruptions due to climate-change. • Risk mitigation tactics, like supplier diversification to minimize reliance on high-risk regions affected by climate change.
metrics and targets —the entity's performance in relation to sustainability-related risks and opportunities, including progress towards any targets the entity has set or is required to meet by law or regulation.	• Measurable indicators, including greenhouse gas (GHG) emissions, energy usage and water consumption. • Progress towards sustainability targets, such as reaching net-zero emissions by 2050 or cutting waste by 50% in next 5 years. • Performance metrics tied to diversity and inclusion, such as the proportion of women in executive leadership positions. • Standards-based metrics aligned with industry frameworks like the Task Force on Climate-related Financial Disclosures (TCFD) and the Sustainability Accounting Standards Board (SASB).

► **Example 05:**

A company plans to transition to net-zero emissions by 2050. How should it disclose this under IFRS S1?

► **ANSWER:**

IFRS S1 requires the company to disclose its strategy, key milestones, and associated sustainability-related risks and opportunities to help investors assess long-term financial implications.

► *Example 06:*

The board of directors of a corporation wants to ensure strong sustainability governance. What does IFRS S1 require?

► *ANSWER:*

IFRS S1 mandates entities to disclose governance structures overseeing sustainability, including board responsibilities, sustainability committees, and management accountability through KPIs.

► *Example 07:*

A business faces risks due to changing carbon regulations. How should IFRS S1 guide its disclosure?

► *ANSWER:*

IFRS S1 requires entities to identify climate-related risks that could impact financial prospects, including regulatory shifts like carbon pricing, and disclose mitigation strategies.

► *Example 08:*

A technology company is impacted by new ESG regulations. How should IFRS S1 guide its response?

► *ANSWER:*

IFRS S1 requires entities to disclose emerging risks, regulatory changes, and opportunities, allowing stakeholders to assess their financial and sustainability impact.

► *Example 09:*

A retail business wants to report sustainability KPIs. How should IFRS S1 guide this?

► *ANSWER:*

IFRS S1 encourages reporting specific, measurable sustainability metrics aligned with industry standards, ensuring transparency on targets like emissions reduction or diversity initiatives.

► *Example 10:*

A bank wants to disclose how climate change affects its loan portfolio. How should IFRS S1 guide this?

► *ANSWER:*

IFRS S1 requires financial institutions to report sustainability-related risks that could impact their prospects, such as exposure to climate risks affecting borrowers' ability to repay loans. The bank should disclose its risk assessment and mitigation strategies.

► *Example 11:*

An oil and gas extraction company faces increasing pressure to reduce emissions. How does IFRS S1 help structure its disclosure?

► *ANSWER:*

IFRS S1 mandates transparent disclosure of sustainability-related risks, including regulatory changes and environmental impact. The company should report on carbon reduction strategies and any financial implications of shifting to renewable energy sources.

► *Example 12:*

A software company wants to disclose its approach to responsible data management. How does IFRS S1 apply?

► *ANSWER:*

IFRS S1 emphasizes governance and social responsibility, requiring companies to disclose risks related to data security and privacy regulations that may impact their business operations and financial health.

► *Example 13:*

A retail chain aims to improve sustainable sourcing of materials. How does IFRS S1 guide reporting?

► *ANSWER:*

IFRS S1 requires companies to disclose sustainability strategies that impact financial performance. The retailer should report on ethical supply chain management and risks tied to resource availability.

2.5 General Requirements [IFRS S1: 55, 60, 61, 64, 70 & 72]

Requirement	Details
Source of guidance	In addition to IFRS Sustainability Disclosure Standards, an entity shall refer to and consider the applicability of the disclosure topics in the SASB Standards. Note: The Sustainability Accounting Standards Board (SASB) develops industry-specific standards to help companies disclose sustainability-related risks and opportunities that could impact their financial performance. Additionally, entities may refer to: - the CDSB Framework Application Guidance for water-related and biodiversity-related disclosures; - pronouncements from other standard-setting bodies designed for general-purpose financial reporting; and - the sustainability-related risks and opportunities identified by entities that operate in the same industry(s) or geographical region(s).
Location of disclosure	An entity is required to provide disclosures required by IFRS Sustainability Disclosure Standards as part of its general purpose financial reports. These disclosures can be included in various sections of an entity's general-purpose financial reports, depending on regulatory requirements. These disclosures may be part of management commentary or similar reports, which are mandatory in many jurisdictions. Such reports may be referred to by different names, including management report, management's discussion and analysis, operating and financial review, integrated report, or strategic report.
Timing of reporting	An entity shall report its sustainability-related financial disclosures at the same time as its related financial statements. The entity's sustainability-related financial disclosures shall cover the same reporting period as the related financial statements.
Comparative information	Unless another IFRS Sustainability Disclosure Standard permits or requires otherwise, an entity shall disclose comparative information in respect of the preceding period for all amounts disclosed in the reporting period. If such information would be useful for an understanding of the sustainability-related financial disclosures for the reporting period, the entity shall also disclose comparative information for narrative and descriptive sustainability-related financial information.
Statement of compliance	An entity whose sustainability-related financial disclosures comply with all the requirements of IFRS Sustainability Disclosure Standards shall make an explicit and unreserved statement of compliance. An entity shall not describe sustainability-related financial disclosures as complying with IFRS Sustainability Disclosure Standards unless they comply with all the requirements of IFRS Sustainability Disclosure Standards.

► *Example 14:*

A logistics company is unsure whether SASB Standards apply to its sustainability reporting. What does IFRS S1 require?

► *ANSWER:*

IFRS S1 mandates companies to consider SASB Standards to identify applicable sustainability risks and opportunities. If SASB topics are relevant to its operations, they should be included in disclosures.

► *Example 15:*

A multinational company operates in multiple regions with different ESG regulations. How does IFRS S1 address this?

► *ANSWER:*

IFRS S1 allows entities to consider global sustainability risks while ensuring region-specific disclosures align with applicable ESG frameworks and regulatory requirements.

2.6 Judgements, Uncertainties and errors [IFRS S1: 74, 77 & 83]

Requirement	Detail
Judgements	An entity shall disclose information to enable users of general purpose financial reports to understand the judgements, apart from those involving estimations of amounts, that the entity has made in the process of preparing its sustainability-related financial disclosures and that have the most significant effect on the information included in those disclosures.
Measurement uncertainty	An entity shall disclose information to enable users of general purpose financial reports to understand the most significant uncertainties affecting the amounts reported in its sustainability-related financial disclosures.
Errors	An entity shall correct material prior period errors by restating the comparative amounts for the prior period(s) disclosed unless it is impracticable to do so.

► *Example 16:*

What type of judgements must an entity disclose under IFRS S1 when preparing sustainability-related financial disclosures?

► *ANSWER:*

IFRS S1 requires entities to disclose judgements—excluding estimations—that significantly affect sustainability-related financial disclosures. This ensures users understand key decisions impacting reported information, such as materiality assessments or industry-specific disclosure choices.

► *Example 17:*

How does IFRS S1 address measurement uncertainty in sustainability-related financial disclosures?

► *ANSWER:*

IFRS S1 requires entities to disclose significant uncertainties that affect reported amounts, such as estimates related to carbon emissions or future regulatory impacts. This transparency allows stakeholders to assess the reliability and risks associated with reported sustainability figures.

► *Example 18:*

How should an entity correct material errors in prior period sustainability-related financial disclosures under IFRS S1?

► *ANSWER:*

IFRS S1 mandates restating comparative amounts for prior periods if material errors are identified, unless impracticable. This ensures accuracy and consistency in financial reports, maintaining credibility in sustainability-related disclosures.

3. COMPREHENSIVE EXAMPLES

▶ *Example 19:*

A pharmaceutical company wants to disclose sustainability risks related to drug production. What should it consider under IFRS S1?

▶ *ANSWER:*

IFRS S1 directs firms to assess risks such as supply chain disruptions and environmental concerns in production. The company should report strategies for sustainable manufacturing and minimizing resource scarcity.

▶ *Example 20:*

A car manufacturer is transitioning to electric vehicles (EVs). How should it disclose this under IFRS S1?

▶ *ANSWER:*

IFRS S1 requires disclosures on sustainability opportunities, including EV production benefits, challenges, and financial risks tied to shifting market demand and regulatory incentives.

▶ *Example 21:*

An agricultural business faces risks from climate change affecting crop yields. How does IFRS S1 apply?

▶ *ANSWER:*

IFRS S1 requires companies to disclose climate-related risks that impact financial stability. The agri-business should report mitigation strategies, such as adaptive farming techniques and alternative crop investments.

▶ *Example 22:*

An airline wants to disclose its fuel efficiency strategy. How does IFRS S1 support this?

▶ *ANSWER:*

IFRS S1 mandates disclosure of sustainability-related risks such as carbon emissions and rising fuel costs. The airline should detail efforts to improve fuel efficiency and transition to sustainable aviation fuel.

▶ *Example 23:*

A construction firm needs to report sustainability-related risks in real estate development. How does IFRS S1 guide this?

▶ *ANSWER:*

IFRS S1 requires companies to disclose risks like resource consumption, environmental regulations, and sustainability strategies for green building initiatives.

▶ *Example 24:*

A media company wants to disclose its environmental impact. How does IFRS S1 apply?

▶ *ANSWER:*

IFRS S1 encourages companies to report sustainability-related risks, including energy consumption in digital operations and responsible sourcing in physical media production.

▶ *Example 25:*

[Based on IFRS S1 Illustrative Example 1 – An entity with single line of business]

Applicability of Standards

Entity Y, a regional passenger airline, is required to apply IFRS Sustainability Disclosure Standards to assess sustainability-related risks and opportunities affecting its prospects. It also considers SASB Standards and determines that its business model aligns best with the Airlines SASB Standard. Additionally, Entity Y applies IFRS S2 Climate-related Disclosures to identify climate-related risks and opportunities relevant to its operations.

► **Example 26:**

[Based on IFRS S1 Illustrative Example 1 – An entity with single line of business]

Relevance of disclosure topics

Entity Y applies IFRS S1 and determines that all four disclosure topics in the Airlines SASB Standard are relevant to its operations. It uses these topics to identify sustainability-related risks and opportunities. In its disclosures, Entity Y follows IFRS Sustainability Disclosure Standards, including IFRS S2 for reporting greenhouse gas emissions.

Where no IFRS standard directly applies, it refers to SASB metrics to ensure relevant and reliable reporting. For example, the metrics associated with the 'Accident & Safety Management' disclosure topic include:

- (a) TR-AL-540a.1—Description of implementation and outcomes of a Safety Management System;
- (b) TR-AL-540a.2—Number of aviation accidents; and
- (c) TR-AL-540a.3—Number of governmental enforcement actions of aviation safety regulations.

► **Example 27:**

[Based on IFRS S1 Illustrative Example 1 – An entity with single line of business]

Disclosure

Entity Y ensures its sustainability disclosures align with IFRS S1 by considering relevant technical protocols and metrics. In reporting on its Safety Management System, it details actions taken to mitigate risks, including adjustments to operations, processes, and training. It incorporates disclosure topics and metrics from the Airlines SASB Standard to support strategy and target-setting. Entity Y also confirms compliance with IFRS S1 by applying SASB disclosure metrics in its sustainability-related financial reporting.

► **Example 28:**

[Based on IFRS S1 Illustrative Example 2 – A large conglomerate with diverse activities]

Applicability of Standards

Entity A, a large conglomerate producing electrical and industrial equipment, applies IFRS Sustainability Disclosure Standards while also considering SASB Standards to assess sustainability-related risks and opportunities. Given its diverse operations across multiple sectors—including Health Care, Infrastructure, Resource Transformation, Transportation, and Consumer Goods—it evaluates the relevance of SASB Standards based on its business model. After review, Entity A identifies eight applicable SASB Standards are applicable to its business model and activities.

► **Example 29:**

[Based on IFRS S1 Illustrative Example 2 – A large conglomerate with diverse activities]

Relevance of Disclosure Topics

Although eight SASB Standards are applicable but Entity A determines that some disclosure topics are insignificant and unlikely to impact its future prospects.

Entity A concludes that most of the disclosure topics in the SASB Standards it has considered are applicable to its significant activities. In some cases where it has less significant activities, it finds that only particular disclosure topics in those related industries are applicable. For example, Entity A concludes that most of the disclosure topics that it considered for its transportation and retail businesses are not applicable, due to the relatively small size of these businesses. However, Entity A concludes that incidents related to safety and labour practices in these businesses, although unlikely to have a large effect on its cash flows in the short term, could have a major effect on its reputation over the medium and long term. This reputational risk could affect the performance of its larger businesses, including its ability to attract and retain talent, over a medium- and long-term time horizon, which could be reasonably expected to affect its medium- and long-term cash flows, access to finance and cost of capital. Thus, Entity A considers these topics in identifying sustainability-related risks and opportunities that could reasonably be expected to affect its prospects.

Where no IFRS Sustainability Disclosure Standard directly applies, Entity A considers relevant SASB metrics to ensure accurate and useful sustainability reporting for financial stakeholders.

► *Example 30:*

[Based on IFRS S1 Illustrative Example 2 – A large conglomerate with diverse activities]

Disclosure

Entity A determines that some sustainability-related financial information should be aggregated to maintain clarity, such as its strategy for sourcing critical materials, which is managed centrally. However, it avoids aggregation where it might obscure material information, such as distinguishing recall data for Health Care and Consumer Goods sectors due to differences in technology, production, and market factors. Entity A discloses the SASB Standards, disclosure topics, and metrics used in its sustainability reporting, following IFRS S1 guidelines, including key judgments that significantly impact its disclosures.

4. OBJECTIVE BASED Q&A

01. What is the primary objective of IFRS S1 in sustainability reporting?
 - (a) To provide detailed environmental impact assessments
 - (b) To regulate carbon emissions globally
 - (c) To standardize sustainability-related financial disclosures
 - (d) To enforce corporate social responsibility programs
02. Under IFRS S1, sustainability-related risks should be disclosed if they:
 - (a) Impact an entity's reputation only
 - (b) Could reasonably be expected to affect financial prospects
 - (c) Have public interest but no financial impact
 - (d) Align with a company's sustainability commitments
03. Which framework entities must refer to alongside IFRS S1 for industry-specific disclosures?
 - (a) GRI Standards
 - (b) SASB Standards
 - (c) UN Global Compact
 - (d) IPCC Guidelines
04. How does IFRS S1 integrate sustainability-related financial disclosures into financial reporting?
 - (a) Requires them to be reported separately
 - (b) Treats them as supplementary reports
 - (c) Mandates integration with general-purpose financial statements
 - (d) Limits reporting to climate-related risks only
05. What is the role of materiality in IFRS S1 sustainability disclosures?
 - (a) It allows companies to disclose all environmental risks regardless of relevance
 - (b) It helps filter sustainability factors that significantly impact financial performance
 - (c) It requires disclosure of all sustainability concerns
 - (d) It mandates reporting on ESG goals, whether financially relevant or not
06. Which governance factor must be disclosed under IFRS S1?
 - (a) CEO salary details
 - (b) Board oversight of sustainability matters
 - (c) Employee training initiatives
 - (d) Internal company politics
07. How does IFRS S1 guide companies in selecting sustainability-related disclosure metrics?
 - (a) Companies must create their own metrics
 - (b) Only environmental impact should be measured
 - (c) IFRS S1 encourages use of established frameworks like SASB and TCFD
 - (d) Metrics should not be included in financial statements

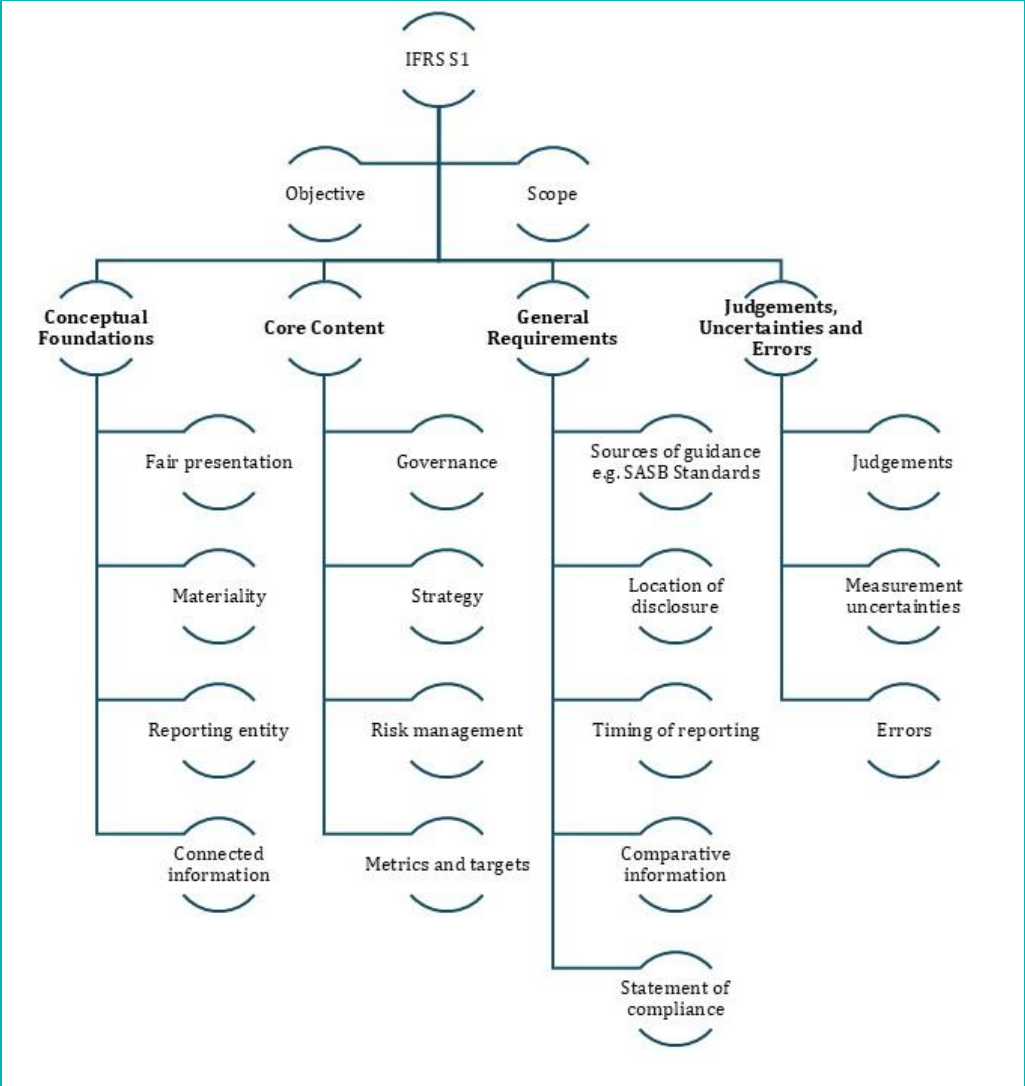
- 08.** What is the purpose of IFRS S1 requiring disclosure of sustainability-related risks?
- (a) To promote corporate social responsibility
 - (b) To help investors assess financial risks linked to sustainability factors
 - (c) To advocate for environmental activism
 - (d) To enhance brand reputation
- 09.** Which sustainability-related risks must entities disclose under IFRS S1?
- (a) Only climate change risks
 - (b) All ESG factors, even if financially insignificant
 - (c) Those that could materially impact cash flow, financing, or capital costs
 - (d) Only social issues
- 10.** If IFRS S1 does not provide a standard for a specific sustainability-related risk, what should entities do?
- (a) Ignore the risk in reporting
 - (b) Refer to SASB or similar industry standards
 - (c) Only disclose voluntary reports
 - (d) Wait for future IFRS updates before reporting
- 11.** A manufacturing company is assessing the financial risks of carbon taxes. How should IFRS S1 guide its disclosure?
- (a) The company should disclose only voluntary sustainability initiatives
 - (b) It should report financial impacts of carbon taxes on operational costs
 - (c) Only climate activists need this information
 - (d) No disclosure is needed unless laws specifically require it
- 12.** A mining company is reviewing its sustainability risks related to water usage. What should be reported under IFRS S1?
- (a) Water consumption metrics and risk mitigation strategies
 - (b) Only environmental benefits of its operations
 - (c) Generic corporate social responsibility statements
 - (d) Sustainability-related risks are optional for mining firms
- 13.** A hotel chain is analysing sustainability-related risks in energy consumption. How should IFRS S1 guide its reporting?
- (a) Disclose energy efficiency strategies and financial impact
 - (b) Ignore energy consumption, as it is not an industry standard
 - (c) Only report sustainability actions if mandated by regulators
 - (d) Focus only on customer satisfaction metrics
- 14.** A clothing brand is facing sustainability risks due to unethical labour practices in its supply chain. What should IFRS S1 require?
- (a) Disclosure of labour practices and their financial impact
 - (b) Avoid reporting to maintain brand image
 - (c) Only disclose environmental factors, not social issues
 - (d) Report sustainability initiatives in a separate voluntary report

15. A telecom provider wants to disclose its ESG strategy under IFRS S1. Which aspect is most relevant?
- (a) Energy efficiency of data centres and infrastructure
 - (b) Personal opinions of board members on sustainability
 - (c) Only community engagement programs
 - (d) General statements without financial analysis
16. A real estate company is assessing the impact of climate change on property values. How should IFRS S1 guide its disclosure?
- (a) Report sustainability factors only if legally required
 - (b) Only disclose rental prices and short-term profit metrics
 - (c) Avoid climate discussions in financial reports
 - (d) Report climate-related risks affecting long-term property valuation
17. A beverage company wants to disclose its sustainability efforts in reducing packaging waste. What does IFRS S1 require?
- (a) No reporting necessary unless investors request it
 - (b) Only disclose water usage, not packaging waste
 - (c) General sustainability commitments without financial details
 - (d) Report waste reduction strategies and financial benefits
18. A university wants to disclose its approach to sustainability under IFRS S1. What should it focus on?
- (a) Energy consumption and impact on operational costs
 - (b) Avoid ESG disclosures since it's not a corporation
 - (c) Only report voluntary sustainability projects
 - (d) Ignore sustainability-related financial disclosures
19. A pharmaceutical company wants to disclose its efforts to reduce emissions in drug manufacturing. What does IFRS S1 require?
- (a) Report emissions reduction strategies with financial implications
 - (b) Only disclose non-financial sustainability commitments
 - (c) Avoid reporting sustainability-related risks
 - (d) Disclose manufacturing practices without financial analysis
20. A media company is reviewing the financial impact of sustainability-related risks in digital operations. What should IFRS S1 guide it to disclose?
- (a) Energy consumption in digital infrastructure
 - (b) Only social responsibility programs
 - (c) General ESG statements without financial analysis
 - (d) Disclose sustainability efforts separately, not in financial reports

ANSWERS

01.	(c)	IFRS S1 aims to ensure relevant, comparable, and reliable sustainability disclosures, integrating them into financial reporting to aid investor decision-making.
02.	(b)	IFRS S1 requires companies to disclose risks and opportunities that materially impact financial performance, ensuring transparency in sustainability reporting.
03.	(b)	IFRS S1 mandates entities to consider SASB Standards for industry-specific sustainability disclosure topics relevant to financial performance.
04.	(c)	IFRS S1 ensures that sustainability-related disclosures are integrated into financial reporting rather than treated as separate, independent reports.
05.	(b)	IFRS S1 emphasizes materiality, ensuring only relevant sustainability risks and opportunities affecting financial prospects are reported.
06.	(b)	IFRS S1 requires entities to disclose governance structures overseeing sustainability risks and strategies to ensure transparency.
07.	(c)	IFRS S1 allows entities to refer to SASB and other frameworks for selecting industry-relevant sustainability-related metrics.
08.	(b)	IFRS S1 ensures transparency in financial risks tied to sustainability concerns, enabling informed decision-making by investors.
09.	(c)	IFRS S1 requires disclosure of sustainability-related risks that could influence financial prospects, including cash flow and capital costs.
10.	(b)	IFRS S1 allows entities to refer to SASB or other frameworks when no specific IFRS Sustainability Disclosure Standard exists for a given risk.
11.	(b)	IFRS S1 mandates disclosure of sustainability-related risks, such as carbon taxes, that could affect an entity's financial prospects.
12.	(a)	IFRS S1 requires disclosure of sustainability risks such as water usage, along with measures taken to manage their financial impact.
13.	(a)	IFRS S1 requires entities to report sustainability strategies, including energy efficiency initiatives, if they affect financial performance.
14.	(a)	IFRS S1 mandates the disclosure of social risks, including unethical labour practices, if they materially affect financial prospects.
15.	(a)	IFRS S1 encourages reporting on sustainability-related risks like energy consumption in telecom operations that impact financial viability.
16.	(d)	IFRS S1 emphasizes disclosing climate-related financial risks, including those affecting real estate investments.
17.	(d)	IFRS S1 mandates disclosure of sustainability risks and opportunities affecting costs, such as waste reduction initiatives.
18.	(a)	IFRS S1 requires organizations, including educational institutions, to report material sustainability-related financial risks and opportunities
19.	(a)	IFRS S1 mandates reporting sustainability initiatives that impact financial prospects, such as emissions reduction efforts.
20.	(a)	IFRS S1 encourages reporting on material sustainability risks, including energy efficiency in media operations that influence financial outcomes.

STICKY NOTES



AT A GLANCE

SPOTLIGHT

STICKY NOTES