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IAS 20 GOVERNMENT ASSISTANCE AND GRANTS

IN THIS CHAPTER:

AT A GLANCE

SPOTLIGHT

1. Definitions and scope
2. Recognition
3. Presentation and disclosure
4. Repayment
5. Comprehensive Examples
6. Objective Based Q&A

STICKY NOTES

AT A GLANCE

IAS 20 Accounting for government grants and disclosure of government assistance requires government grants to be recognised if there is reasonable assurance that the grant will be received and entity will comply with the conditions of the grant. It also requires disclosure of other government assistances except the benefits provided only indirectly through action affecting general trading conditions, such as the provision of infrastructure in development areas or the imposition of trading constraints on competitors.

Government grants shall be recognised as income over the periods necessary to match them with the related costs which they are intended to compensate, on a systematic basis.

Government grants related to assets can be presented as deferred income or deducted from the cost of related assets.

Government grant related to income are amortized in the pattern of future expenses to be incurred, however, government grant if related to an immediate relief requiring no expenses to be incurred in future are included in profit or loss immediately.

The amortization of grant related to income can be presented as other income or deducted from the related expenses.

The non-monetary grants are allowed to be recognised at fair value of the goods/assets received or at nominal value.

Repayment of a grant related to income shall be applied first against any unamortised deferred credit set up in respect of the grant. To the extent that the repayment exceeds any such deferred credit, or where no deferred credit exists, the repayment shall be recognised immediately as an expense.

Repayment of a grant related to an asset shall be recorded by increasing the carrying amount of the asset or reducing the deferred income balance by the amount repayable. The cumulative additional depreciation that would have been recognised to date as an expense in the absence of the grant shall be recognised immediately as an expense.

1 DEFINITIONS AND SCOPE

1.1 Introduction [IAS 20: 1]

Across the globe, the governments provide various types of assistance to businesses in order to achieve various economic objectives such as to promote a specific type of business (say, electric vehicles) or to create employment opportunities. The assistance may be mere an aid by creating ease of doing business or it may be in the form of a financial assistance. The most common form of such assistance is a grant of cash or land to the business entity from local or national government.

IAS 20 is applied in accounting for, and in the disclosure of, government grants and in the disclosure of other forms of government assistance.

1.2 Key definitions [IAS 20: 3 & 6]

Government refers to government, government agencies and similar bodies whether local, national or international.

► Example 01:

As per IAS 20, the following may be considered "Government" if providing financial assistance to an entity:

1.	Federal governments	5.	Small and Medium Enterprises Development Authority
2.	Provincial governments	6.	United Nations
3.	District governments	7.	International Monetary Fund (IMF)
4.	Federal/State Banks	8.	World Health Organisation

Government assistance is action by government designed to provide an economic benefit specific to an entity or range of entities qualifying under certain criteria.

However, government assistance does not include benefits provided only indirectly through action affecting general trading conditions, such as the provision of infrastructure in development areas or the imposition of trading constraints/quotas on competitors.

► Example 02:

JK Limited constructed its factory few years ago in Gwadar. Since then, the government has provided infrastructure by improvement to the general transport and communication network and the supply of improved facilities including water reticulation which is available on an ongoing indeterminate basis for the benefit of an entire local community including JK Limited factory. The business of JK Limited has become much more profitable since provision of these facilities.

Required:

State whether the actions by government in above circumstances are considered government assistance in accordance with IAS 20.

► Answer:

The above actions affecting general trading conditions are not government assistance as per IAS 20.

Government grants are assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity.

However, they exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the entity.

Government grants are sometimes called by other names such as subsidies, subventions, or premiums.

► *Example 03:*

The government provided following to XYZ Limited:

- i. Free technical advice
- ii. Free marketing advice for export to Central Europe
- iii. Free provision of guarantees for export trade with European Countries.
- iv. Supportive government procurement policy that is responsible for significant sales by XYZ Limited.

Required:

Briefly explain whether the above benefits provided by government will be considered as government grant.

► *Answer:*

Items (i) to (iii) are not government grants as these are government assistance that cannot reasonably have a value placed upon them.

Item (iv) is not government grant as it cannot be distinguished from general trading conditions.

Grants related to assets are government grants whose primary condition is that an entity qualifying for them should purchase, construct or otherwise acquire long-term assets. Subsidiary conditions may also be attached restricting the type or location of the assets or the periods during which they are to be acquired or held.

Grants related to income are government grants other than those related to assets.

► *Example 04:*

Identify the following government grants as either “related to assets” or “related to income”.

- i. Grant by Federal Government on condition to import and install new power generation plant in Pakistan.
- ii. Grant by Provincial Government on condition of construction and operation of factory in a specific rural area.
- iii. Grant by sports ministry for conducting a Football League for next three years.
- iv. Grant by ministry of manpower for maintaining low labour turnover in last five years.

► *Answer:*

Item (i) and (ii) are grant related to assets while item (iii) and (iv) are grant related to income.

2 RECOGNITION

2.1 Recognition criteria [IAS 20: 7 & 8]

Government grants, including non-monetary grants at fair value, shall not be recognised until there is reasonable assurance that:

- the entity will comply with the conditions attaching to them; and
- the grants will be received.

Receipt of a grant does not of itself provide conclusive evidence that the conditions attaching to the grant have been or will be fulfilled.

2.2 Non-monetary grant [IAS 20: 23 & 3]

A government grant may take the form of a transfer of a non-monetary asset, such as land or other resources, for the use of the entity. The usual treatment is to record both grant and non-monetary asset at the fair value. The alternative treatment is to record both asset and grant at a nominal amount.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

2.3 Approaches to recognition [IAS 20: 13]

There are two broad approaches to the accounting for government grants:

Capital approach	Under this approach, grant is recognised outside profit or loss (e.g. directly in equity). IAS 20 does not allow this approach, hence not examinable
Income approach	Under this approach, a grant is recognised in profit or loss over one or more period. This approach is applied in accordance with IAS 20.

2.4 Period of recognition [IAS 20: 12, 17, 18 & 20]

Government grants shall be recognised in profit or loss on a systematic basis over the periods in which the entity recognises as expenses the related costs for which the grants are intended to compensate.

The application of above principle may be summarised as follows:

Grant related to income	Grants in recognition of specific expenses These are recognised in profit or loss in the same period as the relevant expenses. Compensation of expenses already incurred or immediate financial support A government grant that becomes receivable as compensation for expenses or losses already incurred or for the purpose of giving immediate financial support to the entity with no future related costs shall be recognised in profit or loss of the period in which it becomes receivable.
	Grants related to depreciable assets These are usually recognised in profit or loss over the periods and in the proportions in which depreciation expense on those assets is recognised. Grants related to non-depreciable assets These may also require the fulfilment of certain obligations and would then be recognised in profit or loss over the periods that bear the cost of meeting the obligations. As an example, a grant of land may be conditional upon the construction of a building on the site and it may be appropriate to recognise the grant in profit or loss over the life of the building.
Grant related to assets	

► *Example 05:*

State the time of recognition of income related to following government grants:

- a) The grant was received for maintaining good working conditions in the past.
- b) The grant was received for maintaining certain working conditions for next three years.
- c) The grant was received for installation of a plant that has useful life of 15 years and being depreciated using 30% reducing balance method.
- d) The grant was awarded to facilitate the acquisition of land subject to condition of building a factory thereon.
- e) The grant was awarded to facilitate the acquisition of land for dairy farming subject to condition of maintaining minimum 70% local employment for next 10 years.

► *Answer:*

- a) Recognise immediately in profit or loss
- b) Recognise in profit or loss over next three years
- c) Recognise in profit or loss over 15 years in proportion to depreciation expense recognised using 30% reducing balance method.
- d) Recognise in profit or loss over the useful life of building.
- e) Recognise in profit or loss over next 10 years.

2.5 Forgivable loan [IAS 20: 3 & 10]

Forgivable loans are loans which the lender undertakes to waive repayment of under certain prescribed conditions.

A forgivable loan from government is treated as a government grant when there is reasonable assurance that the entity will meet the terms for forgiveness of the loan. Until then, such a loan is treated as a liability in accordance with IFRS 9. (IFRS 9 not examinable at this Level)

► *Example 06:*

ABC Pharmaceutical Company received cash from government for a research and development project of a children vaccine. As per the terms of the loan, the cash received from the government shall be waived, if the entity is able to develop the vaccine within 3 years and sell it free of cost for 5 years.

Required:

Briefly explain the accounting treatment of the above loan?

► *Answer:*

This is forgivable loan as the repayment shall be waived, under prescribed conditions i.e. ability to develop vaccine within 3 years and sell it free of cost for 5 years.

If there is **reasonable assurance** to meet the conditions of waiver, this forgivable loan shall be recognised as government grant.

However, if there is expectation that it will take more time than three years in the development or there is expectation of selling the vaccine for a price before 5 years, the loan shall be recognised as a liability in accordance with IFRS 9.

► *Example 07:*

ABC Pharmaceutical Company received cash from government for a research and development project of a children vaccine. As per the terms of the loan, the cash received from the government is repayable in cash only if the entity decides to commercialize the results of the research phase of the project. If the entity decides not to commercialize the results of the research phase, the cash received is not repayable in cash, but instead the entity must transfer to the government the rights to the research.

Required:

Explain whether the loan will be considered a forgivable loan?

► *Answer:*

In this scenario, cash received from the government does not meet the definition of a forgivable loan in IAS 20.

This is because, in this arrangement, the government does not undertake to waive repayment of the loan, but rather to require settlement in cash or by transfer of the rights to the research. The cash received from government shall be recognised as liability in accordance with IFRS 9.

2.6 Benefit of loan at below-market rate of interest [IAS 20: 10A]

The benefit of a government loan at a below market rate of interest is treated as a government grant. The benefit of below market rate of interest shall be measured as the difference between the cash receipt under the government loan and the initial carrying amount of the loan measured and recognised in accordance with IFRS 9.

The entity shall consider the conditions and obligations that have been, or must be, met when identifying the costs for which the benefit of the loan is intended to compensate.

► *Example 08:*

On 1 January 2023, MZ Limited received a loan under government support scheme whereby the loan of Rs. 100,000 is provided at a mark-up rate of 5% per annum whereas market rate of interest for similar loan is 12% annum. The loan is for immediate financial support and is repayable on 31 December 2023.

MZ Limited has determined the initial carrying amount of loan in accordance with IFRS 9 at Rs. 93,750 (i.e. Rs. $100,000 + 5\% \times 100,000 = \text{Rs. } 105,000 \times 1.12^{-1}$)

Required:

Prepare the journal entry on 1 January 2023 on receipt of the above loan.

► *Answer:*

Date	Particulars	Debit	Credit
		Rs.	Rs.
1 Jan 2023	Cash/Bank	100,000	
	Government grant (profit or loss)		6,250
	Loan (liability)		93,750

3 PRESENTATION & DISCLOSURE

3.1 Presentation: grants related to income [IAS 20: 29]

Grants related to income are presented as part of profit or loss, either separately or under a general heading such as 'other income'; alternatively, they are deducted in reporting the related expense.

Presentation method	Journal entries
Present the grant as other income	On receipt/accrual of grant Debit Cash/Receivable Credit Deferred grant On recognition of grant as income in profit or loss Debit Deferred grant Credit Other income (PL)
Present the grant as deduction from related expense	On receipt/accrual of grant Debit Cash/Receivable Credit Deferred grant On recognition of grant as income in profit or loss Debit Deferred grant Credit Expenses (PL)

► **Example 09:**

On 31 December 2020, JKL Limited received grant of Rs. 50,000 towards the cost of training young apprentices. The training program is expected to last for two years.

Actual total cost of training was Rs. 200,000 (70% incurred in year 2021 and 30% incurred in year 2022 as originally planned).

Required: Prepare financial statement extracts under both methods of presentation. Year end is 31 December.

► **Answer:**

Presentation method: Other income	2020	2021	2022
Statement of financial Position (extracts)	Rs.	Rs.	Rs.
Non-current liabilities: Deferred grant	15,000	-	-
Current liabilities: Deferred grant	35,000	15,000	-
Statement of profit or loss (extracts)			
Training costs	-	(140,000)	(60,000)
Other income: training grant	-	35,000	15,000

Presentation method: Net expense	2020	2021	2022
Statement of financial Position (extracts)	Rs.	Rs.	Rs.
Non-current liabilities: Deferred grant	15,000	-	-
Current liabilities: Deferred grant	35,000	15,000	-
Statement of profit or loss (extracts)			
Training costs (net)	-	(105,000)	(45,000)

3.2 Presentation: grants related to assets [IAS 20: 24]

Government grants related to assets, including non-monetary grants at fair value, shall be presented in the statement of financial position either by setting up the grant as deferred income or by deducting the grant in arriving at the carrying amount of the asset.

Presentation method	Journal entries
Setting up the grant as deferred income	On acquisition of asset
	Debit Non-current asset (PPE, etc.)
	Credit Bank
	On receipt/accrual of grant
	Debit Cash/Receivable
	Credit Deferred grant
	Period end depreciation expense
	Debit Depreciation expense
	Credit Accumulated depreciation (PPE, etc.)
	Period end amortisation of deferred grant
	Debit Deferred grant
	Credit Profit or loss
Deducting the grant in arriving at the carrying amount of an asset	On acquisition of asset
	Debit Non-current asset (PPE, etc.)
	Credit Bank
	On receipt/accrual of grant
	Debit Cash/Receivable
	Credit Non-current asset (PPE, etc.)
	Period end depreciation expense (reduced)
	Debit Depreciation expense
	Credit Accumulated depreciation (PPE, etc.)

► **Example 10:**

On 1 January, 2021 ABC Limited acquired a plant at a cost of Rs. 600 million and received a grant of Rs. 60 million on the same date.

The plant is to be depreciated on straight line basis over its useful life of 3 years and Rs. 120 million residual value. There is reasonable assurance that conditions of the grant shall be complied with.

Required:

Prepare financial statement extracts under both methods of presentation. Year end is 31 December.

► **Answer:**

Presentation: Separate deferred income	2021	2022	2023
Statement of financial Position (extracts)	Rs. m	Rs. m	Rs. M
PPE (Cost)	600	600	600
Accumulated depreciation	(160)	(320)	(480)
	440	280	120
Non-current liabilities: Deferred grant	20	-	-
Current liabilities: Deferred grant	20	20	-
Statement of profit or loss (extracts)			
Depreciation $[(600 - 120) / 3 \text{ years}]$	(160)	(160)	(160)
Other income: grant $[60 / 3 \text{ years}]$	20	20	20

Method 2: Deduct from asset's carrying amount	2021	2022	2023
Statement of financial Position (extracts)	Rs. m	Rs. m	Rs. M
PPE (Cost) $[600 - 60]$	540	540	540
Accumulated depreciation	(140)	(280)	(420)
	400	260	120
Statement of profit or loss (extracts)			
Depreciation $[(540 - 120) / 3 \text{ years}]$	(140)	(140)	(140)

3.3 Disclosure [IAS 20: 36 & 39]

The following matters shall be disclosed:

- the accounting policy adopted for government grants, including the methods of presentation adopted in the financial statements;
- the nature and extent of government grants recognised in the financial statements and an indication of other forms of government assistance from which the entity has directly benefited; and
- unfulfilled conditions and other contingencies attaching to government assistance that has been recognised.

Government assistance may be significant so that disclosure of the nature, extent and duration of the assistance is necessary in order that the financial statements may not be misleading.

4 REPAYMENT OF GOVERNMENT GRANT

4.1 Change in accounting estimate [IAS 20: 32]

A government grant that becomes repayable shall be accounted for as a change in accounting estimate. It means that repayment is to be recorded in the year the grant becomes repayable and prior period adjustments are not made.

4.2 Repayment of a grant related to income [IAS 20: 32]

First, debit unamortised balance of deferred grant, and any excess is recognised as expense in profit or loss.

Journal entry

Debit	Deferred grant (to the extent of unamortised balance)
Debit	Profit or loss (excess, if any)
Credit	Bank

► Example 11:

On 1 January 2021 Jam Limited (JL) received a cash grant of Rs. 1.5 million towards the cost of employing a blockchain analyst on a new project for a 5 years' period.

The grant is repayable in full if the project is not completed. The analyst was employed and the project commenced from the 1 January 2021.

On 20th January 2023, the project was cancelled and the grant had to be repaid in full.

Required:

Journal entries from 1 January 2021 till the date of repayment.

► Answer:

Journal entries

Date	Particulars	Debit Rs.	Credit Rs.
1 Jan 2021	Cash	1,500,000	
	Deferred grant		1,500,000
31 Dec 2021	Deferred grant	300,000	
	Profit or loss		300,000
31 Dec 2022	Deferred grant	300,000	
	Profit or loss		300,000
20 Jan 2023	Deferred grant [1,500,000 – 300,000 x 2 years]	900,000	
	Profit or loss (balancing)	600,000	
	Cash		1,500,000

4.3 Repayment of grant related to asset [IAS 20: 32 & 33]

Repayment of a grant related to an asset shall be recognised by increasing the carrying amount of the asset or reducing the deferred income by the amount repayable.

The cumulative additional depreciation that would have been recognised in profit or loss to date in the absence of the grant shall be recognised immediately in profit or loss.

Presentation method	Journal entries on repayment	
Setting up the grant as deferred income	Debit	Deferred grant (balancing figure)
	Debit	Profit or loss (cumulative additional depreciation, if any)
	Credit	Bank
Deducting the grant in arriving at the carrying amount of an asset	Debit	Non-current asset (balancing figure)
	Debit	Profit or loss (cumulative additional depreciation, if any)
	Credit	Bank

Circumstances giving rise to repayment of a grant related to an asset may require consideration to be given to the possible impairment of the new carrying amount of the asset.

► **Example 12:**

On 1st January 2020, Deep Water Limited installed a non-current asset with a cost of Rs. 500,000 and received a grant of Rs. 100,000 in relation to that asset. The asset is being depreciated on a straight-line basis over five years.

Grant was repaid on 1st January 2022 in full on failing to meet the conditions.

Required:

Journal entries for the year 2020 to 2022 (under both methods of presentation).

► **Answer:**

Presentation method: Setting up the grant as deferred income

Date	Particulars	Debit Rs. 000	Credit Rs.000
1 Jan 2020	PPE	500	
	Cash		500
1 Jan 2020	Cash	100	
	Deferred grant		100
31 Dec 2020	Depreciation [500 / 5 years]	100	
	PPE		100
31 Dec 2020	Deferred grant [100 / 5 years]	20	
	P&L		20
31 Dec 2021	Depreciation [500 / 5 years]	100	
	PPE		100

Date	Particulars	Debit Rs. 000	Credit Rs.000
31 Dec 2021	Deferred grant [100 / 5 years]	20	
	P&L		20
1 Jan 2022	Deferred grant	60	
	Profit or loss [100 / 5 x 2 years]	40	
	Cash		100
31 Dec 2022	Depreciation [300 / 3 years]	100	
	PPE		100

Presentation method: Deducting the grant in the carrying amount of an asset

Date	Particulars	Debit Rs. 000	Credit Rs.000
1 Jan 2020	PPE	500	
	Cash		500
1 Jan 2020	Cash	100	
	PPE		100
31 Dec 2020	Depreciation [400 / 5 years]	80	
	PPE		80
31 Dec 2021	Depreciation [400 / 5 years]	80	
	PPE		80
1 Jan 2022	PPE	60	
	Profit or loss [100 / 5 x 2 years]	40	
	Cash		100
31 Dec 2022	Depreciation [(240 + 60) / 3 years]	100	
	PPE		100

► **Example 13:**

On 1st January 2020, Deep Sea Limited installed a non-current asset with a cost of Rs. 500,000 and received a grant of Rs. 100,000 in relation to that asset. The asset is being depreciated on a straight-line basis over five years.

Grant of Rs. 90,000 was repaid on 1st January 2022 on failing to meet the few conditions of grant.

Required:

Journal entries for the year 2020 to 2022 (under both methods of presentation).

► Answer:

Presentation method: Setting up the grant as deferred income

Date	Particulars	Debit Rs. 000	Credit Rs.000
1 Jan 2020	PPE	500	
	Cash		500
1 Jan 2020	Cash	100	
	Deferred grant		100
31 Dec 2020	Depreciation [500 / 5 years]	100	
	PPE		100
31 Dec 2020	Deferred grant [100 / 5 years]	20	
	P&L		20
31 Dec 2021	Depreciation [500 / 5 years]	100	
	PPE		100
31 Dec 2021	Deferred grant [100 / 5 years]	20	
	P&L		20
1 Jan 2022	Deferred grant	54	
	Profit or loss [90 / 5 x 2 years]	36	
	Cash		90
31 Dec 2022	Depreciation [300 / 3 years]	100	
	PPE		100
31 Dec 2022	Deferred grant [(60-54) / 3 years]	2	
	P&L		2

Presentation method: Deducting the grant in the carrying amount of an asset

Date	Particulars	Debit Rs. 000	Credit Rs.000
1 Jan 2020	PPE	500	
	Cash		500
1 Jan 2020	Cash	100	
	PPE		100
31 Dec 2020	Depreciation [400 / 5 years]	80	
	PPE		80
31 Dec 2021	Depreciation [400 / 5 years]	80	
	PPE		80
1 Jan 2022	PPE	54	
	Profit or loss [90 / 5 x 2 years]	36	
	Cash		90
31 Dec 2022	Depreciation [(240+54) / 3 years]	98	
	PPE		98

5 COMPREHENSIVE EXAMPLES

► Example 14:

Adeel Limited (AL) imported and installed a plant at total cost of Rs. 250 million on 1 January 2021. The plant has useful life of 3 years. The residual value of plant at the end of useful life has been estimated at Rs. 128 million. Based on this AL has correctly determined depreciation rate of 20% under reducing balance method that it uses for depreciating plant and machineries.

On the same date, AL also received a government grant of Rs. 60 million towards this plant. It is reasonably certain that AL will comply with the conditions of this grant. AL has policy to present the plant and grant separately in its financial statements.

AL year-ends on 31 December.

Required:

Prepare journal entries in the books of AL in respect of above plant from 1 January 2021 to 31 December 2023 (Journal entry for disposal of plant is not required).

► Answer:

Tutorial note: Grants related to depreciable assets are usually recognised in profit or loss over the periods and in the proportions in which depreciation expense on those assets is recognised (IAS 20.17).

Year	Annual depreciation	Rs. m	Grant income	Rs. M
2021	Rs. 250m x 20%	50	Rs. 60m x 50/122	24.59
2022	Rs. 50m x 80%	40	Rs. 60m x 40/122	19.67
2023	Rs. 40m x 80%	32	Rs. 60m x 32/122	15.74
	Total	122	Total	60

Journal entries

Date	Particulars	Debit Rs. m	Credit Rs. M
1 Jan 2021	Property, plant & equipment	250	
	Bank		250
	Bank	60	
	Deferred government grant		60
31 Dec 2021	Depreciation	50	
	Accumulated depreciation		50
	Deferred government grant	24.59	
	Profit or loss		24.59
31 Dec 2022	Depreciation	40	
	Accumulated depreciation		40
	Deferred government grant	19.67	
	Profit or loss		19.67

Date	Particulars	Debit Rs. m	Credit Rs. M
31 Dec 2023	Depreciation	32	
	Accumulated depreciation		32
	Deferred government grant	15.74	
	Profit or loss		15.74

► **Example 15:**

Kashif Limited (KL) imported and installed a plant at total cost of Rs. 250 million on 1 January 2021. The plant has useful life of 3 years. The residual value of plant at the end of useful life has been estimated at Rs. 128 million. Based on this KL has correctly determined depreciation rate of 20% under reducing balance method that it uses for depreciating plant and machineries.

On the same date, KL also received a government grant of Rs. 60 million towards this plant. It is reasonably certain that KL will comply with the conditions of this grant. KL has policy to present the grant as deduction from the carrying amount of the plant in its financial statements.

KL year-ends on 31 December.

Required:

Prepare journal entries in the books of KL in respect of above plant from 1 January 2021 to 31 December 2023 (Journal entry for disposal of plant is not required).

► **Answer:**

Tutorial note: Grants related to depreciable assets are usually recognised in profit or loss over the periods and in the proportions in which depreciation expense on those assets is recognised (IAS 20.17).

Year	Annual depreciation	Rs. m	Grant income	Rs. m	Reduced Depreciation Rs. M
2021	Rs. 250m x 20%	50	Rs. 60m x 50/122	24.59	25.41
2022	Rs. 50m x 80%	40	Rs. 60m x 40/122	19.67	20.33
2023	Rs. 40m x 80%	32	Rs. 60m x 32/122	15.74	16.26
	Total	122	Total	60	62

Journal entries

Date	Particulars	Debit Rs. m	Credit Rs. M
1 Jan 2021	Property, plant & equipment	250	
	Bank		250
	Bank	60	
	Property, plant & equipment		60
31 Dec 2021	Depreciation	25.41	
	Accumulated depreciation		25.41

Date	Particulars	Debit Rs. m	Credit Rs. M
31 Dec 2022	Depreciation	20.33	
	Accumulated depreciation		20.33
31 Dec 2023	Depreciation	16.26	
	Accumulated depreciation		16.26

► **Example 16:**

Discuss how the following should be dealt with in the financial statements of relevant entities according to IAS 20 Accounting for Government Grants and Disclosure of Government Assistance:

- The government makes a grant to an entity which is planning to develop teaching software for children with learning difficulties. The purpose of the grant is to help the entity to meet its general financing requirement in the initial phase. There are no further conditions attached to the grant.
- A manufacturing entity sets up a plant in an area of high unemployment. A government grant of Rs. 4 million is received with a condition that the grant is repayable in full if the number of its employees fell below 100 at any time during the next four years. It is highly probable that the entity will comply with the condition attached to the grant.
- Free technical advice has been provided by the government's export promotion department to help an exporter to market his new technology in North America.

► **Answer:**

Part (a)

The grant has been provided for the purpose of giving immediate financial support to the entity with no further conditions, so this grant should be immediately recognised in profit or loss in full in the period in which the entity qualifies to receive it (when it is receivable) with disclosure to ensure that its effect is clearly understood.

Part (b)

Since there is reasonable assurance that conditions attaching to the grant will be met, the grant is recognised in statement of profit or loss over the four year period in which the entity incurs the costs of employing 100 people. Amount taken to statement of profit or loss may be either be presented as other income or shown as deduction from the related expense. The remaining amount of grant will be presented as deferred income under liabilities in the balance sheet.

Part (c)

Free technical advice is government assistance that cannot reasonably have a value placed upon it and therefore should not be recognised. However, an indication of such assistance should be disclosed in financial statements.

► **Example 17:**

You have recently joined as the finance manager of Corv Limited (CL). While reviewing the draft financial statements for the year ended 31 December 2020 prepared by the junior accountant, you have noted that in January 2020, Government allotted an industrial plot to CL at a prime location subject to the condition that CL will establish a factory. CL constructed the factory building which was available for use on 1 October 2020. Due to delay in recruitment of key factory employees, the production activities will commence on 15 March 2021.

The accountant has not recorded the land as it was given free of cost. While the factory building is still appearing in capital work in progress as production activities will commence on 15 March 2021.

The accounting policy of CL is to carry land and building at fair value (wherever permitted by IFRS).

Required:

Discuss how the above issue should be dealt in the financial statements of CL for the year ended 31 December 2020 in accordance with the requirements of IFRSs.

► *Answer:*

The accounting treatment adopted by accountant for not recording land is incorrect. Allotment of land by Government is a transfer of a non-monetary asset and should be considered as a government grant. Such non-monetary grant may be recorded at fair value or at a nominal value. As per CL's policy, fair value of the land should be assessed and reported in the financial statements under the head property, plant and equipment (PPE). The grant was made subject to construction of factory so the resulting deferred income should be recognised in income on a systematic basis over the useful life of the factory building.

The factory building should also be transferred from capital work in progress to PPE account as the building is available for use on 1 October 2020. Further depreciation on building should also be charged from same date i.e. 1 October 2020.

► *Example 18:*

Discuss how the following should be dealt with in the current year's financial statements of relevant entities in accordance with IAS 20.

- a) Xero Limited (XL) received a government grant to setup a plant in an under-developed rural area three years ago. One of the conditions of the grant was that XL will maintain a minimum of 200 employees during the next five years. However, due to worsening economic conditions, XL failed to maintain 200 employees and the full grant became repayable immediately in the current year.

XL has been presenting the grant in statement of financial position by deducting the grant in arriving at the carrying value of the plant.

- b) One Limited received a loan from government in the current year at an interest rate of 5% per annum. The prevailing market interest rate is 12% per annum. The only condition attached to the loan is that it should be used for acquisition of textile machinery.

► *Answer:***Part (a)**

- When a government grant becomes repayable it is accounted for as a change in accounting estimate.
- As the grant was presented as deduction from related plant, its repayment would be recognised by increasing the carrying value of the plant
- The cumulative additional depreciation that would have been recognised in profit or loss to date in the absence of the grant must be recognised immediately in profit or loss.
- Also the circumstances giving rise to repayment of the grant might indicate the possible impairment of the new carrying amount of the plant.

Part (b)

- The benefit of the government loan at a below market rate of interest is treated as a government grant. The loan shall be recognised and measured as per IFRS 9.
- Government grant should be recorded as the difference between the initial carrying amount of the loan and the proceeds received.
- As the primary condition for the loan is acquisition of textile machinery, the grant should be considered as grant related to asset and should be recognised in profit or loss over the life of the machinery.
- The grant may be presented in the statement of financial position by setting up the grant as deferred income or by deducting the grant in arriving at the carrying value of the machinery.

► **Example 19:**

During the year ended 30 June 2023, Katie received three grants, the details of which are set out below:

- On 1 September 2022, a grant of Rs. 40,000 from local government. This grant was in respect of training costs of Rs. 70,000 which Katie had incurred.
- On 1 November 2022 Katie bought a machine for Rs. 350,000. A grant of Rs. 100,000 was received from central government in respect of this purchase. The machine, which has a residual value of Rs. 50,000, is depreciated on a straight-line basis over its useful life of five years.
- On 1 June 2023, a grant of Rs. 100,000 from local government. This grant was in respect of relocation costs that Katie had incurred moving part of its business from outside the local area. The grant is repayable in full unless Katie recruits ten employees locally by the end of 30 June 2023. Katie is finding it difficult to recruit as the local skill base does not match the needs of this part of the business.

Required:

Show how the above transactions should be reflected in the financial statements of Katie for the year ended 30 June 2023. Where any accounting standards allow a choice, you should show all possible options.

► **Answer:****Presentation: Separate deferred grant / other income**

Statement of financial position as at 30 June 2023		Rs.
Non-current assets		
Property, plant & equipment [Rs. 350,000 – 40,000 accumulated dep.]	(b)	310,000
Non-current liabilities: deferred grant [100,000 – 13,333 PL – 20,000 CL]	(b)	66,667
Current liabilities: deferred grant [Rs. 100,000 / 5 years]	(b)	20,000
Current liabilities: grant repayable	(c)	100,000
Statement of profit or loss for the year ended 20 June 2023		
Training expense	(a)	(70,000)
Grant related to training expense	(a)	40,000
Depreciation on machine [Rs. (350,000 – 50,000) / 5 years x 8/12]	(b)	(40,000)
Amortisation of deferred grant [Rs. 100,000 / 5 years x 8/12]	(b)	13,333

Presentation: Deduct from carrying amount / net expense

Statement of financial position as at 30 June 2023		Rs.
Non-current assets		
Property, plant & equipment [Rs. 350,000 – 100,000 grant – 26,667 Dep.]	(b)	223,333
Current liabilities: grant repayable	(c)	100,000
Statement of profit or loss for the year ended 20 June 2023		
Training expense [Rs. 70,000 – 40,000]	(a)	(30,000)
Depreciation on machine [Rs. ((350,000 – 50,000) - 100,000) / 5 x 8/12]	(b)	(26,667)

Tutorial note:

The grant (a) is related to income and it shall be immediately recognised in profit or loss as it relates to expenditure already incurred. Katie may present the training cost expense of Rs. 70,000 and grant income of Rs. 40,000 separately. Alternatively, it may present the training cost expense of Rs. 30,000 (net).

The grant (b) is related to asset and it shall be recognised in profit or loss in line with depreciation on related asset.

The amount of Rs. 100,000 received for grant (c) has conditions attached to it. In such a situation, IAS 20 states that grants should not be recognised until there is reasonable assurance that the entity will comply with any conditions attaching to the grant. Since Katie is struggling to recruit, and there is only one month left for recruitment to meet these conditions, then it does not seem that there is 'reasonable assurance'. Hence the grant should not be recognised as such, but should be held in current liabilities, pending repayment.

► **Example 20:**

Discuss how the following should be dealt with in the financial statements of relevant entities according to IAS 20:

- A government grant of Rs. 25 million was received by an entity in 2022 for the damage to its head office building caused by the flood in December 2021. As a result of damage, an impairment loss of Rs. 21 million was recognised in 2021.
- A manufacturing entity established a plant in an area with high illiteracy rate and received a government grant of Rs. 40 million. The grant received was equivalent to two years' salaries of the 50 local persons employed by the entity. The grant is repayable in full if the number of these employees falls below 50 at any time during the next five years. It is highly probable that the entity will comply with the condition attached to the grant.
- Government built an alternate road to the industrial zone, in which an entity's factory is situated. The new road has reduced the distance to the market and would result in an annual saving of transportation costs of Rs. 3 million for the entity.

► **Answer:**

- Since this grant has been given as compensation for expenses or losses that were already incurred in 2021, it should be recorded in profit or loss in 2022. The amounts reported in 2021 should not be restated.
- Since there is reasonable assurance that conditions attaching to the grant will be met, this is a grant related to income which should be recognised in the statement of profit or loss over the 5 years in which the entity incurs the costs of employing 50 local people. Amount taken to the statement of profit or loss may either be presented as other income or shown as deduction from the related expense. The remaining amount of grant will be presented as deferred income under liabilities in the statement of financial position.
- The saving of transportation cost is not a government grant as no transfer of resources has been made. Further, it is not considered as government assistance as the benefits is provided indirectly to the entity. Building of the road is basically a provision of better trading conditions to all entities operating in the industrial zone. Consequently, the effect of saving of transportation cost need not be accounted for nor disclosed in the financial statements of the entity.

► **Example 21:**

Shark Limited (SL) established a desalination plant at a total cost of Rs. 300 million in a coastal area to provide clean drinking water. The plant started commercial production on 1 January 2019 and had an estimated useful life and residual value of six years and Rs. 30 million, respectively.

On 1 January 2020, SL received a government grant of Rs. 160 million towards the cost of the plant. The sanction letter stated that SL should also operate the plant for at least 300 days in each of the next three years. At inception, there was a reasonable assurance that condition of the grant shall be complied with. SL recorded the grant as deferred income.

In 2022, the plant was not operated for 120 days. Owing to this, the government issued a notice to SL for repayment of Rs. 100 million. Accordingly, the amount was repaid by SL immediately.

Required:

Prepare relevant extracts from SL's statement of profit or loss for the year ended 31 December 2022, and statement of financial position as at that date. (Show comparative figures)

► *Answer:*

Shark Limited

Extracts from statement of profit or loss	2022	2021
For the year ended 31 December 2022	Rs. m	Rs. m
Depreciation expense $(300-30) \div 6$ years	(45)	(45)
Government grant income $(96-60) \div 3$; $(160 \div 5)$	12	32
Loss on repayment of government grant $100 \div 5 \times 2$	(40)	-

Extracts from statement of financial position	2022	2021
As on 31 December 2022	Rs. m	Rs. m
Non-current assets:		
Desalination plant	300	300
Accumulated depreciation (45×4) ; (45×3)	(180)	(135)
	120	165
Non-current liabilities:		
Deferred government grant $96 - (100 - 40) - 12 - 12$; $160 - (32 \times 2) - 32$	12	64
Current liabilities:		
Deferred government grant	12	32

1. OBJECTIVE BASED Q&A

1. On 1 January 2021 Aim Limited (AL) received Rs. 1,000,000 from the local government on the condition that they employ at least 150 persons each year for the next 4 years.

Due to an economic downturn and reduced consumer demand on 1 January 2022, AL no longer needed to employ any more staff and the conditions of the grant required full repayment.

What should be recorded in the financial statements on 1 January 2022?

- a) Reduce deferred income balance by Rs. 750,000
 - b) Reduce deferred income by Rs. 750,000 and recognise a loss of Rs. 250,000
 - c) Reduce deferred income by Rs. 1,000,000
 - d) Reduce deferred income by Rs. 1,000,000 and recognise a gain of Rs. 250,000
2. Which of the following are acceptable methods of accounting for a government grant relating to an asset in accordance with IAS 20 Accounting for Government Grants and Disclosure of Government Assistance?
- i. Set up the grant as deferred income
 - ii. Credit the amount received to profit or loss
 - iii. Deduct the grant from the carrying amount of the asset
 - iv. Add the grant to the carrying amount of the asset
- a) (i) and (ii)
 - b) (ii) and (iv)
 - c) (i) and (iii)
 - d) (iii) and (iv)
3. On 1 January 2019, Boom Limited (BL) received Rs. 2,000,000 from the local government on the condition that they employ at least 200 staff each year for the next 4 years. On this date, it was virtually certain that BL would meet these requirements.

However, on 1 January 2022, due to an economic downturn and reduced consumer demand, BL no longer needed to employ 100 staff. The conditions of the grant required half repayment.

What should be recorded in the financial statements on 1 January 2022 for repayment of grant?

- a) Debit Deferred grant by Rs. 500,000 and PL by Rs. 500,000
 - b) Debit Deferred grant by Rs. 250,000 and PL by Rs. 250,000
 - c) Debit Deferred grant by Rs. 1,500,000 and PL by Rs. 500,000
 - d) Debit Deferred grant by Rs. 500,000 and PL by Rs. 1,500,000
4. Which TWO of the following statements about IAS 20 Accounting for Government Grants and Disclosure of Government Assistance are true?
- a) A government grant related to the purchase of an asset must be deducted from the carrying amount of the asset in the statement of financial position.
 - b) A government grant related to the purchase of an asset should be recognised in profit or loss over the life of the asset.
 - c) Free marketing advice provided by a government department is excluded from the definition of government grants.
 - d) Any required repayment of a government grant received in an earlier reporting period is treated as prior period adjustment.

5. A manufacturing entity receives a grant of Rs. 1,000,000 towards the purchase of a machine on 1 January 2013. The grant will be repayable if the entity sells the asset within 4 years, which it does not intend to do. The asset has a useful life of 5 years.

What is the deferred income liability balance at 30 June 2013?

- a) Rs. 750,000
- b) Rs. 800,000
- c) Rs. 875,000
- d) Rs. 900,000

6. A company receives a government grant of Rs. 500,000 on 1 April 2017 to facilitate purchase on the same day of an asset which costs Rs. 750,000. The asset is depreciated on a 30% reducing balance basis assuming that the residual value is negligible. Company policy is to account for all grants received as deferred income.

What amount of income will be recognised in respect of the grant in the year to 31 March 2019?

- a) Rs. 500,000
- b) Rs. 150,000
- c) Rs. 350,000
- d) Rs. 105,000

7. A manufacturing entity is entitled to a grant of Rs. 3 million for creating 50 jobs and maintaining them for three years. Rs. 1.5m is received when the jobs are created and the remaining Rs. 1.5m is receivable after three years, provided that the 50 jobs are still in existence. The entity creates 50 jobs at the beginning of year one and there is reasonable assurance that this level of employment will be maintained.

What is the amount of liability (net) to be presented in statement of financial position as at the end of the first year?

- a) Rs. 500,000
- b) Rs. 1,000,000
- c) Rs. 1,500,000
- d) Rs. 3,000,000

8. If a government grant must be repaid, then it is;

- a) An error
- b) A change in accounting policy
- c) A change in accounting estimate
- d) A new transaction

9. If an entity receives a non-monetary asset as a grant, this is accounted for at the;

- a) Market value
- b) Fair value
- c) Net realizable value
- d) Present value

10. Which of the following are not considered government assistance in accordance with IAS 20?

- a) Provision of infrastructure in development areas
- b) Employment grants
- c) Subsidized loans
- d) Forgivable loans

11. Which of the following is not a correct treatment of government grants related to depreciable asset?
- Deferred income
 - Credit to income in period received
 - Deducting the grant from the carrying amount of the asset
 - None of the above
12. Which of the following is not a correct treatment of government grants related to income?
- Present as 'other income'
 - Deduct from the related expense
 - Deduct from the cost of the asset
 - None of the above
13. The forgivable loan from government is accounted for as _____ if there is no reasonable assurance that the entity will meet the terms for forgiveness of loan.
- a liability
 - an income
 - a government assistance
 - a government grant
14. On 1 January 2019, a company purchased an asset for Rs. 5 million against which it received the government grant of Rs. 0.5 million. The company deducted the grant from the cost of asset. It is the policy of the company to depreciate such assets using straight line method over ten years. On 1 January 2021, the government grant became repayable due to non-fulfilment of conditions. Repayment of grant will result in increasing:
- carrying value by Rs. 0.5 million
 - carrying value by Rs. 0.4 million
 - expense by Rs. 0.4 million
 - expense by Rs. 0.5 million
15. As per IAS 20 'Accounting for Government Grants and Disclosure of Government Assistance', presenting the whole grant as other income in the statement of comprehensive income or deducting it from a related expense, is the correct treatment of:
- grant related to income
 - forgivable loan expected to be received in next year
 - government assistance in the form of free technical advice
 - grant related to assets
16. On 1 January 2021, Delta Limited (DL) acquired a manufacturing plant at a cost of Rs. 200 million and received a government grant of Rs. 40 million related to the plant. DL recorded the grant as deferred income. The plant is being depreciated on a straight-line basis over five years. The accounting period ends on 31 December each year. On 1 January 2023, the grant was repaid in full on failing to meet the attached conditions. Profit or loss will be debited on the repayment of the grant by:
- Nil
 - Rs. 16 million
 - Rs. 24 million
 - Rs. 40 million

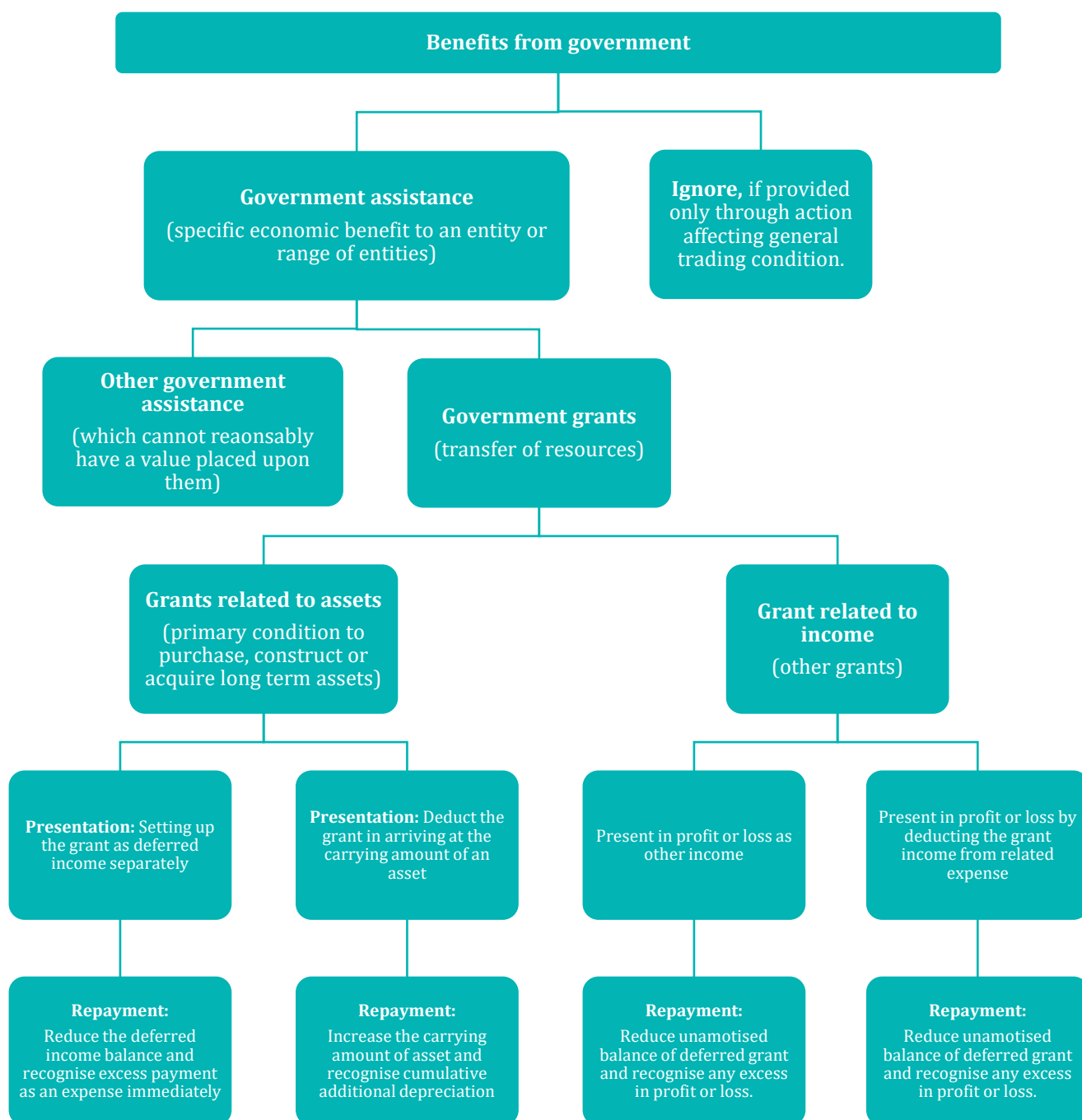
17. Which of the following is NOT considered government assistance in accordance with IAS 20?
- a) Forgivable loans by government
 - b) Subsidized loans by government
 - c) Government grants
 - d) Imposition of trading constraints on competitors

ANSWERS

01.	(b)	This is a grant related to income and would therefore be released to the statement of profit or loss over the 4 year life. By the end of year one, Rs. 250,000 would have been credited to the statement of profit or loss, leaving Rs. 750,000 held in deferred income. At this point the amount is repaid, meaning that the deferred income is removed, as well as the Rs. 250,000 income previously recorded.		
02.	(c)	The grant can be treated as deferred income or deducted from the carrying amount of the asset. It cannot be credited directly to profit or loss.		
03.	(a)	Half repayment is Rs. 1,000,000 (Rs. 2,000,000 x 50%) At the date of repayment, the balance in deferred grant would be Rs. 500,000 and additional Rs. 500,000 shall be charged to profit or loss.		
04.	(b, c)	Item a) is incorrect as the deferred income method can be used. Item d) is incorrect, as any repayment is recorded in the current period, not as prior period adjustment.		
05.	(d)	The grant should be released over the useful life, not based on the possibility of the item being repaid. Therefore, the Rs. 1m should be released over 5 years, being a release of Rs. 200,000 a year. At 30 June 2013, 6 months should be released, meaning Rs. 100,000 has been released (6/12 x Rs. 200,000). This leaves Rs. 900,000 in deferred income.		
06.	(d)		Rs.	
		Grant received 1.4.2017	500,000	
		Recognised year to 31.3.2018 (500,000 x 30%)	(150,000)	
		Balance 31.3.2018	350,000	
		Recognised year to 31.3.2019 (350,000 x 30%)	105,000	
07.	(a)	The total grant income is Rs. 3m, to be recognised over a three-year period. Annual income is therefore Rs. 1m. At the end of the first year the entity has received Rs. 1.5m of which Rs. 1m has been recognised in the statement of profit or loss, leaving Rs. 500,000 deferred into future periods.		
08.	(c)	Repayment of government grant is accounted for as change in accounting estimate (IAS 20.32).		
09.	(b)	It is usual to assess the fair value of the non-monetary asset and to account for both grant and asset at that fair value. (IAS 20.23)		
10.	(a)	Government assistance for the purpose of IAS 20 does not include benefits provided only indirectly through action affecting general trading conditions, such as the provision of infrastructure in development areas or the imposition of trading constraints on competitors (IAS 20.3).		
11.	(b)	Grants related to depreciable assets are usually recognised in profit or loss over the periods and in the proportions in which depreciation expense on those assets is recognised (IAS 20.17).		
12.	(c)	Grants related to income are presented as part of profit or loss, either separately or under a general heading such as 'Other income'; alternatively, they are deducted in reporting the related expense (IAS 20.29).		
13.	(a)	It would have been treated as government grant only if there was reasonable assurance that entity would meet the conditions of the waiver.		

14.	(b)	Increase in carrying amount (amount repaid)	Rs. 0.5 million	
		Additional depreciation [Rs. 0.5m x 2/10 years]	Rs. 0.1 million	
		Net increase in carrying amount [Rs. 0.5m – 0.1m]	Rs. 0.4 million	
15.	(a)	Grants related to income are presented as part of profit or loss, either separately or under a general heading such as ‘Other income’; alternatively, they are deducted in reporting the related expense (IAS 20.29).		
16.	(b)	Reversal of income = Additional depreciation = Rs. 40m / 5 years x 2 years = Rs. 16 million		
17.	(d)	Imposition of trading constraints on competitors		

STICKY NOTES



AT A GLANCE

SPOTLIGHT

STICKY NOTES

IAS 23 BORROWING COSTS

IN THIS CHAPTER:

AT A GLANCE

SPOTLIGHT

1. Definitions and recognition
2. Capitalisation period and disclosure
3. Comprehensive Examples
4. Objective Based Q&A

STICKY NOTES

AT A GLANCE

IAS 23 deals with the accounting treatment of borrowing costs which include all costs incurred in connection with the borrowing of funds and in particular the interest cost.

A qualifying asset is one that takes a substantial period of time to get ready for its intended use or sale. Examples include manufacturing plants, constructed properties and some inventories.

Borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset are capitalised as part of the cost of that asset, but only when it is probable that these costs will result in future economic benefits to the entity and the costs can be measured reliably. All other borrowing costs are expensed when incurred.

The borrowing cost of specific loans is measured net of any interest income on un-utilized funds, however, borrowing cost of general funds is calculated by multiplying the capitalisation rate (weighted average of borrowing costs applicable to the general outstanding borrowings during the period) expenditure incurred on the qualifying asset during the period.

The commencement date for capitalisation of borrowing costs is the date when the entity first meets all of the following conditions namely: it incurs expenditures for the asset; and it incurs borrowing costs; and it undertakes activities that are necessary to prepare the asset for its intended use or sale.

The capitalisation of borrowing costs shall be suspended when the construction of asset is suspended due to unforeseen interruptions which extend the construction period of asset.

The capitalisation of borrowing costs shall cease when asset is substantially completed for its intended use/sale. Any borrowing costs incurred after this date are charged to profit or loss.

1 DEFINITIONS AND RECOGNITION

1.1 Borrowing costs [IAS 23: 3, 5 & 6]

Borrowing costs are interest and other costs that an entity incurs in connection with the borrowing of funds.

Examples include interest expense (calculated using effective interest method), loan processing fee, commissions, documentation charges, and legal charges relating to borrowing of funds. Exchange differences on foreign currency borrowings are also borrowing costs.

IAS 23 does not deal with the actual or imputed cost of equity (including preferred share capital not classified as liability), therefore, dividend paid to equity-holders of an entity is not a borrowing cost.

1.2 Qualifying assets [IAS 23: 5 & 7]

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

Qualifying assets are usually self-constructed non-current assets and long maturing inventories. Depending on the circumstances, any of the following may be qualifying assets:

- inventories (IAS 2)
- manufacturing plants (IAS 16)
- power generation facilities (IAS 16)
- intangible assets (IAS 38)
- investment properties (IAS 40)

Financial assets (i.e., cash and investments etc.), and inventories that are manufactured, or otherwise produced, over a short period of time, are not qualifying assets. Similarly, assets that are ready for their intended use or sale when acquired are not qualifying assets.

► **Example 01:**

Identify whether or not the following are qualifying assets.

- i. A construction company constructing a bridge for government which will take 6 years to complete.
- ii. A very sophisticated integrated circuits being made by an entity who manufactures and sales 10,000 to 12,000 units every month.
- iii. A power plant under construction, it may take 10 months to complete this.
- iv. An equipment purchased by X Limited, the equipment may be used immediately after it is delivered.
- v. Special order from a customer to manufacture a machine for him which will take 11 months at the least.
- vi. An entity is constructing office building which will take 8 months to complete.

► **Answer:**

Items (i), (iii), (v) and (vi) are qualifying assets.

Items (ii) and (iv) are not qualifying assets.

1.3 Recognition rule [IAS 23: 8 to 10]

Capitalise as part of the cost of that asset	Borrowing costs directly attributable (that would have been avoided if the expenditure on the qualifying asset had not been made) to the acquisition, construction or production of a qualifying asset. Such borrowing costs are capitalised as part of the cost of the asset when: - it is probable that they will result in future economic benefits to the entity; and - the costs can be measured reliably.
Expense in the period in which it is incurred	Other borrowing costs.

1.4 Specific borrowings [IAS 23: 12 & 13]

Specific borrowings are funds borrowed specifically for the purpose of obtaining a qualifying asset.

The financing arrangements for a qualifying asset may result in an entity obtaining borrowed funds and incurring associated borrowing costs before some or all of the funds are used for expenditures on the qualifying asset. In such circumstances, the funds are often temporarily invested pending their expenditure on the qualifying asset.

The amount of borrowing costs eligible for capitalisation is the actual borrowing costs incurred on that borrowing during the period less any investment income on the temporary investment of those borrowings.

Borrowing costs eligible for capitalisation	Rs.
Actual borrowing costs incurred on that borrowing	xxx
Less: Temporary investment income	(xx)
	xxx

► *Example 02:*

Up Limited borrowed a loan of Rs. 10 million from Down Bank on 15% per annum for constructing its power generation facilities.

The loan was received on February 01, 2011. Up Limited paid Rs. 3 million to contractor immediately but remaining Rs. 7 million were paid to the contractor on March 1, 2011. The remaining Rs. 7 million were temporarily invested in a saving account at 9% per annum.

Up Limited has year-end of 31 December. As on December 31, 2011 the construction is still in process and the loan is also outstanding.

Required:

Calculate the amount of borrowing cost to be capitalised for the year ended December 31, 2011?

► *Answer:*

Borrowing costs to be capitalised	Rs.
Actual borrowing costs [Rs. 10 m x 15% x 11/12]	1,375,000
Less: Temporary investment income [Rs. 7m x 9% x 1/12]	(52,500)
	1,322,500

► *Example 03:*

On 1 January 2016 Okara Engineering issued a bond to raise Rs. 25,000,000 to fund a capital project which will take three years to complete. Amounts not yet needed for the project are invested on a temporary basis. During the year to 31 December 2016, Okara Engineering spent Rs. 9,000,000 on the project for labour, materials and direct overheads etc.

The cost of servicing the bond was Rs. 1,250,000 during this period and the company was able to earn Rs. 780,000 through the temporary reinvestment of the amount borrowed.

Required:

Calculate the amount of addition to capital work in progress during the year to December 31, 2016.

► *Answer:*

	Rs.
Costs incurred (labour, material, overhead etc.)	9,000,000
Borrowing costs to be capitalised:	
Actual borrowing costs incurred on that borrowing	1,250,000
Less: Temporary investment income	(780,000)
	470,000
Additions to capital work in progress	9,470,000

► *Example 04:*

Shayan Limited (SL) started the construction of its new factory on 1 January 2018 with a loan of 50,000,000 borrowed at an interest rate of 8% per annum.

The loan was used on the factory as follows:

Date of Payment	Rs. in million
January 1, 2018	25
May 1, 2018	15
October 1, 2018	10

The construction of the asset was completed on 31 December 2018. During the accounting period SL invested the surplus funds at an interest rate of 3%.

Required:

How much the amount of borrowing cost eligible for capitalization for the year ended December 31, 2018.

► *Answer:*

Borrowing costs to be capitalised	Rs.
Borrowing costs incurred [Rs. 50m x 8%]	4,000,000
Less: Temporary investment income [Rs. 25m x 3% x 4/12]	(250,000)
	(125,000)
	3,625,000

1.5 General borrowings [IAS 23: 14]

General borrowings are funds borrowed generally and use them for the purpose of obtaining/construction of a qualifying asset or for other operating needs.

The amount of borrowing costs eligible for capitalisation is determined by applying a capitalisation rate to the expenditures on qualifying asset. The amount of borrowing costs that an entity capitalises during a period shall not exceed the amount of borrowing costs it incurred during that period.

Borrowing costs eligible for capitalisation	Rs.
Expenditure (i) x capitalisation rate	xxx
Expenditure (ii) x capitalisation rate	xxx
	xxx

The capitalisation rate shall be the weighted average of the borrowing costs applicable to all borrowings (other than specific borrowings) of the entity that are outstanding during the period.

$$\text{Capitalisation rate} = \frac{\text{Borrowing costs incurred}}{\text{Weighted average general borrowings}} = \%$$

► **Example 05:**

SIKA Sports Limited is constructing a stadium for last some years. During the year ended 31 December 2011, it has incurred the following expenditures.

April 30, 2011	Rs. 2,500,000
July 31, 2011	Rs. 2,300,000

No specific loan was borrowed for the construction; rather general pool of funds was used. The following loans are outstanding:

Loan from FBL @12%	Outstanding since beginning of year	Rs. 5,000,000
Loan from BAH @14%	Outstanding since beginning of year	Rs. 10,000,000
Loan from BAF @16%	Outstanding since 01-04-2011	Rs. 750,000

Required:

Calculate total borrowing costs eligible for capitalisation during the year ended December 31, 2011.

► **Answer:**

Capitalisation rate =

$$= \frac{[Rs. 5m \times 12\%] + [Rs. 10m \times 14\%] + [750,000 \times 16\% \times \frac{9}{12}]}{Rs. 5m + Rs. 10m + Rs. 750,000 \times \frac{9}{12}} = 13.43\%$$

Borrowing costs to be capitalised	Rs.
Rs. 2,500,000 x 13.43% x 8/12	223,829
Rs. 2,300,000 x 13.43% x 5/12	128,701
	352,530
Borrowing costs to be capitalised (alternative calculation)	Rs.
Rs. 2,500,000 x 13.43% x 3/12	83,936
Rs. 4,800,000 x 13.43% x 5/12	268,594
	352,530

► *Example 06:*

Sahiwal Construction has three sources of borrowing:

	Average loan in the year (Rs.)	Interest expense incurred in the year (Rs.)	Interest rate
7-year loan	8,000,000	800,000	10%
10-year loan	10,000,000	900,000	9%
Bank overdraft	5,000,000	900,000	18%

The 7-year loan has been specifically raised to fund the building of another qualifying asset.

Sahiwal Construction has incurred the following expenditure on a project funded from general borrowings for year ended 31 December 2016.

Date incurred:	Amount (Rs.)
31st March	1,000,000
31st July	1,200,000
30th October	800,000

Required:

Calculate the capitalisation rate and addition to capital work in progress.

► *Answer:*

$$\text{Capitalisation rate} = \frac{900,000 + 900,000}{10,000,000 + 5,000,000} = 12\%$$

	Rs.
Expenditure on qualifying asset [Rs. 1m + 1.2m + 0.8m]	3,000,000
Borrowing costs to be capitalised:	
Rs. 1,000,000 x 12% x 9/12	90,000
Rs. 1,200,000 x 12% x 5/12	60,000
Rs. 800,000 x 12% x 2/12	16,000
	166,000
Additions to capital work in progress	3,166,000

► *Example 07:*

On January 1, 2018 Sara Limited (SL) started the construction of an asset. To meet the financing requirements, borrowing was made from three different banks at the start of the year as follows:

Banks	Loan Rs.	Interest per annum
A	70,000	10%
B	60,000	8%
C	50,000	12%

The funds were used on the assets as follows:

Date of Payment	Rs.
January 1, 2018	30,000
May 1, 2018	20,000
October 1, 2018	15,000

The construction of asset was completed on 31 December 2018.

Required:

Calculate the general weighted average borrowing rate and eligible borrowing cost for capitalisation.

► **Answer:**

Capitalisation rate

$$= \frac{[\text{Rs. } 70,000 \times 10\%] + [\text{Rs. } 60,000 \times 8\%] + [\text{Rs. } 50,000 \times 12\%]}{\text{Rs. } 70,000 + 60,000 + 50,000} = 9.89\%$$

Borrowing costs to be capitalised	Rs.
$30,000 \times 9.89\% \times 12/12$	2,967
$20,000 \times 9.89\% \times 8/12$	1,319
$15,000 \times 9.89\% \times 3/12$	371
Borrowing costs to be capitalised	4,657

2 CAPITALISATION PERIOD AND DISCLOSURE

2.1 Commencement date of capitalisation [IAS 23: 17 to 19]

An entity shall begin capitalising borrowing costs as part of the cost of a qualifying asset on the commencement date.

The commencement date for capitalisation is the date when the entity first meets all of the following conditions:

- it incurs expenditures (resulted in payment of cash or transfer of other assets) for the asset;
- it incurs borrowing costs; and
- it undertakes activities that are necessary to prepare the asset for its intended use or sale.

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

However, such activities exclude the holding of an asset when no production or development that changes the asset's condition is taking place. For example, borrowing costs incurred while land is under development are capitalised during the period in which activities related to the development are being undertaken. However, borrowing costs incurred while land acquired for building purposes is held without any associated development activity do not qualify for capitalisation.

2.2 Suspension of capitalisation [IAS 23: 20 & 21]

An entity shall suspend capitalisation of borrowing costs during extended periods in which it suspends active development of a qualifying asset.

An entity does not normally suspend capitalising borrowing costs during a period when it carries out substantial technical and administrative work. An entity also does not suspend capitalising borrowing costs when a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale. For example, capitalisation continues during the extended period that high water levels delay construction of a bridge, if such high water levels are common during the construction period in the geographical region involved.

2.3 End of capitalisation period [IAS 23: 22 to 25]

An entity shall cease capitalising borrowing costs when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete. An asset is normally ready for its intended use or sale when the physical construction of the asset is complete even though routine administrative work might still continue. If minor modifications, such as the decoration of a property to the purchaser's or user's specification, are all that are outstanding, this indicates that substantially all the activities are complete.

When an entity completes the construction of a qualifying asset in parts and each part is capable of being used separately while construction continues on other parts, the entity shall cease capitalising borrowing costs when it completes substantially all the activities necessary to prepare that part for its intended use or sale.

► Example 08:

A business park comprising several buildings, each of which can be used individually, is an example of a qualifying asset for which each part is capable of being usable while construction continues on other parts. Capitalisation of borrowing cost should cease for each part when that part is substantially complete even though the work on other parts continues.

► Example 09:

An example of a qualifying asset that needs to be completed before any part can be used is an industrial plant involving several processes which are carried out in sequence at different parts of the plant within the same site, such as a steel mill. In such case, capitalisation of borrowing costs shall cease when the whole asset is substantially complete.

► **Example 10:**

Cord Limited is engaged in the manufacturing of automobiles. Currently the company is manufacturing its power generation plant. The project was started on January 03, 2011 with company's own funds. Subsequently, Cord Limited borrowed a loan from ZBL Bank to finance the project on February 22, 2011. The first payment out of the loan was made on March 04, 2011.

Due to some law and order situation, the project remained closed from April 25, 2011 to May 9, 2011. The work was also stopped for a week from May 23, 2011 to May 30, 2011 so that necessary plan and layout can be finalized after testing of project completed so far.

The plant was completed on July 31, 2011 except that some sign board could not be installed until August 10, 2011. Loan was repaid on August 31, 2011. Cord Limited started using the plant on September 1, 2011.

Required:

- When should Cord Limited start capitalising borrowing costs?
- Should Cord Limited suspend capitalisation from April 25, 2011 to May 9, 2011?
- Should Cord Limited suspend capitalisation from May 23, 2011 to May 30, 2011?
- When should Cord Limited cease to capitalise borrowing costs?

► **Answer:**

- February 22, 2011 i.e. when all three criteria for commencement date of capitalisation have been met.
- Suspend capitalisation, as active development of qualifying asset was suspended during this period.
- Continue capitalisation, substantial technical and administrative work was still being carried out.
- July 31, 2011 i.e. when asset was substantially completed.

2.4 Expenditure on qualifying asset [IAS 23: 18]

Expenditures on a qualifying asset include only those expenditures that have resulted in payments of cash or transfers of other assets.

The average carrying amount of the asset during a period, including borrowing costs previously capitalised, is normally a reasonable approximation of the expenditures to which the capitalisation rate is applied in that period.

Expenditures are reduced by:

- any progress payments received; and
- grants received in connection with the asset.

► **Example 11:**

Zeal Limited (ZL) is building a dam for Federal Government. The project will take 10 years to complete. On February 01, 2011 ZL used Rs. 100 million from pool of general loans with capitalisation rate of 12% for the expenditures incurred on the same date for payment to sub-contractors who started work immediately.

On July 01, 2011 the Federal Government made first progress payment of Rs. 30 million.

As ZL had offered employment opportunities to locals of the area, considering this fact; Provincial Government has given ZL a grant (award) of Rs. 10 million on October 31, 2011.

Required:

The borrowing costs to be capitalised for Zeal Limited for the year ended December 31, 2011.

► *Answer:*

Date	Particulars	Expenditure	Cumulative (net)	Borrowing costs to be capitalised	
		Rs. m			Rs. m
1 Feb	Sub-contract costs	100	100	$\times 12\% \times 5/12$	5
1 Jul	Progress payments	(30)	70	$\times 12\% \times 4/12$	2.8
31 Oct	Grant	(10)	60	$\times 12\% \times 2/12$	1.2
					9

2.5 Disclosure [IAS 23: 26]

An entity shall disclose:

- the amount of borrowing costs capitalised during the period; and
- the capitalisation rate used to determine the amount of borrowing costs eligible for capitalisation.

► *Example 12:*

Alpha Limited borrowed Rs. 9 million @ 15% per annum to fund a qualifying asset project on 1 January 2016. The following expenditures were made on the project during the year ending 31 December 2016:

Date	Rs. m
1 March 2016	2.5
1 October 2016	4.2
1 December 2016	2.3

Surplus funds were invested @10% whenever available.

The project activities started on 1 March 2016. Work on the project was suspended during the whole month of August and resumed at start of September. Construction was completed on 31 December 2016.

Required:

Calculate the borrowing costs to be capitalised and to be charged to profit or loss.

► *Answer:*

The project commenced on 1st March resulting in a construction period of 10 months up to the year end. However, interest cannot be capitalised during the period of suspension. Therefore, interest is capitalised only for 9 months.

Borrowing costs to be capitalised		Rs. 000
Borrowing costs incurred	[Rs. 9m $\times$ 15% $\times$ 9/12]	1,012.5
Less: Temporary investment income	[Rs. 6.5m $\times$ 10% $\times$ 6/12]	(325)
	[Rs. 2.3m $\times$ 10% $\times$ 2/12]	(38.3)
		649.2

Borrowing costs to be charged as expense		Rs.
Borrowing costs incurred (Jan, Feb, Aug)	[Rs. 9m $\times$ 15% $\times$ 3/12]	337.5
Less: Temp. Inv. income (Jan & Feb)	[Rs. 9m $\times$ 10% $\times$ 2/12]	(150)
(Aug)	[Rs. 6.5m $\times$ 10% $\times$ 1/12]	(54.17)
		133.33

► *Example 13:*

Khan Limited (KL) has the following loan arrangements as at 1 January 2020:

	Rs. in million
7% Debentures	55
8% Loan notes	110
12% Line of credit	85
10% Running finance arrangement	150

On the 1 January 2020, KL commenced the construction of a new factory. The construction of the factory will cost Rs. 100 million and the company funded the construction with the existing borrowings.

The factory was completed on 31 August 2020 but was not available for use until 31 January 2021 as a result of minor modification. During the construction period, active work was interrupted, and the building construction was stopped for two months as a result of unexpected adverse weather conditions.

Required:

Calculate the borrowing cost to be capitalised and the cost of the building to be recognised upon initial recognition.

► *Answer:*

The capitalisation period would be 6 months i.e. January to August 8 months less two months suspension.

Total cost to be capitalised	Rs. m
Expenditure	100
Borrowing cost to be capitalised [Rs. 100m x 9.46% x 6/12]	4.73
	104.73

Capitalisation rate

$$= \frac{[Rs. 55m \times 7\%] + [Rs. 110m \times 8\%] + [Rs. 85m \times 12\%] + [Rs. 150m \times 10\%]}{Rs. 55m + 110m + 85m + 150m} = 9.46\%$$

3 COMPREHENSIVE EXAMPLES

► *Example 14:*

On 1 January 20X6 Googly Industries Limited (GIL) borrowed Rs.15 million to finance the production of two assets, both of which were expected to take a year to build. Work started during 20X6. The loan facility was drawn down and incurred on 1 January 20X6, and was utilised as follows, with the remaining funds invested temporarily.

	Asset A	Asset B
	Rupees	
1 January 20X6	2,500,000	5,000,000
1 July 20X6	2,500,000	5,000,000

The loan rate was 9% and GIL can invest surplus funds at 7%.

Required:

Calculate the borrowing costs which may be capitalised for each of the assets and consequently the cost of each asset as at 31 December 20X6.

► *Answer:*

		Rs.
Expenditure	[Rs. 2,500,000 + 2,500,000]	5,000,000
Borrowing costs incurred	[Rs. 5,000,000 x 9% x 12/12]	450,000
Less: Temporary investment income	[Rs. 2,500,000 x 7% x 6/12]	(87,500)
		362,500
Cost of asset A as at 31 December 20X6		5,362,500
Expenditure	[Rs. 5,000,000 + 5,000,000]	10,000,000
Borrowing costs incurred	[Rs. 10,000,000 x 9% x 12/12]	900,000
Less: Temporary investment income	[Rs. 5,000,000 x 7% x 6/12]	(175,000)
		725,000
Cost of asset B as at 31 December 20X6		10,725,000

► *Example 15:*

On August 1, 2015, Steady Industries Limited (SIL) started construction of its new office building and completed it on May 31, 2016. The payments made to the contractor were as follows:

Date of Payment	Rs.
September 1, 2015	10,000,000
December 1, 2015	15,000,000
February 1, 2016	12,000,000
June 1, 2016	9,000,000

In addition to the above payments, SIL paid a fee of Rs. 8 million on August 1, 2015 for obtaining a permit allowing the construction of the building.

The project was financed through the following sources:

- i. On August 1, 2015 a medium term loan of Rs.25 million was obtained specifically for the construction of the building. The loan carried mark up of 12% per annum payable semi-annually. A commitment fee @ 0.5% of the amount of loan was charged by the bank.

Surplus funds were invested in savings account @ 8% per annum. On February 1, 2016 SIL paid the six monthly interest plus Rs.5 million towards the principal.

- ii. Existing running finance facilities of SIL

- Running finance facility of Rs. 28 million from Bank A carrying mark up of 13% payable annually. The average outstanding balance during the period of construction was Rs. 25 million.
- Running finance facility of Rs. 25 million from Bank B carrying mark up of 20% payable annually. The average running finance balance during the period of construction was Rs. 20 million.

Required:

Calculate the amount of borrowing costs to be capitalised on June 30, 2016 in accordance with the requirements of International Accounting Standards. (*Borrowing cost calculations should be based on number of months*).

► Answer:

Borrowing costs to be capitalised		Rs.
Commitment fee	[Rs.25m x 0.5%]	125,000
Interest on specific borrowings	[25m x 12% x 6/12]	1,500,000
	[20m x 12% x 4/12]	800,000
Temporary Investment income	[112,500 + 137,500]	(250,000)
Interest on general borrowings	[218,156 + 1,429,763]	1,647,919
		<u>3,822,919</u>

Date	Particulars	Rs.	Working
01-Aug-15	Specific loan	25,000,000	
	Commitment fee	(125,000)	
	Permit	(8,000,000)	
		16,875,000	x 8% x 1/12 = Rs. 112,500 (temporary investment income)
01-Sep-15	1 st payment	(10,000,000)	
		6,875,000	x 8% x 3/12 = Rs. 137,500 (temporary investment income)
01-Dec-15	2 nd payment	(15,000,000)	
		(8,125,000)	x 16.11% x 2/12 = Rs. 218,156 (Interest on general borrowings)

Date	Particulars	Rs.	Working
01-Feb-16	Loan interest	(1,500,000)	
	Loan Principal	(5,000,000)	
	3 rd payment	(12,000,000)	
		(26,625,000)	x 16.11% x 4/12 = Rs. 1,429,763 (interest on general borrowings)
31-May-16	Completion		

$$\text{Capitalisation rate} = \frac{[\text{Rs. } 25\text{m} \times 13\%] + [\text{Rs. } 20\text{m} \times 20\%]}{\text{Rs. } 25\text{m} + 20\text{m}} = 16.11\%$$

► **Example 16:**

Bulan Pakistan Limited (BPL) is planning to commence construction of a warehouse on 1 January 2023 and is expecting to complete it by 30 November 2023. The management wants to ascertain the borrowing costs that can be included in the cost of warehouse. Relevant details in this respect are as follows:

- i. Expected payments related to the construction of the warehouse will be as follows:

Description	Date of payment	Rs. in million
1st bill of contractor	1-Feb-23	40
2nd bill of contractor	1-Apr-23	120
3rd bill of contractor	1-Sep-23	100
Last bill of contractor	1-Dec-23	90
		350

- ii. The project can be financed through the following sources:

- Specific loan of Rs. 350 million at the rate of 16% per annum to be obtained on 1 January 2023. The principal will be payable in 5 equal annual instalments along with interest, from 1 January 2024.
- Withdrawals to be made from existing running finance facilities. These facilities will also be used to finance other needs of BPL. Details of these facilities are as follows:

Name of bank	Limit	Expected average balance for 2023	Interest rates
		----- Rs. in million -----	
Bank A	300	220	13.7%
Bank B	350	280	14.6%

- iii. The surplus funds available from the loan will be invested in a saving account at 10% per annum.
- iv. The construction work is expected to be suspended for the entire month of June 2023 due to usual monsoon rains.

Required:

Calculate the borrowing costs to be capitalised in the cost of warehouse in each of the following independent cases:

- if all the payments will be made from the specific loan only.
- if all the payments will be made from running finance facilities only.

► *Answer:***Part (a) Borrowing cost to be capitalised – specific borrowing**

Date	Description	Utilisation	Balance	Rate	Months	Rs. m
	Interest		350	16%	10	46.67
1-Feb	1 st bill	40	310	10%	2	(5.17)
1-Apr	2 nd bill	120	190	10%	5	(7.92)
1-Sep	3 rd bill	100	90	10%	3	(2.25)
						31.33

Part (b) Borrowing cost to be capitalised – general borrowing

Date	Description	Utilisation	Balance	Rate (W1)	Months	Rs. m
1-Feb	1 st bill	40	40	14.2%	2	0.95
1-Apr	2 nd bill	120	160	14.2%	5	9.47
1-Sep	3 rd bill	100	260	14.2%	3	9.23
						19.65

$$W1: \text{Capitalisation rate} = \frac{(220m \times 13.7\%) + (280m \times 14.6\%)}{220 + 280} = 14.2\%$$

► *Example 17:*

You have recently joined as the finance manager of Corv Limited (CL). While reviewing the draft financial statements for the year ended 31 December 2020 prepared by the junior accountant, you have noted that CL is constructing a power generation plant for its factory. The project started on 1 February 2020 and would complete on 30 November 2021. The work remained suspended for 3 months. The project is financed through long term loan, acquired specifically on 1 January 2020. The unutilised amount of loan is kept in a separate saving account.

The accountant has deducted income of separate saving account from full year's interest on loan and presented the net amount as finance cost in the statement of profit or loss.

Required:

Discuss how the above issue should be dealt in the financial statements of CL for the year ended 31 December 2020 in accordance with the requirements of IFRSs.

► *Answer:*

The accounting treatment adopted by accountant to expense out borrowing cost is incorrect as some borrowing cost is eligible for capitalization. Power generation plant falls under definition of qualifying asset as its construction involves substantial period.

Construction of the power plant is financed through specific borrowing so actual borrowing cost incurred less temporary investment income on the borrowings would be capitalised. However, the borrowing cost will be capitalised from the date when construction actually started i.e. 1 February 2020 rather than 1 January 2020. Further, the capitalization of borrowing costs should be suspended and charged to the statement of profit or loss during the three months when work was suspended.

In the statement of profit or loss, borrowing cost on loan and interest income earned from saving account should be presented separately.

► **Example 18:**

Following information pertains to non-current assets of Bunny Ear Limited (BEL):

Land:

In January 2019, the government allotted a piece of land to BEL subject to the condition that BEL will establish a factory building on it. The land was recorded at its fair value of Rs. 100 million.

Factory building:

On 1 March 2019, BEL started construction of the factory building. The construction work was completed on 30 June 2020. Payments related to the construction of the factory were as follows:

Description	Date of payment	Rs. in million
1st bill of contractor	1-Mar-2019	130
2nd bill of contractor	1-Aug-2019	190
3rd bill of contractor	1-Jan-2020	180
Last bill of contractor	1-Jul-2020	100

The project was financed through:

- government grant of Rs. 200 million received on 1 February 2019. Unused funds from government grant were invested in a saving account @ 8% per annum.
- withdrawals from the following running finance facilities obtained from Bank A and Bank B. The relevant details are:

	Bank A	Bank B
Obtained on	1 January 2019	1 January 2020
Markup rate	12%	14%
	----- Rs. in million -----	
Balance on 31 December 2019	250	-
Markup for 2019	22	-
Balance on 31 December 2020	350	200
Average balance during 2020	300	150
Markup for 2020	36	21

Manufacturing plant:

The manufacturing plant was purchased on 1 August 2020 at cost of Rs. 420 million. Rs. 240 million was financed through an interest free loan from government. The loan will be forgiven if the plant is operated for at least 4 years by BEL. Upon acquisition, there is a reasonable assurance that BEL will comply with this condition.

Other information:

- BEL uses cost model for subsequent measurement of property, plant and equipment.
- All government grants are recorded as deferred income and a part of it is transferred to income each year.
- Useful life of the factory building and manufacturing plant has been estimated at 25 years and 10 years respectively.

Required:

Prepare relevant extracts (including comparative figures) from BEL's statement of profit or loss for the year ended 31 December 2020 and statement of financial position as on that date. (Notes to the financial statements are not required. Borrowing costs are to be calculated on the basis of number of months)

► Answer:

Bunny Ear Limited**Extracts from statement of profit or loss for the year ended 31 December 2020**

	2020	2019
	Rs. in million	
Depreciation:		
Factory building	625/25 x 6/12	12.5
Manufacturing plant	420/10 x 5/12	17.5
Income from saving account	1.3+2.3 (W-2)	3.6
Grant Income:		
Land	100/25 x 6/12	2.0
Factory building	200/25 x 6/12	4.0
Manufacturing plant	240/10 x 5/12	10.0
Interest expense	(36+21-19); (22-6)	38.0
		16.0

Extracts from statement of financial position as on 31 December 2020

	2020	2019
	Rs. in million	
Non-current assets:		
Property, plant and equipment		
Land	100.0	100.0
Factory building	625 (W-1) – 12.5	612.5
Manufacturing plant	420-17.5	402.5
Capital work-in-process	(W-1)	-
		326.0
Non-current liabilities:		
Deferred government grant		
Land	100 – 2 – 4	94.0
Factory building	200 – 4 – 8	188.0
Manufacturing plant (forgivable loan)	240 – 10 – 24	206.0
		-
Current liabilities:		
Running finance	350+200	550.0
Deferred government grant		
Land	100 / 25 years	4.0
Factory building	200 / 25 years	8.0
Manufacturing plant (forgivable loan)	240 / 10 years	24.0
		-

W1: Cost of factory building

		Rs. m
Payments in 2019 (130 + 190)		320.0
Borrowing cost capitalised in 2019	(W-2)	6.0
Balance as at 31 December 2019		326.0
Payments in 2020 (180 + 100)		280.0
Borrowing cost capitalised in 2020	(W-2)	19.0
		625.0

W2: Utilisation of funds

Date	Description	Amount	Balance	Rate	Months	Rs. m
1-Feb-19	Grant	200	200	8%	1	1.3 PL
1-Mar-19	1 st Payment	(130)	70	8%	5	2.3 PL
1-Aug-19	2 nd Payment	(190)	(120)	12%	5	6*
1-Jan-19	3 rd Payment	(180)	(300)	12.67%	6	19*

*borrowing costs to be capitalised

$$\text{Capitalisation rate 2020} = \frac{36 + 21}{300 + 150} = 12.67\%$$

► **Example 19:**

You are the accountant of Betta Limited (BL). BL has commenced construction of a manufacturing plant to expand its production line, which will take two years to complete. The cost of the plant will be financed through a new loan specifically obtained for this purpose. Remaining cost will be financed through the existing borrowings.

You have pointed out that a portion of borrowing costs needs to be capitalised in the cost of plant. The management is interested in determining the estimated borrowing costs that will be capitalised in the future and has requested you to prepare a working.

Required:

List the information (key dates, amounts, etc.) that you will need to gather in order to calculate the estimated borrowing costs to be capitalised.

► **Answer:**

Following is the list of information which would be required to compute the borrowing costs to be capitalised:

Dates for capitalisation period:

- Date when started incurring expenditures for the plant.
- Date when started incurring borrowings costs.
- Date when activities to construct the plant started.
- Any period of time during which BL suspends active construction of plant.
- Date when substantially all the activities necessary to construct the plant are completed.

Details of borrowings:

- i. Details of new specific loan obtained from bank i.e. amount, rate of interest, date obtained and date of repayment.
- ii. Income earned on the temporary investment of unused funds of specific loan.
- iii. Details of existing general borrowings i.e. amount and rate of interest for computing capitalisation rate.

Details of expenditures incurred:

Amount of expenditures incurred directly for construction of plant and payments dates.

► **Example 20:**

On 1 January 2023, Textio Limited (TL) commenced construction of its factory building. Below is the breakdown of the payments made to the contractor:

Date of payments	Rs. in million
1 February 2023	200
1 April 2023	350
1 September 2023	180
1 February 2024	160
	890

These payments were financed through the following sources:

Date	Descriptions	Rs. in million
1 January 2023	17% long term loan	250
1 March 2023	Right shares (Expected annual dividend is 24%)	300
1 August 2023	19% short term loan (Payable in June 2024)	340
		890

Additional information:

- i. Surplus funds available from both the loans and right shares were invested in a savings account earning interest at a rate of 10% per annum.
- ii. The construction work was suspended from 1 July to 31 July 2023; however, substantial technical and administrative work was carried during July 2023.
- iii. The construction of the factory building was completed on 30 November 2023, but due to minor modifications, it was not available for use until 31 December 2023.

Required:

Calculate the borrowing costs to be capitalised in the cost of factory building.

► Answer:

Borrowing costs to be capitalised

	Rs. in million
Interest on specific loan 1: $250 \times 17\% \times 10/12$	35.42
Interest on specific loan 2: $340 \times 19\% \times 4/12$	21.53
	56.95
Less: Investment income:	
50 (W-1) $\times 10\% \times 2/12$	(0.83)
340 (W-1) $\times 10\% \times 1/12$	(2.83)
160 (W-1) $\times 10\% \times 3/12$	(4.00)
	(7.66)
	49.29

W-1: Schedule of receipts/payments

Date	Descriptions	Equity	Loans
		---- Rs. in million ----	
1 January 2023	Long term loan received		250
1 February 2023	1st payment		(200)
			50
1 March 2023	Right issue	300	
		300	50
1 April 2023	2nd payment	(300)	(50)
		-	-
1 August 2023	Short term loan received		340
1 September 2023	3rd payment		(180)
		-	160

1. OBJECTIVE BASED Q&A

- Which TWO of the statements below regarding IAS 23 *Borrowing Costs* are correct?
 - Borrowing costs must be capitalised if they are directly attributable to qualifying assets
 - Borrowing costs should cease to be capitalised once the related asset is substantially complete
 - Borrowing costs must be capitalised if they are directly attributable to non-current assets
 - Borrowing costs may be capitalised if they are directly attributable to qualifying assets
- Fine Limited (FL) received a Rs.10 million loan at 7.5% on 1 April 2017. The loan was specifically issued to finance the building of a new store.
Construction of the store commenced on 1 May 2017 and it was completed and ready for use on 28 February 2018 but did not open for trading until 1 April 2018.
How much should be recorded as finance costs in the statement of profit or loss for the year ended 31 March 2018?
 - Rs. 250,000
 - Rs. 750,000
 - Rs. 125,000
 - Rs. 625,000
- Fine Limited (FL) received a Rs.10 million loan at 7.5% on 1 April 2017. The loan was specifically issued to finance the building of a new store.
Construction of the store commenced on 1 May 2017 and it was completed and ready for use on 28 February 2018 but did not open for trading until 1 April 2018.
How much interest should be capitalised as part of property, plant and equipment as at 31 March 2018?
 - Rs. 250,000
 - Rs. 750,000
 - Rs. 125,000
 - Rs. 625,000
- An entity decided that not all of the funds raised were needed immediately and temporarily invested some of the funds for one month before the construction started, earning Rs.40, 000 interest.
How should the Rs. 40,000 be accounted for in the financial statements?
 - Net off the amount capitalised in property, plant and equipment
 - Taken to the statement of profit or loss as investment income
 - Taken as other comprehensive income
 - Deducted from the outstanding loan amount in the statement of financial position
- Shine Limited (SL) had the following bank loans outstanding during the whole of 2018:

	Rs. m
9% loan repayable 2019	15
11% loan repayable 2022	24

SL began construction of a qualifying asset on 1 April 2018 and withdrew funds of Rs. 6 million on that date to fund construction. On 1 August 2018 an additional Rs. 2 million was withdrawn for the same purpose.

Calculate the borrowing costs which can be capitalised in respect of this project for the year ended 31 December 2018.

- a) Rs. 545,600
- b) Rs. 472,350
- c) Rs. 750,600
- d) Rs. 350,350

6. Jazzy Limited (JL) has borrowed Rs. 24 million to finance the building of a factory. Construction is expected to take two years.

The loan was drawn down and incurred on 1 January 2019 and work began on 1 March 2019. Rs. 10 million of the loan was not utilized until 1 July 2019 so JL was able to invest it until needed. JL is paying 8% on the loan and can invest surplus funds at 6%.

Calculate the borrowing costs to be capitalised for the year ended 31 December 2019 in respect of this project.

- a) Rs. 1,400,000
- b) Rs. 1,920,000
- c) Rs. 1,300,000
- d) Rs. 1,620,000

7. A company has the following loans in place throughout the year ended 31 December 2018.

	Rs. m
10% bank loan	140
8% bank loan	200

On 1 July 2018 Rs. 50 million was drawn down for construction of a qualifying asset which was completed during 2019.

What amount should be capitalised as borrowing costs at 31 December 2018 in respect of this asset?

- a) Rs. 5.6 million
- b) Rs. 2.8 million
- c) Rs. 4.4 million
- d) Rs. 2.2 million

8. An entity uses funds from its general borrowings to build a new production facility. Details of the entity's borrowings are shown below:

- Rs.10 million 6% loan
- Rs.6 million 8% loan

The entity used Rs.12 million of these funds to construct the facility, which was under construction for the entire year.

How much interest should be capitalised as part of the cost of the asset?

- a) Rs. 810,000
- b) Rs. 840,000
- c) Rs. 960,000
- d) Rs. 1,080,000

9. Which of the following is not considered a “borrowing cost” under IAS 23?
- Interest expense calculated by the effective interest method
 - Finance charges in respect of loan
 - Exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs
 - Principal repayments on a loan for property, plant and equipment
10. When activities to prepare an asset for its sale or use are suspended, borrowing costs must be?
- Capitalised
 - Expensed
 - Ignored
 - Charged to equity
11. Which of the following is not a condition to commence capitalisation of borrowing costs?
- Expenditures are being incurred
 - Borrowing costs are being incurred
 - Repayment of borrowings has commenced
 - Activities to produce the asset for its intended use or sale have commenced
12. Ghazi Limited (GL) is constructing an office building and is capitalising borrowing costs in accordance with IAS 23. The office is almost complete; the only remaining work is to install furniture. Is GL allowed to continue capitalising the borrowing costs?
- Yes
 - No
 - Don't know
 - None of the above
13. Which of the following is not a “qualifying asset” under IAS 23?
- Mass produced inventory
 - Manufacturing plants
 - Made to order inventory
 - Investment property
14. Which of the following can NOT be a ‘qualifying asset’ under IAS 23 Borrowing Costs?
- Inventories
 - Manufacturing plants
 - Assets that are ready for their intended use when acquired
 - Investment property
15. Capitalisation of borrowing costs should be suspended:
- when substantially all the activities necessary to prepare a qualifying asset for its intended use or sale are complete
 - during a temporary delay which is a necessary part of the process of getting an asset ready for its intended use or sale
 - during extended periods in which active development of a qualifying asset is interrupted
 - all of the above

16. Which of the following statements is correct in the context of capitalisation of borrowing costs?
- a) If funds have been arranged from various general borrowings, the amount to be capitalised is based on the weighted average cost of borrowings
 - b) Capitalisation always commences as soon as expenditure for the asset is incurred
 - c) Capitalisation always continues until the asset is brought into use
 - d) Capitalisation always commences as soon as borrowing costs are incurred
17. On 1 January 2021, a company borrowed Rs. 20 million @ 9% per annum for the purpose of constructing an asset. The company started construction on 1 February 2021 and paid Rs. 8 million on 1 March 2021 and Rs. 12 million on 1 July 2021. The asset was ready to use on 1 September 2021. Surplus funds were invested @ 6% per annum.

The borrowing cost that can be capitalised is:

- a) Rs. 660,000
 - b) Rs. 710,000
 - c) Rs. 900,000
 - d) Rs. 1,050,000
18. Which of the following statements are correct?
- i. Investment income on the temporary investment of unused funds of general borrowings is taken to profit or loss.
 - ii. Capitalisation of borrowing cost always commences as soon as construction of a qualifying asset begins.
- a) Only (I) is correct
 - b) Only (II) is correct
 - c) Both are correct
 - d) None is correct
19. Sigma Limited (SL) borrowed Rs. 10 million from a bank on 1 July 2023 at an interest rate of 15% to purchase a delivery truck. SL paid Rs. 6 million immediately to the supplier as an advance. On 1 May 2024, SL paid an additional Rs. 2 million upon the delivery of the truck. The remaining Rs. 2 million was paid to the supplier on 30 June 2024. SL invested the surplus funds from the loan in a saving account at 13% per annum.

The amount of borrowing cost that can be capitalised in the cost of truck amounts to:

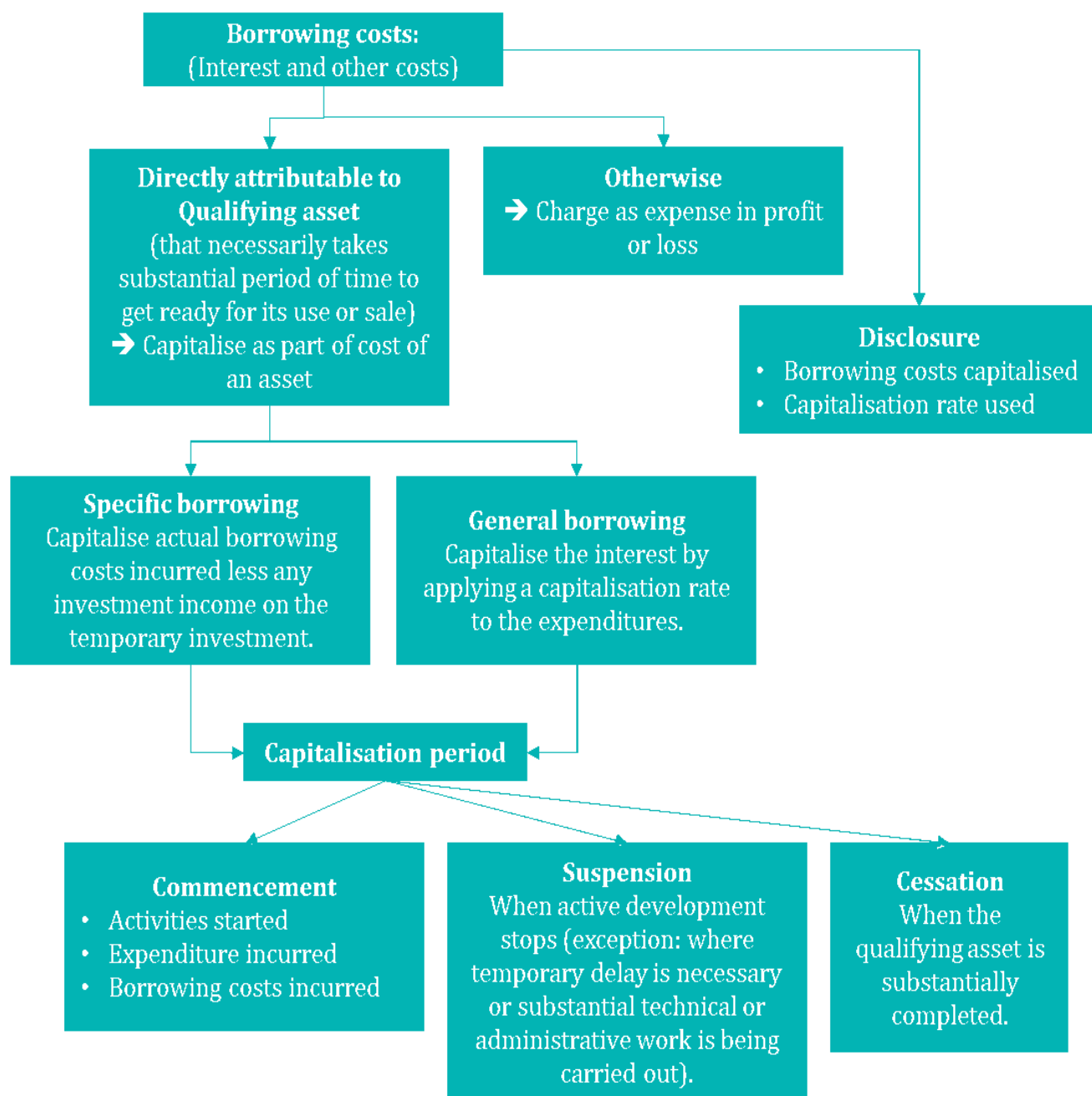
- a) Rs. 1,030,000
- b) Rs. 820,000
- c) Rs. 950,000
- d) Nil

ANSWERS

01.	(a, b)	Borrowing costs must be capitalised if they are directly attributable to qualifying assets, which are assets that take a substantial time to complete. Capitalization should cease once substantially all the activities to prepare the asset are complete.								
02.	(c)	Rs. 10 million x 7.5% x 2/12 = Rs. 125,000								
03.	(d)	Rs. 10 million x 7.5% x 10/12 = Rs. 625,000								
04.	(b)	Temporary investment income earned during the construction period should be netted off the amount capitalised. However, the interest was earned prior to the period of construction. Therefore, the investment income earned should be taken to the statement of profit or loss as investment income.								
05.	(a)	$Capitalisation\ rate = \frac{(9\% \times 15m) + (11\% \times 24m)}{15 + 24} = 10.23\%$ Rs. 6m x 10.23% x 9/12 = Rs.460,350 Rs. 2m x 10.23% x 5/12 = Rs. 85,250 Total Rs. 545,600								
06.	(a)	<table><tr><td></td><td>Rs.</td></tr><tr><td>March – December (Rs. 24m x 8% x 10/ 12)</td><td>1,600,000</td></tr><tr><td>Less investment income (Rs. 10m x 6% x 4/12)</td><td>(200,000)</td></tr><tr><td></td><td>1,400,000</td></tr></table> Temporary investment income before commencement would be recognised as finance income in profit or loss.		Rs.	March – December (Rs. 24m x 8% x 10/ 12)	1,600,000	Less investment income (Rs. 10m x 6% x 4/12)	(200,000)		1,400,000
	Rs.									
March – December (Rs. 24m x 8% x 10/ 12)	1,600,000									
Less investment income (Rs. 10m x 6% x 4/12)	(200,000)									
	1,400,000									
07.	(d)	$Capitalisation\ rate = \frac{(10\% \times 140m) + (8\% \times 200m)}{140 + 200} = 8.8\%$ Rs. 50 million x 8.8% x 6/12 = Rs. 2.2 million								
08.	(a)	Rs.12m x 6.75% = Rs. 810,000 $Capitalisation\ rate = \frac{(6\% \times 10m) + (8\% \times 6m)}{10 + 6} = 6.75\%$								
09.	(d)	Borrowing costs do not include repayment of borrowing itself.								
10.	(b)	Borrowing costs incurred, when not capitalised, are recognised as an expense.								
11.	(c)	Repayment of borrowing is not a criteria for commencement of capitalisation of borrowing costs.								
12.	(b)	Once the asset is substantially complete, the capitalisation of borrowing costs must cease.								
13.	(a)	Inventories that are manufactured, or otherwise produced, in large quantities on a repetitive basis (over a short period of time) are not qualifying assets.								

14.	(c)	Assets that are ready for their intended use when acquired are not qualifying asset.	
15.	(c)	Capitalisation of borrowing costs must suspend during extended periods in which active development of a qualifying asset is interrupted.	
16.	(a)	If funds have been arranged from various general borrowings, the amount to be capitalised is based on the weighted average cost of borrowings.	
17.	(a)		Rs.
		Interest on specific loan Rs. 20m x 9% x 6/12 (Mar to Aug)	900,000
		Less: Investment income Rs. 12m x 6% x 4/12 (Mar to Jun)	(240,000)
			660,000
		In January and February, all criteria for capitalisation of borrowing costs had not been met.	
18.	(a)	Statement (II) is incorrect. Additionally, borrowing cost must have been incurred and expenditure must have been made.	
19.	(d)	Nil	

STICKY NOTES



AT A GLANCE

SPOTLIGHT

STICKY NOTES

IAS 16 PROPERTY, PLANT AND EQUIPMENT

IN THIS CHAPTER:

AT A GLANCE

SPOTLIGHT

1. Recognition and measurement
2. Depreciation
3. Derecognition
4. Measurement after recognition
5. Disclosure
6. Comprehensive Examples
7. Objective Based Q&A

STICKY NOTES

AT A GLANCE

IAS 16 deals with property, plant and equipment i.e. long term tangible assets held for use in the business for:

- a) production or supply of goods or services;
- b) rental to others; or
- c) administrative purposes.

These assets are initially measured at cost, i.e. all the costs incurred to bring the asset to its intended use. It normally includes purchase price less any trade discounts and rebates and includes non-refundable taxes, import duties, cost of site preparation, installation cost, etc.

Subsequent expenditure is normally charged to profit or loss unless it enhances the economic benefits of the related assets.

Depreciation is charged on these assets to match the expense against the benefit derived from use of these assets in the business. The assets are normally depreciated using straight line, reducing balance, units of production or sum of digits method.

After recognition, the entity may choose the policy to subsequently measure the assets at either:

- Cost model: the assets are carried at cost less accumulated depreciation and accumulated impairment losses; or
- Revaluation model: the assets are carried at revalued amount (fair value) less subsequent accumulated depreciation and subsequent accumulated impairment losses.

IAS 16 provides detailed guidance regarding recognition of revaluation gain or loss and reversal thereof including realisation of revaluation surplus.

The assets are derecognised when disposed of or when they become permanently redundant and no economic benefits are expected from their sale or use. The gain or loss on derecognition is charged to profit or loss.

1 RECOGNITION AND MEASUREMENT

1.1 Introduction [IAS 16: 6]

Property, plant and equipment (PPE) are a company's long term, tangible fixed assets that are vital to business operations and cannot be easily liquidated.

Property, plant and equipment are tangible items that:

- a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and
- b) are expected to be used during more than one period.

It is important to distinguish PPE from:

- intangible assets e.g. patents, software, etc. Intangible assets do not have physical substance and therefore are classified and presented separately, although they are also held for long term and are often vital to business operations. Intangible assets are accounted for under IAS 38 (Intangible Assets).
- inventory. Although inventory items usually have physical substance, they differ from PPE because they are held for resale in the ordinary course of business. Inventories are accounted for under IAS 2 (Inventory).

If an entity's main business is selling machines, those machine are inventory items and are not classified as PPE. However, the plant and machinery used to produce the machines for sales is PPE. The same goes for real estate businesses. Their corporate offices are PPE but the houses they sell are inventory.

1.2 Recognition [IAS 16: 7 to 9 & 11]

The cost of an item of PPE shall be recognised as an asset if, and only if:

- a) it is probable that future economic benefits associated with the item will flow to the entity; and
- b) the cost of the item can be measured reliably.

Items of property, plant and equipment may be acquired for safety or environmental reasons. The acquisition of such property, plant and equipment, although not directly increasing the future economic benefits of any particular existing item of property, plant and equipment, may be necessary for an entity to obtain the future economic benefits from its other assets. Such items of property, plant and equipment qualify for recognition as assets because they enable an entity to derive future economic benefits from related assets in excess of what could be derived had those items not been acquired. For example, a chemical manufacturer may install new chemical handling processes to comply with environmental requirements for the production and storage of dangerous chemicals; related plant enhancements are recognised as an asset because without them the entity is unable to manufacture and sell chemicals. Spare parts and servicing equipment are usually carried as inventory and recognised in profit or loss as consumed. However, major spare parts and stand-by equipment qualify as PPE when an entity expects to use them during more than one period. Similarly, if the spare parts and servicing equipment can be used only in connection with an item of PPE, they are accounted for as PPE.

As a practical expedient, immaterial items are not recognised as PPE even if they meet the definition criteria, for example, staplers and calculators etc.

1.3 Measurement at recognition [IAS 16: 15 to 17 & 19 to 22]

PPE are initially recorded at cost.

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

The cost of an item of PPE consists of:

- a) its purchase price after any discounts and rebates have been deducted plus any non-refundable / non-adjustable taxes (for example, import taxes or sales tax); plus

- b) the directly attributable costs of 'bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management'. These directly attributable costs may include:
- employee costs arising directly from the installation or construction of the asset
 - the cost of site preparation
 - initial delivery and handling costs
 - installation and assembly costs
 - testing costs (to determine whether the asset is functioning properly)
 - professional fees such as architect and surveyor fee.
- c) the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, for which an entity incurs legal or constructive obligation.

For example, when land is acquired, certain costs are necessary and should be part of the cost of land. These costs include the cost of the land, title and legal fees, site preparation costs like grading and draining and survey costs etc. All of these costs may be considered necessary to get the land ready for its intended use.

The cost of a self-constructed asset is determined using the same principles as for an acquired asset. Borrowing costs including interest may also be capitalised in accordance with IAS 23.

Examples of costs that are not costs of an item of PPE are:

- costs of opening a new facility;
- costs of introducing a new product or service (including costs of advertising and promotional activities);
- costs of conducting business in a new location or with a new class of customer (including costs of staff training); and
- administration and other general overhead costs.

► **Example 01:**

Alex Limited (AL) has purchased a large item of plant. The following costs were incurred:

	Rs. 000
List price of the plant	1,000,000
Trade discount given	50,000
Delivery cost	100,000
Installation cost	125,000
Cost of site preparation	200,000
Architect's fees	15,000
Administration expense	150,000

Local government officials have granted AL a license to operate the plant on condition that AL will dismantle the plant and restore the site to its former condition at the end of the plant's life. AL has estimated the amount of Rs. 250 million in present value terms for the related obligation.

Required:

Calculate the cost of the plant on its initial recognition.

► *Answer:*

	Rs. 000
Purchase price (1,000,000 – 50,000)	950,000
Delivery cost	100,000
Installation cost	125,000
Cost of site preparation	200,000
Architect's fees	15,000
Estimated dismantling and restoration costs	250,000
	1,640,000

Recognition of costs in the carrying amount of an item of PPE ceases when the item is in the location and condition necessary for it to be capable of operating in the manner intended by management. Therefore, costs incurred in using or redeploying an item are not included in the carrying amount of that item. For example, the following costs are not included in the carrying amount of an item of PPE:

- costs incurred while an item capable of operating in the manner intended by management has yet to be brought into use or is operated at less than full capacity;
- initial operating losses; and
- costs of relocating an entity's operations.

Income may be earned through using a building site as a car park until construction starts. Because incidental operations are not necessary to bring an item to the location and condition necessary for it to be capable of operating in the manner intended by management, the income and related expenses of incidental operations are recognised in profit or loss.

Similarly, sale proceeds and related cost of samples produced, while testing whether the asset is functioning properly, are recognised in profit or loss.

1.4 Exchange transaction [IAS 16: 24 to 26]

An asset may be acquired in exchange for another asset. The cost of such an asset is measured at its fair value unless:

- the exchange transaction lacks commercial substance; or
- the fair value of neither the asset received nor the asset given up is reliably measurable.

In simple terms, an exchange transaction has commercial substance when entity's future cash flows are expected to change to a material extent as a result of the transaction. It is usually assumed that exchange transaction has commercial substance.

If the new asset is measured at fair value, the fair value of the asset given up is used to measure the cost of the asset received unless the fair value of the asset received is more clearly evident.

If the new asset is not measured at fair value, its cost is measured at the carrying amount of the asset given in exchange for it.

► **Example 02:**

Following information pertains to four exchange transactions relating to fixed assets:

	(i)	(ii)	(iii)	(iv)
	----- Rs. in million -----			
Cash received/(paid)	1.1	(2.1)	-	-
Assets given up:				
Original cost	10.3	12.4	14.5	14.5
Book value	6.4	7.3	3.4	3.4
Estimated fair value	8.5	6.6	4.6	4.6
Assets received:				
Estimated fair value	7.1	9.0	4.1	Not available

Additional information:

- In case of transaction (i), fair values of both assets are reliably measurable.
- In case of transaction (ii), fair value of the asset received is clearly more evident.
- In case of transaction (iii), fair value of neither asset is reliably measurable.
- In case of transaction (iv), entity's future cash flows are not expected to change as a result of this exchange.

Required:

Calculate the cost of asset received at recognition for each of above transactions.

► **Answer:****Transaction (i)**

Fair value of asset given up Rs. 8.5m – cash received Rs. 1.1m = Rs. 7.4 million

Transaction (ii)

Fair value of asset received = Rs. 9.0 million

Transaction (iii)

Carrying amount of asset given = Rs. 3.4 million

Transaction (iv)

Carrying amount of asset given = Rs. 3.4 million

1.5 Subsequent expenditure [IAS 16: 12 to 14]

The costs of the day-to-day servicing of the item are recognised in profit or loss as incurred, usually as 'repair and maintenance'.

Subsequent expenditure relating to PPE, after their initial acquisition, is capitalised if it meets the criteria for recognition. In practice, this usually means that expenditure is capitalised if it:

- improves the asset (for example, by enhancing its performance or extending its useful life);
- is for a replacement part (the replaced part is derecognised); or
- relates to major inspection or overhaul (the carrying amount of previous inspection or overhaul is derecognised).

2 DEPRECIATION

2.1 Concept and definitions [IAS 16: 6]

The use of long-term asset provides benefit to business over several years, therefore, it is not appropriate to recognise total cost of such assets as an expense either in the year of acquisition or in the year of disposal. Recognising periodic depreciation expense matches the cost of a non-current asset to the benefit earned from its use in the business. In effect, the cost less residual value of the asset is transferred to the statement of comprehensive income over the period for which asset is used.

It is important to understand that the depreciation is not decrease in value of asset; write down of carrying amount of an item of PPE is called impairment loss (which shall be covered in a later chapter).

Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life.

Depreciable amount is cost (or revalued amount) of an asset less its residual value.

The **residual value** of an asset is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.

Useful life is:

- 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 the asset by an entity.

Accumulated Depreciation is the depreciation charged to date (cumulative) on a non-current asset. This is contra asset account (a negative balance of the asset).

Carrying amount (also called net book value (NBV) or written down value (WDV)) is the amount at which an asset is presented in statement of financial position.

Carrying amount = Cost or revalued amount – accumulated depreciation – accumulated impairment

► **Example 03:**

ABC Enterprise bought a machine for Rs. 700,000 in early 2021. Although the machine can be used for seven years but ABC Enterprises expects to use it for 5 years only.

ABC Enterprise estimated that machine can be disposed of for Rs. 620,000 (at current prices) and for Rs. 680,000 (at prices expected at end of 2025). Further, a 5-year old similar machine can be disposed of for Rs. 150,000 (at current prices) and for Rs. 330,000 (at prices expected at end of 2025).

Required:

Determine the useful life and residual value of above machine.

► **Answer:**

The useful life is 5 years i.e. the period over which machine is expected to be available for use by ABC Enterprise.

The residual value is Rs. 150,000 that can be currently obtained if the machine was already in 5 years old condition.

► **Example 04:**

An asset costs Rs. 100,000 and can be easily used for ten years. The management of the business entity intends to use the asset for six years at which point expected residual value will be Rs. 40,000 (at current prices).

Required:

What is depreciable amount and useful life of above asset?

► **Answer**

Depreciable amount = Rs. 100,000 – 40,000 = Rs. 60,000

Useful life is six years as intended by the management of the entity.

2.2 Methods of calculating depreciation [IAS 16: 60, 62 & 62A]

A variety of depreciation methods can be used to allocate the depreciable amount of an asset on a systematic basis over its useful life. However, the depreciation method used should reflect as fairly as possible the pattern in which the asset's economic benefits are expected to be consumed by the entity. A depreciation method that is based on revenue that is generated by an activity that includes the use of an asset is not appropriate.

The four common methods have been discussed below:

2.2.1 Straight line depreciation

In this method, the depreciable amount is charged in equal amounts to each reporting period over the expected useful life of the asset. With the straight-line method, the annual depreciation charge is the same for each full financial year over the life of the asset. This is the most common method in practice and the easiest to calculate.

$$\text{Depreciation} = \frac{\text{Cost} - \text{Residual value}}{\text{Useful life}}$$

$$\text{Alternatively, depreciation} = \text{Cost} \times \text{Rate}$$

$$\text{Rate} = \frac{\text{Depreciable amount}}{\text{Cost} \times \text{Useful life}}$$

► **Example 05:**

Plant bought on 1 January 2021 for Rs. 100,000 with expected useful life of 5 years and residual value of Rs. 10,000. The entity year ends on 31 December.

Required:

Using straight line method, calculate the amount of annual depreciation and carrying amount along with accumulated depreciation for the year 2021 to 2025.

► **Answer**

$$\text{Rate} = \frac{100,000 - 10,000}{100,000 \times 5 \text{ years}} = 18\%$$

	2021	2022	2023	2024	2025
	Rs.	Rs.	Rs.	Rs.	Rs.
Annual depreciation Rs. 100,000 x 18%	18,000	18,000	18,000	18,000	18,000
Cost	100,000	100,000	100,000	100,000	100,000
Accumulated depreciation	(18,000)	(36,000)	(54,000)	(72,000)	(90,000)
Carrying amount	82,000	64,000	46,000	28,000	10,000

► **Example 06:**

An item of equipment costs Rs. 1,260,000. It has an expected useful life of six years and an expected residual value of Rs. 240,000. Using the straight-line method of depreciation, what is the annual depreciation charge and what will be the carrying amount of the asset after four years?

► *Answer*

Annual depreciation charge = Rs. (1,260,000 – 240,000) / 6 years = Rs. 170,000

	Rs.
Asset at cost	1,260,000
Less: Accumulated depreciation Rs. 170,000 x 4 years	(680,000)
Carrying value	580,000

► *Example 07:*

The financial year of an entity is 1st January to 31st December. A non-current asset was purchased on 1st May for Rs. 60,000. Its expected useful life is five years and its expected residual value is zero. It is depreciated by the straight-line method.

Required:

What will be the charge for depreciation in the year of acquisition if a proportion of a full year's depreciation is charged, according to the period for which the asset has been held?

► *Answer*

Depreciation in year 1 = Rs. (60,000 – 0) / 5 years x 8/12 = Rs. 8,000

2.2.2 Reducing balance method:

In this method, the annual depreciation charge is a fixed percentage of the carrying amount of the asset at the start of the period which results in gradually lower depreciation charge as asset's efficiency is reduced over its useful life.

$$\text{Rate} = 1 - \sqrt[n]{\frac{\text{Residual value}}{\text{Cost}}}$$

$$\text{Depreciation} = \text{Net book value} \times \text{Rate}$$

► *Example 08:*

Plant bought on 1 January 2021 for Rs. 100,000 with expected useful life of 5 years and residual value of Rs. 10,000. The entity year ends on 31 December.

Required:

Using reducing balance method, calculate the amount of annual depreciation and carrying amount along with accumulated depreciation for the year 2021 to 2025.

► *Answer*

$$\text{Rate} = 1 - \sqrt[5]{\frac{10,000}{100,000}} = 36.9\%$$

	2021	2022	2023	2024	2025
	Rs.	Rs.	Rs.	Rs.	Rs.
Annual depreciation Carrying amount x 36.9%	36,900	23,284	14,692	9,271	5,853
Cost	100,000	100,000	100,000	100,000	100,000
Accumulated depreciation	(36,900)	(60,184)	(74,876)	(84,147)	(90,000)
Carrying amount	63,100	39,816	25,124	15,853	10,000

Notice that, each subsequent year's depreciation charge is 63.1% (i.e. 100% – 36.9%) of previous year's charge.

► **Example 09:**

A non-current asset cost Rs. 64,000. It is depreciated by the reducing balance method, at the rate of 25% each year. What is the carrying amount at the end of year 3?

► **Answer**

	Rs.
Cost of asset	64,000
Year 1 Depreciation (25%)	(16,000)
Carrying amount at the end of year 1	48,000
Year 2 Depreciation (25%)	(12,000)
Carrying amount at the end of year 2	36,000
Year 3 Depreciation (25%)	(9,000)
Carrying amount at the end of year 3	27,000

Alternatively, $\text{Rs. } 64,000 \times (0.75)^3 = \text{Rs. } 27,000$

2.2.3 Units of production method

In this method, depreciation is calculated by expressing the useful life of an asset in terms of its expected total output and allocating the annual charge to depreciation based on actual output. The higher the usage, the higher the depreciation charge and vice versa.

$$\text{Rate} = \frac{\text{Cost} - \text{Residual value}}{\text{Useful life in units}}$$

$$\text{Depreciation} = \text{Units used or produced} \times \text{Rate}$$

► **Example 10:**

Plant bought on 1 January 2021 for Rs. 100,000 with expected useful life of 5 years and residual value of Rs. 10,000 and the plant can be used to produce 7500 units over its life. The entity year ends on 31 December.

Actual production of units has been 1500 units, 1800 units, 1200 units, 2000 units and 1000 units from year 2021 to 2025 respectively.

Required:

Using units of production method, calculate the amount of annual depreciation and carrying amount along with accumulated depreciation for the year 2021 to 2025.

► **Answer**

$$\text{Rate} = \frac{100,000 - 10,000}{7500 \text{ units}} = \text{Rs. } 12 \text{ per unit}$$

	2021	2022	2023	2024	2025
	Rs.	Rs.	Rs.	Rs.	Rs.
Annual depreciation Units produced x Rs. 12	18,000	21,600	14,400	24,000	12,000
Cost	100,000	100,000	100,000	100,000	100,000
Accumulated depreciation	(18,000)	(39,600)	(54,000)	(78,000)	(90,000)
Carrying value	82,000	60,400	46,000	22,000	10,000

2.2.4 Sum of digits method

In this method, depreciation is calculated by multiplying the depreciable amount by a fraction where numerator is the remaining life of the asset at the start of the period and the denominator is the sum of all the years' useful life at the start of ownership. This method results in stepwise lower depreciation in later years of useful life.

$$\text{Depreciation} = \text{Depreciable amount} \times \frac{\text{Remaining years}}{\text{Sum of years' digits}}$$

Sum of years' digits may also be calculated using the following formula:

$$= \frac{n(n+1)}{2}$$

► **Example 11:**

Plant bought on 1 January 2021 for Rs. 100,000 with expected useful life of 5 years and residual value of Rs. 10,000. The entity year ends on 31 December.

Required:

Using sum of digits method, calculate the amount of annual depreciation and carrying amount along with accumulated depreciation for the year 2021 to 2025.

► **Answer**

$$\text{Sum of digits} = \frac{n(n+1)}{2} = \frac{5(5+1)}{2} = 15$$

	2021	2022	2023	2024	2025
	Rs.	Rs.	Rs.	Rs.	Rs.
Annual depreciation Rs. 90,000xremaining years/15	30,000	24,000	18,000	12,000	6,000
Cost	100,000	100,000	100,000	100,000	100,000
Accumulated depreciation	(30,000)	(54,000)	(72,000)	(84,000)	(90,000)
Carrying value	70,000	46,000	28,000	16,000	10,000

► **Example 12:**

A motor vehicle cost Rs.400,000. It has an expected residual value after 5 years of Rs.40,000. If the sum of the digits method of depreciation is used, what will be the carrying amount of the asset at the end of Year 2?

► **Answer**

$$\text{Sum of digits} = 5 + 4 + 3 + 2 + 1 = 15$$

	Rs.
Cost of asset	400,000
Year 1 Depreciation (400,000 – 40,000) x 5/15	(120,000)
Carrying amount at the end of year 1	280,000
Year 2 Depreciation (400,000 – 40,000) x 4/15	(96,000)
Carrying amount at the end of year 2	184,000

2.3 Depreciation charge and period [IAS 16: 43, 44, 48, 52, 54 & 55]

The depreciation charge for each period shall be recognised in profit or loss unless it is included in the carrying amount of another asset. For example, if machinery (PPE of the business) is used in construction of office building, the depreciation of such machinery arising during the construction period shall be capitalised in the cost of building.

The journal entry for depreciation expense is as follows:

Debit	Depreciation expense
Credit	Accumulated depreciation

Depreciation is charged even if the asset is idle and not being used. However, in following situations depreciation charge may be zero:

- Under usage methods of depreciation, the depreciation charge can be zero while there is no production.
- Freehold land has an unlimited useful life and therefore is not depreciated. However, leasehold land is depreciated since lease term is definite. Similarly, land improvements (parking lots, sidewalks, landscaping, irrigation systems etc.) have a limited useful life and are also depreciated.
- Depreciation will be zero when the fully depreciated asset is still in use.
- No depreciation will be charged when residual value exceeds carrying amount.

Depreciation of an asset begins when it is available for use, i.e. when it is in the location and condition necessary for it to be capable of operating in the manner intended by management. This may be earlier than the date it is actually brought into use. Depreciation of an asset ceases when it is derecognised/disposed.

Each part of an item of PPE with a cost that is significant in relation to the total cost of the item shall be depreciated separately. For example, it may be appropriate to depreciate separately the airframe and engines of an aircraft.

► Example 13:

An office property cost Rs. 5 million, of which the land value is Rs. 2 million and the cost of the building is Rs. 3 million. The building has an estimated life of 50 years. What is the annual depreciation charge on the property, using the straight-line method?

► Answer

Rs. 3,000,000 (other than land) / 50 years = Rs. 60,000

► Example 14:

An entity constructed a building for its own use. The building was completed on 1 July 2008 and occupied on 1 September 2008. The entity used the building for a long time but then due to expansion in its business it decided on 1 July 2015 to shift to new rented premises. The entity shifted to new premises on 1 August 2015 and disposed of the old building on 31 December 2015.

Required:

Identify the date from which depreciation should be commenced and date when depreciation charge should cease.

► Answer

Commencement of depreciation: 1 July 2008 (when asset became available for use)

Cessation of depreciation: 31 December 2015 (when asset is disposed of)

2.4 Change in estimate: depreciation method [IAS 16: 61]

The depreciation method applied to an asset shall be reviewed at least at each financial year-end and, if there has been a significant change in the expected pattern of consumption of the future economic benefits embodied in the asset, the method shall be changed.

The carrying amount should be written off over the remaining useful life, commencing with the period in which the change is made.

► **Example 15:**

On 1 January 2001, Air Limited purchased an asset for Rs. 10,000 with nil residual value and is intended to be used for 10 years. The entity uses straight line method.

On 1 January 2003, Air Limited reconsidered the use of its depreciation methods and concluded that the straight-line method is not appropriate for this type of asset instead 25% depreciation on reducing balance method is appropriate.

Required:

Calculate depreciation expense from year 2001 to year 2004.

► **Answer**

Year	Calculation	Rs.
2001	Rs. 10,000 / 10 years	1,000
2002	Rs. 9,000 / 9 years	1,000
2003	Rs. 10,000 – 1,000 – 1,000 = Rs. 8,000 x 25%	2,000
2004	Rs. 8,000 – 2,000 = Rs. 6,000 x 25%	1,500

2.5 Change in estimate: Review of useful life and residual values [IAS 16: 51]

Useful life and residual value of assets should be reviewed at end of each financial year and revised if expectations are significantly different from previous estimates.

The carrying amount of the asset at the date of revision less any revised residual value should be depreciated over the revised remaining useful life.

► **Example 16:**

On 1 January 2001, Water Limited purchased an asset for Rs. 12,000 with estimated residual value of Rs. 2,000 and is intended to be used for 10 years. The entity uses straight line method.

In 2003, Water Limited reviewed the useful life and residual value of the asset. It was estimated that the asset's remaining useful life is now only 5 years, however, the estimate of residual value has been increased to Rs. 3,000.

Required:

Calculate depreciation expense from year 2001 to year 2004.

► **Answer:**

Year	Calculation	Rs.
2001	Rs. 12,000 – 2,000 = Rs. 10,000 / 10 years	1,000
2002	Same as above	1,000
2003	Rs. 12,000 – 1,000 – 1,000 = Rs. 10,000 – Rs. 3,000 = Rs. 7,000 / 5 years	1,400
2004	Same as above	1,400

3 DERECOGNITION

3.1 Accounting treatment and calculation [IAS 16: 67 to 71]

The carrying amount of an item of PPE shall be derecognised:

- on disposal (sale/ donation); or
- when no future economic benefits are expected from its use or disposal.

Date of disposal is when recipient obtains control of the asset.

In case part of an asset is replaced, new part is recognised (capitalised) and the replaced (old) part is derecognised regardless of whether the replaced part had been depreciated separately. If it is not practicable for an entity to determine the carrying amount of the replaced part, it may use the cost of the replacement as an indication of what the cost of the replaced part was at the time it was acquired or constructed.

Gain or loss is recognised in profit or loss. However, gain is not classified as revenue; it is presented as other income.

$$\text{Gain (loss)} = \text{Net sale proceeds} - \text{Carrying amount at date of disposal}$$

$$\text{Net disposal proceeds} = \text{Cash received} + \text{New asset received}^* - \text{Cash paid}^* - \text{disposal costs}$$

$$\text{Carrying amount} = \text{Cost} - \text{accumulated depreciation} - \text{accumulated impairment losses}$$

$$\text{Cash to be paid in exchange} = \text{Agreed price of new asset}^* - \text{trade in value}^{**}$$

***in case of exchange of assets.**

****trade in value is value of old asset agreed in asset exchange.**

► Example 17:

A non-current asset originally cost Rs. 75,000. Accumulated depreciation is Rs.51,000. The asset is now sold for Rs. 18,000. Disposal costs are Rs. 500.

Required:

Calculate the gain or loss on disposal of above asset.

► Answer:

$$\text{Net sale proceeds} = \text{Rs. } 18,000 - 500 = \text{Rs. } 17,500$$

$$\text{Carrying amount} = \text{Rs. } 75,000 - 51,000 = \text{Rs. } 24,000$$

$$\text{Gain (loss) on disposal} = \text{Rs. } 17,500 - 24,000 = \text{Rs. } (6,500) \text{ Loss}$$

► Example 18:

The following data relates to exchange of old machinery with new equipment by Adeel Limited:

	Rs.
Cost (old machinery)	100,000
Accumulated depreciation (of machine given)	30,000
Cash received in exchange	18,000
Cost of new equipment acquired in exchange	60,000
Commission paid to broker	3,000

Required:

Calculate gain or loss on disposal.

► **Answer:**

Net disposal proceeds = Rs. 18,000 + 60,000 – 3,000 = Rs. 75,000

Carrying amount = Rs. 100,000 – 30,000 = Rs. 70,000

Gain (loss) = Rs. 75,000 – 70,000 = Rs. 5,000 gain

3.2 Accounting entries: disposal account

The gain or loss on disposal of a non-current asset may be recorded by creating a temporary asset's disposal account. The following journal entries may be recorded:

1.	Transfer the cost of non-current asset disposed (or given in exchange)	Debit Disposal account Credit PPE (old)
2.	Transfer the accumulated depreciation of asset disposed (or given in exchange)	Debit Accumulated depreciation Credit Disposal account
3.	Disposal proceeds / cash received from disposal or part exchange	Debit Bank / Receivable Credit Disposal account
4.	Part-exchange (asset received)	Debit PPE (new) Credit Disposal account
5.	Disposal costs incurred	Debit Disposal account Credit Bank / payable
6.	Cash paid in part exchange	Debit Disposal account Credit Bank / payable
7.	Gain on disposal	Debit Disposal account Credit Gain (profit or loss)
	Loss on disposal	Debit Loss (profit or loss) Credit Disposal account

► **Example 19:**

The following data relates to exchange of old machinery with new equipment by Adeel Limited:

	Rs.
Cost (old machinery)	100,000
Accumulated depreciation (of machine given)	30,000
Cash received in exchange	18,000
Cost of new equipment acquired in exchange	60,000
Commission paid to broker	3,000

Required:

Prepare disposal account to determine the gain or loss on the disposal.

► *Answer:*

Disposal account

	Rs.		Rs.
PPE (old machinery)	100,000	Accumulated depreciation	30,000
Cash paid (disposal costs)	3,000	Bank / Receivable	18,000
Gain on disposal (bal.)	5,000	PPE (new equipment)	60,000
	108,000		108,000

3.3 Combined journal entry for disposal

All journal entries related to the disposal of non-current asset may be combined into one journal entry by skipping the temporary disposal account.

Debit	Accumulated depreciation
Debit	Bank / Receivable
Debit	PPE (new)
Debit	Loss (profit or loss) (balancing, if debit side is short)
Credit	PPE (old)
Credit	Cash (disposal costs)
Credit	Cash (part exchange)
Credit	Gain (profit or loss) (balancing, if credit side is short)

► *Example 20:*

The following data relates to exchange of old machinery with new equipment by Adeel Limited:

	Rs.
Cost (old machinery)	100,000
Accumulated depreciation (of machine given)	30,000
Cash received in exchange	18,000
Cost of new equipment acquired in exchange	60,000
Commission paid to broker	3,000

Required:

Prepare one combined journal entry for the disposal.

► *Answer:*

Journal entry for disposal

	Debit Rs.	Credit Rs.
Accumulated depreciation	30,000	
Bank / Receivable	18,000	
PPE (new)	60,000	
PPE (old)		100,000
Cash (disposal costs)		3,000
Gain (PL) (balancing)		5,000

► **Example 21:**

The following information is available in respect of machines of Akmal Brothers:

- The balances of cost and accumulated depreciation of machines as on 1 January 2017 were Rs. 800,000 and Rs. 333,000 respectively.
- A machine acquired on 1 January 2014 having net book value of Rs. 31,935 on 1 January 2017 was sold for Rs. 34,000 on 30 April 2017. Cost of disposal incurred was Rs. 5,000.
- On 1 July 2017, a machine having fair value of Rs. 40,000 on that date was exchanged for a new machine. The balance of the purchase price was paid through a cheque of Rs. 80,000. The list price of the new machine was Rs. 130,000. The old machine had been acquired at a cost of Rs. 65,000 on 1 October 2015.
- Machines are depreciated at 15% per annum using the reducing balance method.

Required:

Prepare the following ledger accounts pertaining to the machines for the year ended 31 December 2017:

- Cost
- Accumulated depreciation
- Gain/loss on disposal

► **Answer:****Akmal Brothers**

Machines - Cost					
Date	Description	Rs.	Date	Description	Rs.
1 Jan 17	b/d	800,000	30 Apr 17	Disposal [31,935 / 0.85 ³]	52,000
1 Jul 17	Disposal (40,000 + 80,000)	120,000	1 Jul 17	Disposal (exchange)	65,000
			31 Dec 17	c/d	803,000
		920,000			920,000

Accumulated depreciation – Machines					
Date	Description	Rs.	Date	Description	Rs.
30 Apr 17	Disposal (W1)	21,662	1 Jan 17	b/d	333,000
1 Jul 17	Disposal (W2)	15,810	31 Dec 17	Depreciation exp (W3)	71,868
31 Dec 17	c/d	367,396			
		404,868			404,868

Gain (Loss) on Disposal – Machines					
Date	Description	Rs.	Date	Description	Rs.
30 Apr 17	Cost	52,000	30 Apr 17	Acc. Dep.	21,662
30 Apr 17	Bank (disposal costs)	5,000	30 Apr 17	Bank (sale proceeds)	34,000
1 Jul 17	Cost	65,000	1 Jul 17	Acc. Dep.	15,810
1 Jul 17	Bank (for exchange)	80,000	1 Jul 17	Cost (new asset)	120,000
			31 Dec 17	Loss on disposal (P&L)	10,528
		202,000			202,000

W1: Accumulated depreciation – Machine sold		Rs.
Till 31 Dec 2016	[52,000 – 31,935]	20,065
From 1 Jan 2017 to 30 Apr 2017	[31,935 x 15% x 4/12]	1,597
		21,662

W2: Accumulated depreciation – Machine exchanged		Rs.
From 1 Oct 2015 to 31 Dec 2015	[65,000 x 15% x 3/12]	2,438
Year 2016	[(65,000 – 2,438) x 15%]	9,384
		11,822
From 1 Jan 2017 to 30 Jun 2017	[(65,000 – 11,822) x 15% x 6/12]	3,988
		15,810

W3: Depreciation (Year 2017)	Cost	Acc. Dep.	WDV	Rate	Months	Rs.
		1 Jan 2017				
	Rs.					
Disposed 1	52,000	20,065	31,935	15%	4/12	1,597
Disposed 2	65,000	11,822	53,178	15%	6/12	3,988
Other remaining	683,000	301,113	381,887	15%	12/12	57,283
Total opening	800,000	333,000	467,000			
Addition 1	120,000			15%	6/12	9,000
						71,868

4 MEASUREMENT AFTER RECOGNITION

4.1 Subsequent measurement [IAS 16: 29, 30, 31 & 37]

An entity shall choose either the cost model or the revaluation model as its accounting policy and shall apply that policy to an entire class of PPE.

Carrying amount of asset: Cost model	Rs. m
Cost	xxx
Less: Accumulated depreciation	(xx)
Less: Accumulated impairment	(xx)
	xxx

Carrying amount of asset: Revaluation model	Rs. m
Fair value at specific date	xxx
Less: Subsequent accumulated depreciation	(xx)
Less: Subsequent accumulated impairment	(xx)
	xxx

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

- land;
- land and buildings;
- machinery;
- ships;
- aircraft;
- motor vehicles;
- furniture and fixtures; and
- office equipment.

4.2 Conditions for revaluation model [IAS 16: 31, 34 & 36]

The following considerations must be taken into account for applying the revaluation model:

1.	Reliable measurement	The fair value of the item of PPE can be measured reliably. This may or may not be market based valuation.
2.	Sufficient regularity	The frequency of revaluations depends upon the changes in fair values of the items of PPE being revalued. When the fair value of a revalued asset differs materially from its carrying amount, a further revaluation is required. Some items of PPE experience significant and volatile changes in fair value, thus necessitating annual revaluation. Such frequent revaluations are unnecessary for items of PPE with only insignificant changes in fair value. Instead, it may be necessary to revalue the item only every three or five years.
3.	Class wise application	If an item of PPE is revalued, the entire class of PPE to which that asset belongs shall be revalued. For example, if a plant is revalued, all the plant and machineries held by the entity must be revalued.

4.3 Accounting entries [IAS 16: 35]

When an item of PPE is revalued, the carrying amount of that asset is adjusted to the revalued amount by eliminating accumulated depreciation as follows:

1.	Elimination of depreciation	Debit Accumulated depreciation Credit Asset	
2.	Recording gain or loss	Debit Asset Credit Gain on revaluation	Debit Loss on revaluation Credit Asset

After PPE has been revalued, depreciation charge is based on the new valuation over the remaining useful life.

4.4 Recognition of revaluation gain or loss [IAS 16: 39 to 41]

4.4.1 Asset carried at cost, revalued upwards

If an asset's carrying amount is increased as a result of a revaluation, the increase shall be recognised in other comprehensive income and accumulated in equity under the heading of revaluation surplus.

► **Example 22:**

On 1 January 2021, M1 Limited purchased a building for Rs. 100 million with nil residual value and 10 years useful life. The company policy is not to transfer incremental depreciation.

On 31 December 2021, the building was revalued to Rs. 108 million

Required:

Pass the journal entries for the year ended 31 December 2021.

► **Answer:**

Journal entries

Date	Particulars	Debit Rs. m	Credit Rs. m
1 Jan 2021	PPE	100	
	Bank		100
31 Dec 2021	Depreciation [100m / 10 years]	10	
	Accumulated depreciation		10
31 Dec 2021	Accumulated depreciation	10	
	PPE		10
	PPE [108 – (100 – 10)]	18	
	Gain on revaluation (OCI)		18

4.4.2 Asset carried at cost, revalued downwards

If an asset's carrying amount is decreased as a result of a revaluation, the decrease shall be recognised in profit or loss.

► **Example 23:**

On 1 January 2021, J1 Limited purchased premises for Rs. 100 million with nil residual value and 10 years useful life.

On 31 December 2021, the building was revalued to Rs. 63 million.

Required:

Pass the journal entries for the year ended 31 December 2021.

► *Answer:*

Journal entries

Date	Particulars	Debit Rs. m	Credit Rs. m
1 Jan 2021	PPE	100	
	Bank		100
31 Dec 2021	Depreciation [100m / 10 years]	10	
	Accumulated depreciation		10
31 Dec 2021	Accumulated depreciation	10	
	PPE		10
	Loss on revaluation (PL) [63 – (100 – 10)]	27	
	PPE		27

4.4.3 Asset carried at revaluation surplus, revalued downwards

If an asset's carrying amount, that was previously revalued upwards, is decreased as a result of a revaluation, the decrease shall be recognised in other comprehensive income to the extent of any credit balance existing in the revaluation surplus in respect of that asset, reducing the revaluation surplus balance in equity.

Any excess decrease shall be recognised in profit or loss.

► *Example 24:*

On 1 January 2021, M2 Limited purchased a building for Rs. 100 million with nil residual value and 10 years useful life.

On 31 December 2021, the building was revalued to Rs. 108 million and a surplus of Rs. 18 million was recognised. M2 Limited does not transfer any revaluation surplus to retained earnings on annual basis.

On 31 December 2022, due to slump in the property market, the building was again revalued but this time the worth was only Rs. 55 million

Required:

Pass the journal entries for the year ended 31 December 2022.

► *Answer:*

Journal entries

Date	Particulars	Debit Rs. m	Credit Rs. m
31 Dec 2022	Depreciation [108m / 9 years]	12	
	Accumulated depreciation		12
31 Dec 2022	Accumulated depreciation	12	
	PPE		12
	Loss on revaluation (OCI)	18	
	Loss on revaluation (PL) [41 – 18]	23	
	PPE [55 – (108 – 12)]		41

4.4.4 Realisation of revaluation surplus with usage

The unrealised gain on assets is realised either on disposal (will be covered later in this chapter) or over useful life of asset as the asset is used. IAS 16 allows, but does not require, the transfer of some of the revaluation surplus to retained earnings as the asset is used by the entity. The usual assumption is that such transfer is made.

The journal entry for this transfer is:

Debit	Revaluation surplus
Credit	Retained earnings

This transfer is presented in statement of changes in equity and not in profit or loss. This amount of transfer is often referred to as “incremental depreciation” and is calculated as the difference between depreciation based on the revalued carrying amount of the asset and depreciation based on the asset’s original cost.

Alternatively, the amount may be calculated by dividing the balance in revaluation surplus account by remaining useful life of the asset, in case of straight-line method of depreciation.

► **Example 25:**

On 1 January 2021, M3 Limited purchased a building for Rs. 100 million with nil residual value and 10 years useful life.

On 31 December 2021, the building was revalued to Rs. 108 million and a surplus of Rs. 18 million was recognised. M3 Limited transfers maximum possible revaluation surplus to retained earnings on annual basis.

On 31 December 2022, due to slump in the property market, the building was again revalued but this time the worth was only Rs. 55 million

Required:

Pass the journal entries for the year ended 31 December 2022.

► **Answer:**

Journal entries

Date	Particulars	Debit Rs. m	Credit Rs. m
31 Dec 2022	Depreciation [108m / 9 years]	12	
	Accumulated depreciation		12
	Revaluation surplus [12 – 10] or [18 / 9 years]	2	
	Retained earnings		2
31 Dec 2022	Accumulated depreciation	12	
	PPE		12
	Loss on revaluation (OCI) [18 – 2]	16	
	Loss on revaluation (PL) [41 – 16]	25	
	PPE [55 – (108 – 12)]		41

4.4.5 Asset carried at revaluation deficit, revalued upwards

If an asset’s carrying amount, that was previously revalued downwards, is increased as a result of a revaluation, the increase shall be recognised in profit or loss to the extent that it reverses a revaluation decrease of the same asset previously recognised (i.e. revaluation loss recognised in profit or loss – decrease in depreciation due to revaluation loss) in profit or loss.

Any excess increase shall be recognised in other comprehensive income.

► **Example 26:**

On 1 January 2021, J2 Limited purchased premises for Rs. 100 million with nil residual value and 10 years useful life.

On 31 December 2021, the building was revalued to Rs. 63 million and the loss of Rs. 27 million was correctly recorded in profit or loss.

On 31 December 2022, due to surge in the property market, the building was again revalued and this time the worth was Rs. 92 million.

Required:

Pass the journal entries for the year ended 31 December 2022.

► **Answer:****Journal entries**

Date	Particulars	Debit Rs. m	Credit Rs. m
31 Dec 2022	Depreciation [63m / 9 years]	7	
	Accumulated depreciation		7
31 Dec 2022	Accumulated depreciation	7	
	PPE		7
	PPE [92 – (63 – 7)]	36	
	Reversal of revaluation loss* (PL)		24
	Gain on revaluation (OCI)		12
	<i>*[27m – depreciation decrease 3m (10 – 7)]</i>		

4.5 Realisation of revaluation surplus on disposal [IAS 16: 41]

The unrealised gain on assets is completely realised on disposal. IAS 16 allows, but does not require, the transfer of revaluation surplus to retained earnings when the asset is retired or disposed of. The usual assumption is that such transfer is made.

The journal entry for this transfer is same but in case of disposal the whole amount is transferred, not just the differential depreciation:

Debit	Revaluation surplus
Credit	Retained earnings

This transfer is presented in statement of changes in equity and not in profit or loss.

► **Example 27:**

A revalued asset with a gross carrying amount of Rs. 100 million and accumulated depreciation of Rs. 30 million was sold for Rs. 95 million.

There is a Rs. 40 million revaluation surplus, relating to this asset on the date of disposal.

Required:

Pass the journal entries on disposal.

► *Answer:*

Journal entries

Sr #	Particulars	Debit Rs. m	Credit Rs. m
(i)	Bank	95	
	Accumulated depreciation	30	
	Asset		100
	Gain on disposal (balancing)		25
(ii)	Revaluation surplus	40	
	Retained earnings		40

► *Example 28:*

Ali Limited (AL) uses the revaluation model for subsequent measurement of its property, plant and equipment and has a policy of revaluing its assets on an annual basis using the net replacement value method.

The following information pertains to AL's building:

- The building was purchased on 01 January 2010 for Rs. 200 million with expected useful life of ten years.
- AL depreciates buildings on the straight line basis over their useful life.
- The results of revaluations carried out during the last three years by Standard Valuation Service, an independent firm of values, are as follows:

Revaluation date	Fair value Rs. in million
1 January 2011	280
1 January 2012	170
1 January 2013	180

Required:

The journal entries relating to the above transactions including revaluations for the year ended December 31, 2010, 2011, 2012 and 2013.

► *Answer:*

Journal entries

Date	Particulars	Debit Rs. m	Credit Rs. m
1 Jan 2010	Building	200	
	Bank		200
31 Dec 2010	Depreciation [200m / 10 years]	20	
	Accumulated depreciation		20
1 Jan 2011	Accumulated depreciation	20	
	Building		20

Date	Particulars	Debit Rs. m	Credit Rs. m
	Building [280 – (200 – 20)]	100	
	Gain on revaluation (OCI)		100
31 Dec 2011	Depreciation [280m / 9 years]	31	
	Accumulated depreciation		31
	Revaluation surplus [31m – 20m]	11	
	Retained earnings		11
1 Jan 2012	Accumulated depreciation	31	
	Building		31
	Loss on revaluation (OCI) [170 – (280 – 31)]	79	
	Building		79
31 Dec 2012	Depreciation [170m / 8 years]	21.25	
	Accumulated depreciation		21.25
	Revaluation surplus [21.25m – 20m]	1.25	
	Retained earnings		1.25
1 Jan 2013	Accumulated depreciation	21.25	
	Building		21.25
	Building [180 – (170 – 21.25)]	31.25	
	Gain on revaluation (OCI)		31.25
31 Dec 2013	Depreciation [180m / 7 years]	25.7	
	Accumulated depreciation		25.7
	Revaluation surplus [25.7m – 20m]	5.7	
	Retained earnings		5.7

► **Example 29:**

Shahzad Textile Mills Limited (STML) purchased a plant for Rs. 500 million on 1 July 2010. The plant has an estimated useful life of 10 years and no residual value.

STML uses revaluation model for subsequent measurement of its property, plant and equipment and accounts for revaluations on net replacement value method. The details of revaluations performed by an independent firm of valuers are as follows:

Revaluation date	Fair value
1 July 2011	Rs. 575 million
1 July 2012	Rs. 390 million
1 July 2013	Rs. 380 million

Required:

Prepare journal entries to record the above transactions from the date of acquisition of the plant to the year ended 30 June 2014.

► Answer:

Journal entries

Date	Particulars	Debit	Credit
		Rs. m	Rs. m
1-Jul-10	Plant	500	
	Bank		500
30-Jun-11	Depreciation [500m / 10 years]	50	
	Accumulated depreciation - Plant		50
1-Jul-11	Accumulated depreciation - Plant	50	
	Plant		50
1-Jul-11	Plant [575m - (500 - 50)]	125	
	Revaluation Surplus (OCI)		125
30-Jun-12	Depreciation [575m / 9 years]	63.89	
	Accumulated depreciation - Plant		63.89
30-Jun-12	Revaluation surplus [125m / 9 years]	13.89	
	Retained earnings		13.89
1-Jul-12	Accumulated depreciation - Plant	63.89	
	Plant		63.89
1-Jul-12	Revaluation loss (OCI) [125m - 13.89m]	111.11	
	Revaluation loss (PL) [balancing]	10.00	
	Plant [390m - (575 - 63.89)]		121.11
30-Jun-13	Depreciation [390m / 8 years]	48.75	
	Accumulated depreciation - Plant		48.75
1-Jul-13	Accumulated depreciation - Plant	48.75	
	Plant		48.75
1-Jul-13	Plant [380m - (390 - 48.75)]	38.75	
	Rev. gain (PL) [10m - (50 - 48.75)]		8.75
	Revaluation gain (OCI) [balancing]		30.00
30-Jun-14	Depreciation [380m / 7 years]	54.29	
	Accumulated depreciation - Plant		54.29
30-Jun-14	Revaluation surplus [30m / 7 years]	4.29	
	Retained earnings		4.29

► **Example 30:**

Rooney has recently finished building a new item of plant for its own use. The item is a press for use in the manufacture of industrial diamonds. Rooney commenced construction of the asset on 1st April 2013 and completed it on 1st April 2015. The cost of manufacturing the asset were Rs. 30.8 million. The cost of the hydraulic system is 30% of the total cost of manufacture.

The press comprises two significant parts, the hydraulic system and the 'frame'. The hydraulic system has a three-year life and the 'frame' has an eight-year life. Rooney depreciates plant on a straight line basis.

Rooney uses the IAS 16 revaluation model in accounting for diamond presses and revalue these assets on an annual basis.

Revaluation surpluses or deficits are apportioned between the hydraulic system and the 'frame' on the basis of their year-end book values before the revaluation.

Required:

Calculate the amount of revaluation gain or loss (to nearest '000), clearly indicating the amount that will be recognised in profit or loss, for the year ended:

- 31st March 2016 (assume that the press has a fair value of Rs. 21 million on this date)
- 31st March 2017 (assume that the press has a fair value of Rs. 19.6 million on this date).

► **Answer:**

IAS 16 requires that each part of an item (that has a cost that is significant in relation to the total cost) is depreciated separately. Therefore, the cost recognised at initial recognition must be allocated to each part accordingly.

	Hydraulic	Frame	Total
	Rs. 000	Rs. 000	Rs. 000
Cost 1 April 2015 [30:70]	9,240	21,560	30,800
Depreciation [over 3 & 8 years]	(3,080)	(2,695)	(5,775)
WDV before revaluation 31 March 2016	6,160	18,865	25,025
Loss on revaluation in PL [6,160:18,865]	(991)	(3,034)	(4,025)
Fair value 31 March 2016	5,169	15,831	21,000
Depreciation [over 2 & 7 years]	(2,585)	(2,262)	(4,846)
WDV before revaluation 31 March 2017	2,585	13,569	16,154
Gain on revaluation [2,585:13,569]	551	2,895	3,446
Fair value 31 March 2017	3,136	16,464	19,600
Total gain on revaluation	551	2,895	
Loss previously recognised	991	3,034	
Less: Depreciation decrease [3,080 – 2,585]	(495)		
[2,695 – 2,262]		(433)	
Loss to be reversed in profit or loss	496	2,601	
Gain to be recognised in OCI	56	294	

5 DISCLOSURE

5.1 General requirements [IAS 16: 73]

IAS 16 requires the following disclosures in the notes to the financial statements, for each major class of property, plant and equipment.

- The measurement bases used (cost or revaluation model) for determining the gross carrying amount
- The depreciation methods used
- The useful lives or depreciation rates used
- Gross carrying amounts and the accumulated depreciation at the beginning and at the end of the period
- A reconciliation between the opening and closing values for gross carrying amounts and accumulated depreciation, showing:
 - additions during the year
 - disposals during the year
 - depreciation charge for the year
 - increase or decrease in asset resulting from revaluation and impairment losses

The following two illustrations of how a simple table for tangible non-current assets may be presented in a note to the financial statements are relevant:

Note: Property, plant and equipment	Property	Plant & equipment	Total
Cost	Rs. m	Rs. m	Rs. m
At the start of the year	7,200	2,100	9,300
Additions	920	340	1,260
Disposals	(260)	(170)	(430)
At the end of the year	7,860	2,270	10,130
Accumulated depreciation			
At the start of the year	800	1,100	1,900
Depreciation expense	120	250	370
Disposals	(55)	(130)	(185)
At the end of the year	865	1,220	2,085
Net carrying amount: At the start of the year	6,400	1,000	7,400
Net carrying amount : At the end of the year	6,995	1,050	8,045

Note: Property, plant and equipment (Alternative)	Property	Plant & equipment	Total
Gross carrying amount at beginning of period	7,200	2,100	9,300
Less: Accumulated depreciation	(800)	(1,100)	(1,900)
Net carrying amount at beginning of period	6,400	1,000	7,400
Additions	920	340	1,260
Disposals (carrying value)	(205)	(40)	(245)
Depreciation expense	(120)	(250)	(370)
Net carrying amount at end of period	6,995	1,050	8,045
Gross carrying amount at end of period	7,860	2,270	10,130
Less: Accumulated depreciation	(865)	(1,220)	(2,085)
Net carrying amount at end of period	6,995	1,050	8,045

5.2 Requirements under certain circumstances [IAS 16: 74 & 74A]

An entity must also disclose:

- the existence and amounts of restrictions on title, and property, plant and equipment pledged as security for liabilities;
- the amount of expenditures recognised in the carrying amount of an item of property, plant and equipment in the course of its construction;
- the amount of contractual commitments for the acquisition of property, plant and equipment; and
- if it is not disclosed separately in the statement of comprehensive income, the amount of compensation from third parties for items of property, plant and equipment that were impaired, lost or given up that is included in profit or loss.

5.3 Requirements for revalued assets [IAS 16: 77]

When items of property, plant and equipment are stated at revalued amounts the following must be disclosed:

- the effective date of the revaluation;
- whether an independent valuer was involved;
- for each revalued class of property, plant and equipment, the carrying amount that would have been recognised had the assets been carried under the cost model; and
- the revaluation surplus, indicating the change for the period and any restrictions on the distribution of the balance to shareholders.

5.4 Additional disclosure encouraged by IAS 16 [IAS 16: 79]

IAS 16 encourages disclosure of the following information as users of financial statements might find this information to be useful:

- the carrying amount of temporarily idle property, plant and equipment;

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

► **Example 31:**

Abid Limited (AL) uses the revaluation model for subsequent measurement of its property, plant and equipment and has a policy of revaluing its assets on an annual basis using the net replacement value method.

The following information pertains to AL's buildings:

- Four buildings were acquired in same vicinity on 1 January 2012 at a cost of Rs. 300 million. The useful life of the buildings on the date of acquisition was 20 years.
- AL depreciates buildings on the straight line basis over their useful life.
- The results of revaluations carried out during the last three years by Premier Valuation Service, an independent firm of valuers, are as follows:

Revaluation date	Fair value Rs. in million
1 January 2013	323
1 January 2014	252
1 January 2015	272

On 30 June 2015, one of the buildings was sold for Rs. 80 million.

Required:

Prepare a note on "Property, plant and equipment" (including comparative figures) for inclusion in AL's financial statements for the year ended 31 December 2015 in accordance with International Financial Reporting Standards.

► **Answer:**

Notes to the financial statements for the year ended 31 December 2015

	2015	2014
	Rs. m	Rs. m
Gross carrying amount		
1 January	252	323
Revaluation (Adj)	(14)	(17)
Revaluation gain (loss)	34 W4	(54) W2
Disposal	(68)	
31 December	204	252
Accumulated depreciation		
1 January	14	17 W1
Revaluation (Adj)	(14)	(17)
For the year	14 W6	14 W3
Disposal	(2) W5	-
31 December	12	14
Carrying amount	192	238

	2015	2014
	Rs. m	Rs. m
Measurement	Revaluation model	
Useful life	17 years	18 years
Depreciation method	Straight line method	
Effective date of revaluation	1 January 2015	
Independent firm of valuer	M/s Premier valuation Services	
Carrying value under cost model	180 W8	255 W7
Movement in revaluation surplus		
1 January	0	36 W9
Revaluation gain (loss) in OCI	17 W10	(36)
Transfer to RE (incremental depreciation)	(0.88) W11	
Transfer to RE (upon disposal)	(4.12) W14	
31 December	12	0

W1: Depreciation Rs. 323m / 19 years = Rs. 17m

W2: Revaluation Rs. 252m – 306m = Rs. 54m loss

W3: Depreciation Rs. 252m / 18 years = Rs. 14m

W4: Revaluation Rs. 238m – 272m = Rs. 34m gain

W5: Depreciation of asset disposed Rs. 68m / 17 years x 6/12 = Rs. 2m

W6: Depreciation = Rs. 204m / 17 years = Rs. 12m + 2m **W5** = Rs. 14m

W7: Rs. 300m – (Rs. 300m / 20 years x 3 years) = Rs. 255m

W8: Rs. 300m x ¾ buildings = Rs. 225m – (Rs. 225m / 20 years x 4 years) = Rs. 180m

W9: Rs. 323m – [Rs. 300m – (Rs. 300m / 20 years)] = Rs. 38m – 38m/19 years = Rs. 36m

W10: Rs. 34m gain – [Rs. 18m loss in PL – Rs. 18m / 18 years] = Rs. 17m

W11: [Rs. 17m gain x 1/4 buildings / 17 years x 6/12] = Rs. 0.13m Incremental dep.

W12: [Rs. 17m gain x 3/4 buildings / 17 years] = Rs. 0.75m Incremental dep.

W13: Total incremental depreciation 0.13 + 0.75 = Rs. 0.88m

W14: [Rs. 17m gain x 1/4 buildings – 0.13 incremental] = Rs. 4.12m (on disposal)

► **Example 32:**

Games Limited (GL) commenced a business of preparing and burning video game CDs on 1 July 2015. The following information pertains to the year ended 31 March 2016:

- GL purchased 30 computers on the date of commencement of business at a cost of Rs. 20,000 each, purely for the task of burning CDs. The management of GL estimates that since the computers are subject to obsolescence, more of its benefit can be derived in its early life. The total useful life at the date of acquisition was estimated to be 4 years and residual value was estimated to be Rs. 4,802 for each computer. GL decided to adopt historical cost model for subsequent measurement of computers.

- ii. GL purchased an office building at the date of start of business worth Rs. 3 million. GL decided to adopt revaluation model. The useful life is estimated to be 10 years at the date of acquisition with no residual value, and the economic benefits are expected to be derived evenly over its useful life. At the end of the year, the fair value of office buildings was assessed to be Rs. 3,237,500.
- iii. GL also purchased fittings for its administrative and selling departments, costing Rs. 120,000 on 1 July 2015. It is to be depreciated over 10 years using the straight-line method, with no residual value.
- iv. GL made a contractual commitment with Al-Karim Computers to purchase 6 computers of Rs. 20,000 each to be delivered at GL's premises on 1 May 2016.

The following information pertains to the year ended 31 March 2017:

- i. The computers were delivered at the GL's premises by Al-Karim Computers at the said date. It was decided to use the same method and same rate to depreciate these computers.
- ii. At the end of the year, the fair value of office building was assessed to be Rs. 2 million. At the year-end GL mortgaged entire building with SJ Bank to obtain a loan of Rs. 1.75 million for prospective investments in other divisions.
- iii. Fittings with a cost of Rs. 30,000 were disposed of for Rs. 22,000 on 1 January 2017. The delivery charges of Rs. 1,000 were paid to transfer the fittings to buyer's premises.
- iv. The fair values of the office building were determined by an independent firm M/s Hafeez Valuation Services

Required:

Prepare the disclosure note in accordance with IAS 16 in relation to property, plant and equipment in the notes to the financial statements for the year ended 31 March 2017 (comparatives are required but total columns are not required).

► **Answer:**

Notes to the financial statements for the year ended 31 March 2017

Property, plant & equipment	2017			2016		
	Buildings	Computers	Fittings	Buildings	Computers	Fittings
	Rs.			Rs.		
Gross carrying amount						
1 April	3,237,500	600,000	120,000			
Additions		120,000		3,000,000	600,000	120,000
Revaluation (Adj)	(350,000)			(225,000)		
Revaluation gain (loss)	(887,500)			462,500		
Disposal			(30,000)			
31 March	2,000,000	720,000	90,000	3,237,500	600,000	120,000
Accumulated depreciation						
1 April	0	135,000	9,000			
For the year W1	350,000	172,500	11,250	225,000	135,000	9,000
Revaluation (Adj)	(350,000)			(225,000)		
Disposal W1			(4,500)			
31 March	0	307,500	15,750	0	135,000	9,000
Carrying amount	2,000,000	412,500	74,250	3,237,500	465,000	111,000

Property, plant & equipment	2017			2016		
	Buildings	Computers	Fittings	Buildings	Computers	Fittings
	Rs.			Rs.		
Measurement model	Revaluation	Cost	Cost			
Depreciation method	Straight line	Reducing balance	Straight line			
Useful life / Dep. rate	10 years	30%	10 years			
Revaluation of building						
Carrying value: cost model	2,475,000			2,775,000		
Effective revaluation date	31 March 2017					
Independent valuer	M/s Hafeez Valuation Services					

Movement in revaluation surplus	2017	2016
	Rs.	Rs.
1 January	462,500	
Transfer to retained earnings [Rs. 462,500 / 9.25 years]	50,000	
Revaluation gain (loss) in OCI	(412,500)	462,500
31 December	0	462,500

The entire office building is mortgaged with SJ Bank since 31 March 2017 to obtain a bank loan of Rs. 1.75 million for prospective investments in other divisions.

Contractual commitments to acquire property, plant and equipment at year end are Rs. Nil (2016: Rs. 120,000 for acquisition of computers).

W1: Depreciation		Rs.
Buildings: 2016	Rs. 3,000,000 / 10 years x 9/12	225,000
Buildings: 2017	Rs. 3,237,000 / 9.25 years	350,000
Computers: rate	$1 - (4,802 / 20,000)^{1/4}$	30%
Computers: 2016	Rs. 600,000 x 30% x 9/12	135,000
Computers: 2017	Opening [Rs. (600,000 - 135,000) x 30%] + Additions [Rs. 120,000 x 30% x 11/12]	172,600
Fittings: 2017	Disposed [Rs. 30,000 / 10 years x 9/12] + Other [Rs. 90,000 / 10 years]	11,250
Accumulated depreciation on disposed fittings Rs. 30,000 / 10 years x 1.5		4,500

6 COMPREHENSIVE EXAMPLES

► Example 33:

Following information pertains to Rose Enterprises for the year ended 31 December 2017:

i. Acquisition of land and construction of a factory building:

	Rs. in '000
Cost of freehold land purchased with old building structure	25,000
Cost of demolition of the old building structure	1,500
Proceeds from sale of scrap of the old building	250
Fee paid to ABC Architects for site plan and drawings	800
Advance paid to Quality Construction (QC) for construction of the building	6,000
Further payment to QC	35,000

ii. Acquisition and installation of new plant:

	Rs. in '000
25% cost of the plant paid in advance	4,000
Transportation and import charges	1,250
Cost of installation	400

iii. Other information:

- Cost of freehold land includes property tax for 2017-18 and transfer fee of Rs. 120,000 and Rs. 850,000 respectively.
- Factory building was available for use from 1 July 2017. The final invoice of Rs. 19,000,000 is still unpaid.
- Transportation and import charges of the plant include annual fire insurance premium and insurance in-transit of Rs. 350,000 and Rs. 60,000 respectively.
- The plant started operations on 1 August 2017. Remaining amount was paid on 31 August 2017.
- Old plant was sold on 1 September 2017 at its written down value plus 20%. The plant was purchased on 1 April 2015 at a cost of Rs. 8,500,000
- Building and plant are depreciated at the rate of 5% and 10% respectively on reducing balance method.

Required:

- Pass journal entry to record disposal of the old plant.
- Determine written down value of the fixed assets as at 31 December 2017.

► Answer:

Part (a)

Journal entry for disposal of old plant:	Debit Rs.000	Credit Rs. 000
Bank/Cash/Receivable $(8,500 - 1,896) \times 120\%$	7,925	
Accumulated depreciation (W1)	1,896	
Fixed assets (Plant)		8,500
Gain on disposal (Balancing figure)		1,321

W-1: Accumulated depreciation:		Rs. '000
2015: Apr to Dec	$(8,500 \times 10\% \times 9 / 12)$	638
2016:	$(8,500 - 638) \times 10\% \times 12 / 12$	786
2017: Jan to Aug	$(8,500 - 638 - 786) \times 10\% \times 8 / 12$	472
		1,896

Part (b)

	Freehold land	Building	Plant
	--- Rs. in '000 ---		
Purchase price	25,000		
Demolition of old building Rs. 1,500 – 250	1,250		
Architect fee paid to ABC consultant		800	
Construction cost – Advance		6,000	
Construction cost – Further payment		35,000	
Plant cost – advance 25%			4,000
Plant cost – remaining 75%			12,000
Transportation and import charges			1,250
Installation charges			400
Property tax year 2017-18 (should be PL)	(120)		
Transfer fee (correctly included already)	-		
Construction costs – unpaid amount		19,000	
Annual fire insurance (should be expense)			(350)
Insurance in transit (correct already)			-
Cost to be capitalised	26,130	60,800	17,300
Depreciation for 2017			
Land	-		
Building $(60,800 \times 5\% \times 6 / 12)$		(1,520)	
Plant $(17,300 \times 10\% \times 5 / 12)$			(721)
WDV of PPE as at 31 December 2017	26,130	59,280	16,579

► **Example 34:**

Following information pertains to three exchange transactions relating to fixed assets:

	(i)	(ii)	(iii)
	----- Rs. in million -----		
Cash received/(paid)	1.1	(2.1)	-
Assets given up:			
Original cost	10.3	12.4	14.5
Book value	6.4	7.3	3.4
Estimated fair value	8.5	6.6	4.6
Assets received:			
Estimated fair value	7.1	9.0	4.1

Additional information:

- In case of transaction (i), fair values of both assets are reliably measurable.
- In case of transaction (ii), fair value of the asset received is clearly more evident.
- In case of transaction (iii), fair value of neither asset is reliably measurable.

Required:

Calculate the gain or loss on disposal for each of above transactions.

► **Answer:****Transaction (i)**

Fair value of asset given up Rs. 8.5m – cash received Rs. 1.1m = Rs. 7.4 million

Gain (loss) on disposal = 8.5 – 6.4m = Rs. 2.1m gain

Transaction (ii)

Fair value of asset received = Rs. 9.0 million

Gain (loss) on disposal = [Rs. 9.0m – 2.1m] – 7.3m = Rs. (0.4)m loss

Transaction (iii)

Carrying amount = Rs. 3.4 million

Gain (loss) on disposal = 3.4 – 3.4m = Rs. 0 (neither gain nor loss)

► **Example 35:**

Kamran Enterprises (KE) provides depreciation on plant and machines at 10% on written-down value. Depreciation is charged from the month the asset is available for use in operations up to its disposal. Cost of its plant & machines and the accumulated depreciation as on 1 July 2015 were Rs. 75 million and Rs. 17 million respectively.

The following information is available in respect of its plant & machines, for the year ended 30 June 2016:

- On 1 October 2015, a second-hand machine was acquired from a Chinese company for Rs. 15 million. The machine was renovated and overhauled at a cost of Rs. 3 million. 25% of this expenditure was in respect of purchase of consumables.

- ii. On 1 November 2015, KE transferred a machine having a list price of Rs. 10 million from its stock-in-trade to its Engineering Department. KE sells such machines at cost plus 25%.
- iii. On 1 January 2016, certain parts to a plant were added at a cost of Rs. 4 million to extend its useful life.
- iv. On 1 Mar 2016, the plant was damaged and remained in-operative for one month. KE spent an amount of Rs. 3 million on repairs to restore the plant in working condition.
- v. On 1 April 2016, a machine which was purchased on 1 July 2012 for Rs. 12 million was completely damaged and was sold for Rs. 1.2 million.

Required:

Prepare accounting entries to record the above transactions in KE's books for the year ended 30 June 2016.

► **Answer:****Accounting entries**

Date	Description	Debit Rs. 000	Credit Rs. 000
1-Oct-15	Machine B [15m + (3m×75%)]	17,250	
	Repair and maintenance	750	
	Bank		18,000
1-Nov-15	Machine account (10m ×100/125)	8,000	
	Stock-in-trade		8,000
1-Jan-16	Plant	4,000	
	Bank		4,000
1-Mar-16	Repair and maintenance	3,000	
	Bank/payable		3,000
1-Apr-16	Bank	1,200	
	Acc. Dep. – Machine*	3,908	
	Loss on sale of machine (balancing)	6,892	
	Machine		12,000
	*[12m-(12m×0.9×0.9×0.9×0.925)]		
30-Jun-16	Depreciation expense (W1)	7,608	
	Accumulated depreciation P&M		7,608

W1: Depreciation (Year 2016)	Cost	Acc. Dep.	WDV	Rate	Months	Rs. 000
		1 July 2015				
	Rs. 000					
Disposed 1	12,000		8,748*	10%	9/12	656
Other remaining	63,000		49,252	10%	12/12	4,925
Total opening	75,000	17,000	58,000			
Addition 1: Machine B	17,250			10%	9/12	1,294
Addition 2: from inventory	8,000			10%	8/12	533
Addition 3: Parts added	4,000			10%	6/12	200
						7,608

$$*12m \times (0.9)^3$$

► **Example 36:**

Following information pertains to plant and machinery of Alpha Enterprises (AE):

- As at 1 January 2018, balances of cost and accumulated depreciation amounted to Rs. 12,700,000 and Rs. 6,240,000 respectively.
- On 1 April 2018, an old machine having fair value of Rs. 340,000 was exchanged for a new machine. The balance of the purchase price was paid through a cheque of Rs. 680,000. The list price of the new machine was Rs. 1,130,000. The old machine had been acquired for Rs. 870,000 on 1 September 2015.
- On 1 February 2018, a plant having a list price of Rs. 10,000,000 was acquired. A trade discount of 5% was allowed on the list price. The plant was ready for use on 1 August 2018 after incurring the following costs:

	Rs. in '000
Freight charges	660
Consultant fees	540
Installation and testing	600
Administration and other general overheads	160
Staff training	120
Opening ceremony	100
	2,180

- On 31 October 2018, another machine was sold for Rs. 334,000. It was acquired on 1 January 2015 and had a net book value of Rs. 512,000 on 1 January 2018. A cost of Rs. 25,000 was incurred on its disposal.
- AE depreciates plant and machinery at 20% per annum using the reducing balance method.

Required:

Prepare following ledger accounts pertaining to the plant and machinery for the year ended 31 December 2018:

- Cost
- Accumulated depreciation
- Assets disposal

► **Answer:****Alpha Enterprises**

Plant and machinery - Cost					
Date	Description	Rs. 000	Date	Description	Rs. 000
1-Jan-18	Balance	12,700	1-Apr-18	Assets disposal	870
1-Apr-18	Assets disposal (340+680)	1,020	31-Oct-18	Assets disposal (W2)	1,000
1-Aug-18	Capital WIP (W4)	11,300	31-Dec-18	Balance	23,150
		<u>25,020</u>			<u>25,020</u>

Accumulated depreciation - Plant and machinery					
Date	Description	Rs. 000	Date	Description	Rs. 000
1-Apr-18	Assets disposal (W-1)	376	1-Jan-18	Balance	6,240
31-Oct-18	Assets disposal (W-2)	573	31-Dec-18	Depreciation (W3)	2,292
31-Dec-18	Balance	7,583			
		<u>8,532</u>			<u>8,532</u>

Assets disposal - Plant and machinery

Date	Description	Rs. 000	Date	Description	Rs. 000
1-Apr-18	P&M	870	1-Apr-18	Acc. depreciation (W-1)	376
1-Apr-18	Cash paid	680	1-Apr-18	P&M (New)	1,020
31-Oct-18	Cost	1,000	31-Oct-18	Acc. depreciation (W-2)	573
31-Oct-18	Bank (disposal cost)	25	31-Oct-18	Bank (Sales proceeds)	334
			31-Dec-18	Loss on disposal (P&L)	272
		2,575			2,575

W1: Accumulated depreciation – Machine exchange

		Rs. 000
Depreciation for 2015	$870 \times 20\% \times 4/12$	58
Depreciation for 2016	$(870 - 58) \times 20\%$	162
Depreciation for 2017	$(870 - 58 - 162) \times 20\%$	130
Accumulated depreciation up to 31-12-2017		350
Depreciation for 2018	W3	26
		376

W2: Accumulated depreciation – Machine sold

		Rs. 000
Cost	$[512 / (0.8)^3]$	1,000
Accumulated depreciation up to 01-01-2018	$1,000 - 512$	488
Depreciation for 2018	W3	85
Accumulated depreciation at the date of disposal		573

W3: Depreciation (Year 2018)	Cost	Acc. Dep.	WDV	Rate	Months	Rs. 000
		1 Jan 2018				
	Rs. 000					
Disposed 1	870	350	520	20%	3/12	26
Disposed 2	1,000	488	512	20%	10/12	85
Other remaining	10,830	5,402	5,428	20%	12/12	1,086
Total opening	12,700	6,240	6,460			
Addition 1	1,020			20%	9/12	153
Addition 2	11,300			20%	5/12	942
						2,292

W4: Cost of the plant:

		Rs. '000
Purchase price of the plant	$10,000 \times 95\%$	9,500
Other relevant cost	$660 + 540 + 600$	1,800
		11,300

► **Example 37:**

Following information pertains to a building acquired by SK Limited (SKL) on 1 July 2012 for Rs. 360 million:

- The building is being depreciated on straight-line basis over 10 years.
- SKL uses revaluation model for subsequent measurement of buildings. It accounts for revaluation on net replacement value method. The details of revaluations as carried out by independent valuer are as follows:

Revaluation date	Fair value (Rs. in million)
31 December 2013	323
31 December 2015	208
31 December 2017	167

- There is no change in useful life of the building.
- SKL transfers the maximum possible amount from the revaluation surplus to retained earnings on an annual basis.
- SKL's financial year ends on 31 December.

Required:

Prepare entries to record revaluation surplus/loss on each of the above revaluation date. **(Entries to record depreciation expense, incremental depreciation and elimination of accumulated depreciation are not required)**

► **Answer:**

Date	Description	Debit	Credit
		Rs. million	
31 Dec 2013	Accumulated depreciation [18 + 36]	54	
	Building		54
	Building	17	
	Gain on revaluation (OCI)		17
31 Dec 2015	Accumulated depreciation [38+38]	76	
	Building		76
	Loss on revaluation (OCI)	13	
	Loss on revaluation (PL)	26	
	Building		39
31 Dec 2017	Accumulated depreciation [32+32]	64	
	Building		64
	Building	23	
	Reversal of revaluation loss (PL)		18
	Gain on revaluation (OCI)		5

Workings	Building	OCI	PL
	Rs. m	Rs. m	Rs. m
Cost 1 Jul 2012	360		
2012 Depreciation $360 / 10 \text{ years} \times 6/12$	(18)		
2013 Depreciation $360 / 10 \text{ years} \times 12/12$	(36)		
	306		
Gain on revaluation (balancing figure)	17	17	
Fair value on 31 December 2013	323	17	
2014 Depreciation $323 / 8.5 \text{ years}$	(38)	(2)	
2015 Depreciation (same)	(38)	(2)	
	247	13	
Loss on revaluation (balancing figure)	(39)	(13)	(26)
Fair value on 31 December 2015	208	0	(26)
2016 Depreciation $208 / 6.5 \text{ years}$	(32)		4
2017 Depreciation (same)	(32)		4
	144		(18)
Gain on revaluation (balancing figure)	23	5	18
Fair value on 31 December 2017	167	5	0

► **Example 38:**

On 31 December 2013, Omega Chemicals Limited (OCL) changed its valuation model from cost to revaluation for its buildings. The following information pertains to its buildings as at 31 December 2013:

	Estimated useful life as originally estimated	Prior to revaluation as at 31-12-2013		Revalued amount as per valuation report
		Cost	Accumulated depreciation*	
		-----Rs. in million-----		
Factory buildings	20 years	100.00	37.50	52.00
Office buildings	25 years	164.50	26.32	149.94

***Including depreciation for the year ended 31 December 2013**

As per the report of the professional valuer, there was no change in estimated useful life of the buildings. OCL recorded revaluation effect for the office buildings on 31 December 2013 as per the valuation report. However, no valuation effect was incorporated for the factory buildings as the change in their value was considered to be temporary by OCL.

On 1 July 2014, one of the office buildings was sold for Rs. 30 million. On 31 December 2013, written down value before revaluation and revalued amount of the sold building amounted to Rs. 27.72 million and Rs. 31.92 million respectively.

On 31 December 2014, factory buildings were revalued at Rs. 64 million whereas there was no change in value of the office buildings.

OCL uses straight line method of depreciation which is charged from the date the asset is available for use up to the date of disposal. Revaluation is to be accounted for by using net replacement value method.

Required:

In the light of the requirements of the International Financial Reporting Standards, prepare accounting entries from the above information for the year ended 31 December 2014 including correcting entries as on 31 December 2013.

► Answer:

Accounting entries

Date	Description	Debit	credit
		Rs. in million	
	Factory buildings		
31-Dec-13	Acc. depreciation-Factory buildings	37.50	
	Factory building		37.50
31-Dec-13	Retained earnings (2013 loss) [52 – (100 – 37.5)]	10.50	
	Factory buildings		10.50
31-Dec-14	Depreciation expense(52÷12.5W1)	4.16	
	Acc. depreciation-Factory buildings		4.16
31-Dec-14	Acc. depreciation-Factory buildings	4.16	
	Factory buildings		4.16
31-Dec-14	Factory buildings[64 – (52 – 4.16)]	16.16	
	Reversal of loss (PL) [10.5-(10.5÷12.5W1)]		9.66
	Revaluation gain (OCI) (Bal.)		6.50
	OFFICE BUILDINGS		
1-Jul-14	Depreciation expense[31.92 ÷ 21 × 0.5]	0.76	
	Acc. depreciation-Office buildings		0.76
1-Jul-14	Revaluation surplus [(31.92-27.72=4.2) ÷ 21 × 0.5]	0.10	
	Retained earnings		0.10
1-Jul-14	Bank	30.00	
	Acc. depreciation	0.76	
	Loss on disposal 30– (31.92-0.76)	1.16	
	Office buildings		31.92
1-Jul-14	Revaluation surplus(4.2 – 0.1)	4.10	
	Retained earnings		4.10
31-Dec-14	Depreciation expense (149.94 – 31.92) ÷ 21	5.62	
	Acc. depreciation-Office buildings		5.62
31-Dec-14	Revaluation surplus [149.94-(164.5-26.32)-4.2]÷21	0.36	
	Retained earnings		0.36

W1 – Remaining useful life of the buildings on revaluation date of 31 December 2013

		Years
Factory buildings	20 – [(37.5 ÷ (100÷ 20))]	12.5
Office buildings	25 – [(26.32 ÷ (164.5÷ 25))]	21

► **Example 39:**

PQR Enterprises was incorporated on 1 July 2012. The company depreciates its property, plant and equipment on straight line basis over their useful life. It uses revaluation model for subsequent measurement of the property, plant and equipment and has a policy of revaluing these after every two years.

Following information pertains to its property, plant and equipment:

Assets	Cost as on 01-07- 2013	WDV as on 01-07- 2013	Value as determined by professional valuer on 30-06-2014	Useful life in years	
				Original at acquisition	Revised during 2015
	----- Rs. in million -----				
Office building	6,000	5,500	5,750	12	8
Factory building	4,400	3,960	3,320	10	9
Warehouse	4,500	4,050	3,350	10	8

During the year there were no addition or deletion in the above assets. As per policy, PQR transfers the maximum possible amount from the revaluation surplus to retained earnings on an annual basis.

Required:

Prepare necessary journal entries for the year ended 30 June 2014 and 2015.

► **Answer:****Journal entries**

Date	Particulars	Debit	Credit
		Rs. in million	
30-Jun-14	Depreciation for the year (W-1)	1,390	
	Acc. depreciation – Office building		500
	Acc. depreciation – Factory building		440
	Acc. depreciation – Warehouse		450
30-Jun-14	Acc. depreciation – Office building (W-1)	1,000	
	Acc. depreciation – Factory building (W-1)	880	
	Acc. depreciation – Warehouse (W-1)	900	
	Office building		1,000
	Factory building		880
	Warehouse		900
30-Jun-14	Office building (W-1)	750	
	Revaluation loss (PL) – buildings and warehouse	450	
	Revaluation gain (OCI)		750
	Factory building (W-1)		200
	Warehouse (W-1)		250
30-Jun-15	Depreciation expense (W-1)	1,507	
	Acc. depreciation – Office building		719
	Acc. depreciation – Factory buildings		369
	Acc. depreciation – Warehouse		419
30-Jun-15	Revaluation surplus (750 / 8 years)	94	
	Retained earnings		94

W-1:

Assets	Cost (A)	WDV (B)	Dep. for the year 2014 (C)	Acc. Dep. D=A-B+C	Revalued amount (E)	Revaluation gain (loss) F=E-(A-D)	Dep. for the year 2015
----- Rupees in million -----							
Office building	6,000	5,500	500	1,000	5,750	750	719
Factory building	4,400	3,960	440	880	3,320	(200)	369
Warehouse	4,500	4,050	450	900	3,350	(250)	419
			1,390				1,507

► Example 40:

The following information pertains to Piano Limited (PL):

	Plant	Equipment
Acquisition		
• Date of acquisition	1 January 2015	1 July 2015
• Cost	Rs. 500 million	Rs. 360 million
• Estimated useful life	10 years	12 years
• Residual value	Rs. 60 million	Nil
• Depreciation method	Straight line method	Straight line method
Revaluation on 31 December 2016		
• Fair value	Rs. 526 million	Rs. 280 million
• Residual value	Rs. 78 million	Nil
Revaluation on 31 December 2018		
• Fair value	Rs. 310 million	Rs. 275 million
• Residual value	Rs. 64 million	Nil

Additional information:

- PL uses revaluation model for subsequent measurement and accounts for revaluation on net replacement value method.
- There is no change in useful life of plant. The remaining useful life of equipment was estimated as 15 years and 10 years in 2016 and 2018 respectively.
- PL transfers maximum possible amount from the revaluation surplus to retained earnings on an annual basis.
- PL's financial year ends on 31 December.

Required:

- Calculate depreciation on each asset for 2015 to 2018.
- Prepare entries to record revaluation in 2018. (Entries to record depreciation expense, incremental depreciation and elimination of accumulated depreciation are not required. Further, entries prior to 2018 are also not required.)

► Answer:

Part (a)

		Plant	Equipment
		----- Rs. in million -----	
Cost		500	360
Depreciation 2015	$[(500-60)/10], [(360/12) \times (6/12)]$	(44)	(15)
		456	345
Depreciation 2016	$[(456-78)/9], [345/15]$	(42)	(23)
		414	322
Revaluation-surplus/(loss) 2016 (balancing)		112	(42)
Fair value		526	280
Depreciation 2017	$[(526-78)/8], [280/14]$	(56)	(20)
		470	260
Depreciation 2018	$[(470-64)/7], [260/10]$	(58)	(26)
		412	234

Part (b) Accounting entries for revaluation

Date	Particulars	Debit Rs. m	Credit Rs. m
31-Dec-18	Revaluation loss (PL)	18	
	Loss on revaluation (OCI)	84	
	Plant		102
31-Dec-18	Equipment	41	
	Reversal of revaluation loss (PL)		35.1
	Gain on revaluation (OCI)		5.9

	Plant	Equipment
W1: Revaluation gain (loss)	----- Rs. in million -----	
Fair value	310	275
Book value [From part(a)]	(412)	(234)
Increase / (Decrease) in asset	(102)	41
Adjustment for previous:		
Revaluation gain $112 - (112 \div 8) - (112 \div 8)$	84	
Revaluation loss $42 - (42 \div 14) - (39 \div 10)$		(35.1)
Revaluation gain (loss)	(18)	5.9

► **Example 41:**

Sputnik Sea Limited (SSL) runs a cruise business across oceans. Following information in respect of one of SSL's cruise ship is available:

- i. SSL bought a cruise ship on 1 March 2018. After completing all the required formalities, the ship was ready to sail on 1 April 2018.
- ii. Details regarding components of the ship are as under:

Component	Cost (Rs. in million)	Useful life	Estimated residual value (Rs. in million)
Engine	840	50,000 hours	40
Body	535	25 years	35
Dry-docking (overhaul)	60	5 years	-

- iii. On 1 May 2019, the ship suffered an accident which damaged its body. Repair work took 2 months and costed Rs. 26 million. The repair work did not change useful life and residual values of the components.
- iv. The average monthly sailing of the ship during the last three years are as under:

Year	Hours
2018	360
2019	480
2020	600

- v. SSL uses revaluation model for subsequent measurement. SSL accounts for revaluation on net replacement value method and transfers the maximum possible amount from the revaluation surplus to retained earnings on an annual basis.
- vi. The revalued amounts of the ship as at 31 December 2019 and 2020 were determined as Rs. 1,400 million and Rs. 1,000 million respectively. Revalued amounts are apportioned between the components on the basis of their book values before the revaluation.

Required:

Prepare necessary journal entries to record the above transaction from the date of acquisition of the ship to the year ended 31 December 2020.

► **Answer:****Journal entries**

Date	Particulars	Debit	Credit
		Rs. m	Rs. m
01-Mar-18	Cruise ship	1,435	
	Bank		1,435
31-Dec-18	Depreciation expense (W2)	75.84	
	Accumulated depreciation - Cruise ship		75.84
01-May-19	Repair cost	26	
	Bank		26

Date	Particulars	Debit	Credit
		Rs. m	Rs. m
31-Dec-19	Depreciation expense (W2)	108.8	
	Accumulated depreciation - Cruise ship		108.8
31-Dec-19	Accumulated depreciation - Cruise ship	184.64	
	Cruise ship [75.84 + 108.80]		184.64
31-Dec-19	Cruise ship	149.64	
	Gain on revaluation (OCI)		149.64
31-Dec-20	Depreciation expense (W2)	165.82	
	Accumulated depreciation - Cruise ship		165.82
31-Dec-20	Revaluation surplus (W1)	18.62	
	Retained earnings		18.62
31-Dec-20	Accumulated depreciation - Cruise ship	165.82	
	Cruise ship		165.82
31-Dec-20	Loss on revaluation (OCI) [149.64 - 18.62 W1]	131.02	
	Loss on revaluation (PL) [Balancing]	103.16	
	Cruise ship (W2)		234.18

W1: Depreciation	Rs. m
Engine	
2018: $(840 - 40) / 50,000 \text{ hours} \times (360 \text{ hours} \times 9 \text{ months})$	51.84
2019: $(840 - 40) / 50,000 \text{ hours} \times (480 \text{ hours} \times 10 \text{ months})$	76.80
2020: $(796.38 - 40) / (50,000 - 3,240 - 4,800 \text{ hours}) \times (600 \text{ hours} \times 12 \text{ months})$	129.81
2020 (cost model): $(840 - 40) / 50,000 \text{ hours} \times (600 \text{ hours} \times 12 \text{ months})$	115.20
Body	
2018: $(535 - 35) / 25 \text{ years} \times 9/12$	15
2019: $(535 - 35) / 25 \text{ years}$	20
2020: $(559.84 - 35) / (25 - 1.75 \text{ years})$	22.57
2020 (cost model): $(535 - 35) / 25 \text{ years}$	20
Dry Docking	
2018: $60 / 5 \text{ years} \times 9/12$	9
2019: $60 / 5 \text{ years}$	12
2020: $43.67 / (5 - 1.75 \text{ years})$	13.44
2020 (cost model): $60 / 5 \text{ years}$	12

W1: Depreciation	Rs. m
Incremental depreciation (Year 2020)	
On revalued amount 129.81 + 22.57 + 13.44	165.82
On cost 115.20 + 20.00 + 12.00	147.20
	18.62

W2: Revaluation gain (loss)	Engine	Body	Dry Docking	Total
	Rs. m	Rs. m	Rs. m	Rs. m
Acquisition cost (1 Mar 2018)	840	535	60	1,435
Depreciation 2018 (W1)	(51.84)	(15)	(9)	(75.84)
Depreciation 2019 (W1)	(76.80)	(20)	(12)	(108.80)
	711.36	500	39	1,250.36
Revaluation gain (balancing)				149.64
31 December 2019	796.49	559.84	43.67	1,400
Depreciation 2020	(129.81)	(22.57)	(13.44)	(165.82)
				1,234.18
Revaluation loss (balancing)				(234.18)
31 December 2020				1,000

► **Example 43:**

The following information pertains to property, plant and equipment of Orchid Limited (OL), a listed company:

Description	Date of purchase	Cost Rs. m	Original useful life	Depreciation method	Subsequent measurement model
Buildings	1-Jan-15	600	30 years	Straight line	Revaluation
Plant	1-Jan-15	475	25 years	Straight line	Cost

Buildings

The revalued amount of buildings as determined by Shabbir Associates, an independent valuer, on 31 December 2015 and 2017 was Rs. 700 million and Rs. 463 million respectively.

On 30 June 2017 a building having original cost of Rs. 66 million was sold to Baqir Limited for Rs. 85 million. It was last revalued at Rs. 87 million. OL incurred a cost of Rs. 2 million on disposal.

OL transfers the maximum possible amount from revaluation surplus to retained earnings on an annual basis.

Plant

On 31 December 2016 the recoverable amount of the plant was assessed at Rs. 360 million with no change in useful life.

During 2017, OL has decided to change the depreciation method for plant from straight line to reducing balance. The new depreciation rate would be 10%.

Required:

Prepare following disclosure note of property, plant and equipment (along with comparative figures) to be presented in the financial statements of OL for the year ended 31 December 2017. *(Total column is not required)*

► Answer:

Orchid Limited**Notes to the financial Statements for the year ended 31 December 2017**

Property, plant & equipment	2017		2016	
	Building	Plant	Building	Plant
	Rs. m	Rs. m	Rs. m	Rs. M
Cost / Revalued amount				
1 Jan	700	475	700	475
Disposal	(87)			
Revaluation (Adj.)	(42.28)			
Revaluation loss W1	(107.72)			
31 December	463	475	700	475
Accumulated depreciation and impairment losses				
1 Jan	24.14	115	0	19
Disposal W2	(4.5)			
Depreciation W1	22.64	36	24.14	19
Revaluation (Cancellation)	(42.28)			
Impairment W1				77
31 Dec	0	151	24.14	115
Carrying amount	463	324	675.86	360
Carrying amount (cost model)				
Cost	534	[600 – 66]	600	
Accumulated Depreciation	(53.4)	[534/30x2]	(40)	[600/30x2]
	480.6		560	

	Building	Plant
Measurement basis	Revaluation model	Cost model
Useful life / depreciation rate	30 years	10%
Depreciation method	Straight line	Reducing balance
The last revaluation was performed on 31 December 2017 by Shabbir Associates, an independent firm of valuer.		

Movement of Revaluation surplus	Rs. m
At 1 Jan 2017 [120 - (120/29)]	115.86
Transfer on disposal W2	(22)
Incremental depreciation $[(115.86/28 \times 6/12) + (115.86 - 22)/27.5 \times 6/12]$	(3.76)
Revaluation loss charged to OCI	(90.12)
At 31 December 2017	Nil

W1 – Depreciation / Impairment / Revaluation Surplus	Rs. m
Building	
2015 – Depreciation [600 / 30 years]	20
2015 – Revaluation Gain [700 - (600 - 20)]	120
2016 – Depreciation [700 / 29 years]	24.14
2017 – Depreciation $[((700 - 24.14) - 84)) / 28] + 1.5 \text{ W2}$	22.64
2017 – Revaluation 463 FV - [(700 - 87 Cost) - 42.28 Acc. Dep.]	(107.72)
Plant	
2015 – Depreciation [475 / 25 years]	19
2016 – Depreciation [475 / 25 years]	19
2016 – Impairment [475 - 19 - 19] - [360 Recoverable amount]	77
2017 – Depreciation [360 x 10% reducing balance]	36

W2 – Depreciation and Revaluation (disposed equipment)	Rs. m	Rs. m
Cost	66	
Depreciation 2015 [66 / 30 years]	(2.2)	
	63.8	
Revaluation gain	23.2	23.2
Revalued 31 Dec 2015	87	
Depreciation 2016 [87 / 29 years]	(3)	(0.8)
	84	
Depreciation 2017 [87 / 29 years x 6/12]	(1.5)	(0.4)
	82.5	22
Accumulated depreciation related to disposed equipment 3 + 1.5	4.5	

► **Example 42:**

Abbas Limited (AL) is engaged in the business of manufacturing near the Karachi-Hyderabad Motorway. Its property, plant and equipment comprises of land, buildings, plant and machinery, and equipment.

The balances of the property, plant and equipment as at 30 June 2018 are given below:

Assets	Gross Carrying Amount (Rs. Million)	Accumulated Depreciation (Rs. Million)
Land	12	N/A
Buildings	125	38
Plant and Machinery	500	300
Equipment	100	36

The relevant information regarding measurement and depreciation is given below:

Assets	Depreciation Method	Subsequent Measurement
Land	Not applicable	Revaluation model
Buildings	Straight-line	Cost model
Plant and Machinery	Units of Production	Cost model
Equipment	Reducing balance	Cost model

Additional information for the period up to 30 June 2018 are as follows:

- The equipment was purchased on 1 July 2016. No disposals and acquisitions took place in the period up to 30 June 2018.
- Until 30 June 2018, 12,000 units had been produced by Abbas Limited in its factory. The plant and machinery does not have any residual value. No additions or disposals of plant and machinery took place till this date.
- The buildings were acquired on 1 July 2014 with a residual value of Rs. 11 million. No additions and disposals took place till 30 June 2018.
- The land had actually cost Rs. 15 million on the date of its acquisition.

The following information pertains to the year ended on 30 June 2019:

- On 1 July 2018, land was revalued to Rs. 20 million. The value was determined by an independent firm M/s Ashfaq Valuation Services.
- During the year, 5,000 units were produced in the factory of AL.
- On January 1, 2019, AL disposed 25% of its area comprising of land and buildings at a price of Rs. 90 million. The portion of land was sold at its fair value as determined on 1 July 2018. The legal costs of drafting transfer agreements were Rs. 0.1 million. It is assumed that value of land and buildings is spread evenly across the area occupied.
- Further equipment costing Rs. 60 million was acquired on 1 November 2018.
- In the meeting of its board of directors, it was decided to open a new factory premises near Lahore-Islamabad motorway. An expenditure of Rs. 20 million was spent of the construction of the factory on 1 December 2018. The construction had not been completed by the end of the year.
- Moreover, the directors also made a contract with M/s Uni Power & Co. to purchase plant and machinery worth Rs. 35 million once the construction of factory building is completed.

Required:

Prepare the disclosure note in accordance with IAS 16 in relation to property, plant and equipment in the notes to the financial statements for the year ended 30 June 2019. (**Comparatives and column for total is not required**).

► Answer:

Notes to the financial statements for the year ended 30 June 2019

Property, plant and equipment	Land (W1) Rs. m	Buildings (W2) Rs. m	P&M (W3) Rs. m	Equipment (W4) Rs. m
Gross carrying amount				
1 July	12	125	500	100
Additions				60
Revaluation gain	8			
Disposal (25%)	(5)	(31.25)		
30 June	15	93.75	500	160
Accumulated depreciation				
1 July		38	300	36
For the year		8.31	125	20.8
Disposal		(10.69)		
30 June	0	35.62	425	56.8
Carrying amount	15	58.13	75	103.2
Measurement model	Revaluation	Cost	Cost	Cost
Depreciation method	N/A	Straight line	Unit of production	Reducing balance
Useful life / Dep. rate	N/A	12 years	Rs. 0.025m /u	20%
Carrying value: cost model	Rs. 11.25m			
Effective date of revaluation	1 July 2018			
Independent valuer	M/s Ashfaq Valuation Services			
Movement in revaluation surplus				
1 July 2018	0			
Revaluation gain (OCI) 8 – 3 PL	5			
Transfer on disposal 25%	(1.25)			
30 June 2019	3.75			

A factory building near Lahore-Islamabad motorway is under construction and Rs. 20 million expenditure has been incurred so far. Contractual commitments to acquire plant and machinery for the factory building under construction at year end are Rs. 35 million.

W1 – Land

Cost model Rs. 15m original cost - 25% disposed	Rs. 11.25m
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W2 – Buildings

Total useful life of building [Rs. 125 – 11m] / [Rs. 38m / 4 years]	12 years
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Accumulated depreciation of disposed building Rs. 125m - 11m = Rs. 114m x 25% / 12 years x 4.5 years	Rs. 10.69m
---	------------

Depreciation for the year On disposed [(125m – 11m) x 25% / 12 years x 6/12] = Rs. 1.19m On Other [(125m – 11m) x 75% / 12 years x 12/12] = Rs. 7.13m	Rs. 8.31m
---	-----------

W3 – Plant & machinery

Depreciation rate per unit [Rs. 300m / 12000 units made so far]	Rs. 0.025m
---	------------

Depreciation for the year Rs. 0.025m x 5,000 units	Rs. 125m
--	----------

W4 – Equipment

Depreciation rate = $1 - ((100-36)/100)^{1/2}$	20%
--	-----

Depreciation for the year On addition Rs. 60m x 20% x 8/12 = Rs. 8m On opening Rs. (100-36) x 20% = Rs. 12.8m	Rs. 20.8m
---	-----------

► **Example 43:**

The following information pertains to Sherdil Limited (SL):

- Buildings and equipment were acquired on 1 January 2014 for Rs. 450 million and Rs. 50 million respectively.
- The relevant information relating to both assets is summarised below:

Assets	Depreciation method	Life/rate	Subsequent measurement
Buildings	Straight line	20 years	Annual revaluation
Equipment	Reducing balance	10%	Cost

SL transfers the maximum possible amount from revaluation surplus to retained earnings on an annual basis.

- The revalued amount of buildings as determined by Accurate Valuers (Private) Limited, an independent valuation company, on 1 January 2015 and 2016 was Rs. 456 million and Rs. 378 million respectively.
- Equipment costing Rs. 35 million was purchased on 1 August 2015. Half of the equipment purchased on 1 January 2014 was disposed of on 30 June 2016.

Required:

In accordance with International Financial Reporting Standards, prepare a note on 'Property plant & equipment' (including comparative figures) for inclusion in SL's financial statements for the year ended 31 December 2016. **(Columns for total are not required)**

► Answer:

Notes to the financial statements for the year ended 31 December 2016

Property, plant and equipment	2016		2015	
	Building	Equipment	Building	Equipment
	Rs. m		Rs. m	
Gross carrying amount				
1 January	456	85	450	50
Additions				35
Revaluation (Adj)	(24)		(22.5)	
Revaluation gain (loss)	(54)		28.5	
Disposal (50 x 50%)		(25)		
31 December	378	60	456	85
Accumulated depreciation				
1 January	24	10.96	22.5	5
Revaluation (Adj)	(24)		(22.5)	
For the year	21	6.39	24	5.96
Disposal		(5.76)		
31 December	21	11.59	24	10.96
Carrying amount	357	48.41	432	74.04
Carrying value: cost model	382.5		405	
	[450 – 450/20 x 3 years]		[450 – 450/20 x 2 years]	

	Building	Equipment
Measurement basis	Revaluation model	Cost model
Useful life / dep. rate	20 years	10%
Depreciation method	Straight line	Reducing balance

The revaluation was performed on 1 January 2016 by Accurate Valuers (Private) Limited, an independent firm of valuers.

W1 – Depreciation		Rs. m
2015 – Building	[456 / 19 years]	24
2015 – Equipment	[45 x 10% = 4.5] + [35 x 10% x 5/12 = 1.46]	5.96
2016 – Building	[378 / 18 years]	21
2015 – Equipment	[74.04 – 20.25] x 10% + 1.01	6.39

W2 – Depreciation on disposed equipment	Rs. m
Cost 50 x 50%	25
Depreciation 2014 10%	(2.5)
	22.5
Depreciation 2015 10%	(2.25)
	20.25
Depreciation 2016 10% x 6/12	(1.01)
	19.24
Accumulated depreciation related to disposed equipment 2.5 + 2.25 + 1.01	5.76

► **Example 44:**

Following information pertains to property, plant and equipment of Tsuki Limited (TL):

	Office building	Warehouse
Acquisition:		
Date of acquisition	1 July 2017	1 July 2018
Cost (Rs. in million)	96	156
Estimated useful life (in years)	16	12
Revalued amount:		
1 January 2019 (Rs. in million)	116	138
1 January 2021 (Rs. in million)	80	143
Revised useful life on 1 January 2020 (in years)	9	14

Additional information:

- TL uses revaluation model for subsequent measurement and accounts for revaluation on net replacement value method.
- TL transfers maximum possible amount from the revaluation surplus to retained earnings on an annual basis.
- The revalued amounts were determined by Sagheer Valuers (Private) Limited, an independent valuation company.

Required:

In accordance with IFRSs, prepare a note on 'Property, plant and equipment' (including comparative information) for inclusion in TL's financial statements for the year ended 31 December 2021. (Column for total is not required)

► Answer:

Notes to the financial statements for the year ended 31 December 2021

Property, plant and equipment	2021		2020	
	Building	Warehouse	Building	Warehouse
	Rs. m		Rs. m	
Gross carrying amount				
1 January	116	138	116	138
Revaluation (Adj)	(20)	(21)		
Revaluation gain (loss)	(16)	26		
31 December	80	143	116	138
Accumulated depreciation				
1 January	20	21	8	12
Revaluation (Adj)	(20)	(21)		
For the year	10	11	12	9
31 December	10	11	20	21
Carrying amount	70	132	96	117
Carrying value: cost model	63	117	72	126.75
	[70 – 7]	[132 – 15]	[96 – 24]	[117 + 9.75]

	Building	Warehouse
Measurement basis	Revaluation model	Revaluation model
Useful life	9 years	14 years
Depreciation method	Straight line	Straight line

The revaluation was performed on 1 January 2021 by Sagheer Valuers (Private) Limited, an independent firm of valuers.

Movement in revaluation surplus		Rs. m
1 January 2021	Building 24 + Warehouse 0	24
Revaluation loss	Building	(16)
Revaluation gain	Warehouse	16.25
Transfer to retained earnings	Building 1 + Warehouse 1.25	(2.25)
31 December 2021		22

W1 – Building		Rs. m
2017 & 2018: Depreciation	96 / 16 years x 1.5 years	9
1 Jan 2019: Gain on revaluation (OCI)	Rs. 116 – (96 – 9)	29
2019: Depreciation	116 / 14.5 years	8
2020: Depreciation	(116 – 8) / 9 years	12
1 Jan 2021: Loss on revaluation (OCI)	80 – (116 – 8 – 12)	16
Revaluation surplus balance	29 – 29/14.5 years – 27/9 years	24
Depreciation	80 / 8 years	10
Transfer to RE	(24 – 16) / 8 years	1

W2 – Warehouse		Rs. m
2018: Depreciation	156 / 12 years x 6/12	6.5
1 Jan 2019: Loss on revaluation (PL)	Rs. 138 – (156 – 6.5)	11.5
2019: Depreciation	138 / 11.5 years	12
2020: Depreciation	(138 – 12) / 14 years	9
1 Jan 2021: Gain on revaluation	143 – (138 – 12 – 9)	26
Reversal in PL	11.5 – 11.5/11.5 years – 10.5/14 years	9.75
Gain in OCI	26 – 9.75	16.25
Depreciation	143 / 13 years	11
Transfer to RE	16.25 / 13 years	1.25

► **Example 45:**

Following information pertain to property, plant and equipment of Harappa Industries Limited (HIL) for the year ended 30 June 2020:

i.

Assets	Balance as on 30 June 2019			Depreciation method	Useful life/rate
	Cost/revalued amount	Accumulated depreciation	Revaluation surplus		
	----- Rs. in '000 -----				
Land*	100,000	-	-	-	Infinite
Buildings	70,000	14,000	16,000	Straight line	20 years
Plant	180,000	60,000	-	Straight line	15 years
Vehicles	8,800	4,000	-	Reducing balance	20%

*An amount of Rs. 12 million had been charged to profit or loss upon previous revaluation.

ii. On 30 June 2020, the revalued amounts of the land and buildings were assessed by Smart Consultant at Rs. 120 million and Rs. 35 million respectively.

- iii. Setting up of a new plant was commenced on 1 July 2019 and substantially completed on 29 February 2020. The plant was available for use on 1 April 2020 and immediately put into use. Useful life of the plant was estimated at 10 years. Details of the cost incurred are as under:

Description	Payment date	Rs. in '000
1st payment	1 August 2019	12,000
2nd payment	1 October 2019	48,000
3rd payment	29 February 2020	48,000
4th payment	31 July 2020	12,000
		120,000

- iv. The cost of the plant was financed through an existing running finance facility with a limit of Rs. 200 million carrying mark-up of 12% per annum. A government grant of Rs. 20 million related to the plant was received on 1 January 2020. The grant amount was used for repayment of the running facility.
- v. One of the vehicles had an engine failure on 1 January 2020 and its engine had to be sold as scrap for Rs. 0.1 million. The vehicle had been acquired on 1 January 2018 at a cost of Rs. 2.5 million. 40% of the cost is attributable to its engine. Though the engine of similar capacity was available at a cost of Rs. 1.2 million, the old engine was replaced on 1 January 2020 with a higher capacity engine at a cost of Rs. 1.8 million.
- vi. HIL uses cost model for subsequent measurement of property, plant and equipment except for land and buildings.
- vii. HIL accounts for revaluation on net replacement value method and transfers the maximum possible amount from revaluation surplus to retained earnings on an annual basis.
- viii. HIL deducts government grant in arriving at the carrying amount of the asset.

Required:

In accordance with IFRSs, prepare a note on 'Property, plant and equipment' for inclusion in HIL's financial statements for the year ended 30 June 2020. (Comparatives figures and column for total are not required).

► **Answer:**

Notes to the financial statements for the year ended 30 June 2020

	Land (W1)	Buildings (W2)	Plant (W3)	Vehicles (W4)
Property, plant and equipment	Rs. 000	Rs. 000	Rs. 000	Rs. 000
Gross carrying amount				
1 July	100,000	70,000	180,000	8,800
Additions			102,840	1,800
Revaluation (Adj)		(17,500)		
Revaluation gain (loss)	20,000	(17,500)		
Disposal				(1,000)
30 June	120,000	35,000	282,840	9,600

	Land (W1)	Buildings (W2)	Plant (W3)	Vehicles (W4)
Property, plant and equipment	Rs. 000	Rs. 000	Rs. 000	Rs. 000
Accumulated depreciation				
1 July		14,000	60,000	4,000
For the year		3,500	14,571	1,068
Revaluation (Adj)		(17,500)		
Disposal				(352)
30 June	0	0	74,571	4,716
Carrying amount	120,000	35,000	208,269	4,884
Measurement model	Revaluation	Revaluation	Cost	Cost
Depreciation method	N/A	Straight line	Straight line	Reducing balance
Useful life / Dep. rate	Infinite	15 years	15 & 10 years	20%
Carrying value: cost model	112,000	37,500		
Effective date of revaluation	30 June 2020			
Independent valuer	Smart Consultants			
Movement in revaluation surplus				
1 July 2019	0	16,000		
Transfer to RE [16,000 / 16]		(1,000)		
Revaluation gain (loss) OCI	8,000	(15,000)		
30 June 2020	8,000	0		

W1 – Land

Gain in OCI Rs. 20,000 gain – previous reversal in PL 12,000	Rs. 8,000
Carrying amount under cost model Rs. 120,000 – 8,000 gain	Rs. 112,000

W2 – Buildings

Annual depreciation Rs. 70,000 / 20 years	Rs. 3,500
Remaining useful life 20 years – [Rs. 14,000 / 3,500]	16 years
Loss on revaluation [Rs. 35,000 – (Rs. 70,000 – 14,000 – 3,500)]	Rs. 17,500
Loss in PL Rs. 17,500 – 15,000 reversal in OCI	Rs. 2,500
Carrying amount under cost model Rs. 35,000 + 2,500 loss	Rs. 37,500

W3 – Plant		
Cost of plant		Rs. 000
Cost		120,000
Government grant		(20,000)
Capitalisation of borrowing cost:		
1 August - 1 October 2019	$12,000 \times 12\% \times 2 \div 12$	240
1 October - 31 December 2019	$60,000 \times 12\% \times 3 \div 12$	1,800
1 January - 29 February 2020	$(60,000 - 20,000) \times 12\% \times 2 \div 12$	800
		2,840
		102,840
Depreciation		
On opening balance	$180,000 \div 15$	12,000
On the new plant	$102,840 \div 10 \times 3 \div 12$	2,571
		14,571

W4 – Vehicle		
Written down value: Engine disposal		Rs. 000
Cost	$2,500 \times 40\%$	1,000
Accumulated depreciation:		
Six months upto 30 June 2018	$1,000 \times 20\% \times 6 \div 12$	100
For 2018-2019	$(1,000 - 100) \times 20\%$	180
Six months upto 31 Dec. 2019	$(1,000 - 280) \times 20\% \times 6 \div 12$	72
		352
		648
Depreciation		
On disposal of old engine	$(1,000 - 280) \times 20\% \times 6 \div 12$	72
On remaining opening balance	$[(8,800 - 1,000) - (4,000 - 280)] \times 20\%$	816
On addition of new engine	$1,800 \times 20\% \times 6 \div 12$	180
		1,068

► **Example 46:**

The following information is available regarding property, plant and equipment of Khangarh Limited (KL):

- On 1 July 2023, KL revalued its factory building for the second time, resulting in an upward revaluation of Rs. 18 million. Before this revaluation, the carrying amount was recorded as Rs. 81 million (gross amount of Rs. 90 million and accumulated depreciation of Rs. 9 million). This followed a previous revaluation on 1 July 2021, which had resulted in a revaluation loss of Rs. 12 million.
- On 1 November 2023, KL replaced a significant part of its machine that accounted for 30% of the machine's total value. The new part had a price of Rs. 35 million, however, only Rs. 22 million was paid as the old part was given in exchange. This replacement extended the machine's life by an additional year. Originally, the machine was purchased for Rs. 75 million on 1 January 2021, and it had accumulated depreciation of Rs. 12.5 million as at 30 June 2023 based on useful life of 15 years.

- iii. On 1 January 2024, KL sold a vehicle for Rs. 36 million and incurred a disposal cost of Rs. 2 million. The vehicle was originally purchased on 1 April 2021, for Rs. 40 million.

Other information:

- KL accounts for revaluation using the net replacement value method and transfers the maximum possible amount from the revaluation surplus to retained earnings on an annual basis.
- All items of property, plant, and equipment are subsequently measured using the cost model, except for the factory building.
- Depreciation is applied using the straight-line method, except for vehicles, which are depreciated using the reducing balance method at 15% per annum.

Required:

Prepare the journal entries to be recorded in the books of KL during the year ended 30 June 2024 in respect of the above information. (Show all necessary workings. Narrations are not required)

► **Answer:**

Khargarh Limited's General Journal

Date	Description	Debit	Credit
		--- Rs. in million ---	
Factory building			
1 Jul 2023	Accumulated depreciation - factory building	9.00	
	Factory building		9.00
1 Jul 2023	Factory building	18.00	
	Revaluation gain (P&L) 12 – 12×10%(i.e. 9÷90)		10.80
	Revaluation surplus (OCI) Bal. fig.		7.20
30 Jun 2024	Depreciation expense	5.50	
	Acc. dep. - factory building (81+18)÷18 (W-1)		5.50
30 Jun 2024	Revaluation surplus	0.40	
	Retained earnings 7.2÷18 (W-1)		0.40
Machinery			
1 Nov 2023	Depreciation expense (75÷15 years)×4÷12	1.67	
	Accumulated dep. – machinery		1.67
1 Nov 2023	Machinery	35.00	
	Accumulated depreciation (12.5+1.67)×30%	4.25	
	Loss on disposal Bal. fig.	5.25	
	Cash		22.00
	Machinery 75×30%		22.50
30 June 2024	Depreciation expense	3.92	
	Accumulated dep. – machinery (W-2)		3.92
Vehicles			
1 Jan 2024	Depreciation expense (W-3)	2.08	
	Accumulated depreciation - Vehicles		2.08

Date	Description	Debit	Credit
		--- Rs. in million ---	
1 Jan 2024	Cash 36-2	34.00	
	Accumulated depreciation - Vehicles (W-3)	14.25	
	Vehicles		40.00
	Gain on disposal Bal. fig.		8.25

W-1: Remaining life of building

Yearly depreciation	9÷2	Rs. 4.5 million
Remaining life of building on 1 July 2021	90÷4.5	20 years
Remaining life of building on 1 July 2023	20-2	18 years

W-2: Depreciation on machinery for next 8 months

Rs. in million	
Remaining book value of machinery	
Cost	75 - 22.5 + 35
Accumulated depreciation	12.5 + 1.67 - 4.25
	77.58
Remaining life = (15+1) - 2.83 = 13.17 years	
Depreciation (November 2023 - June 2024)	77.58 ÷ 13.17 × 8÷12
	3.92

W-3: Accumulated depreciation of vehicle on disposal

Rs. in million	
Depreciation for 2020-21	40×15%×3÷12
Depreciation for 2021-22	(40-1.5)×15%
	7.27
Depreciation for 2022-23	(40-7.27)×15%
	12.17
Depreciation for 2023-24	(40-12.17)×15%×6÷12
	14.25

1. OBJECTIVE BASED Q&A

1. An entity purchased a property 15 years ago at a cost of Rs. 100,000 and have been depreciating it at a rate of 2% per annum, on the straight-line basis. The entity has had the property professionally revalued at Rs. 500,000.

What is the revaluation surplus that will be recorded in the financial statements in respect of this property?

- a) Rs. 400,000
- b) Rs. 500,000
- c) Rs. 530,000
- d) Rs. 430,000

2. An entity owns two buildings, A and B, which are currently recorded in the books at carrying amounts of Rs. 170,000 and Rs. 330,000 respectively. Both buildings have recently been valued as follows:

Building A Rs. 400,000

Building B Rs. 250,000

The entity currently has a balance on the revaluation surplus of Rs. 50,000 which arose when building A was revalued several years ago. Building B has not previously been revalued.

What double entry will need to be made to record the revaluations of buildings A and B?

- a) Dr Non-current assets Rs. 150,000
Dr Statement of profit or loss Rs. 80,000
Cr Other comprehensive income (revaluation surplus) Rs. 230,000
- b) Dr Non-current assets Rs. 150,000
Dr Statement of profit or loss Rs. 30,000
Cr Other comprehensive income (revaluation surplus) Rs. 180,000
- c) Dr Non-current assets Rs. 150,000
Cr Other comprehensive income (revaluation surplus) Rs. 150,000
- d) Dr Non-current assets Rs. 150,000
Dr Statement of profit or loss Rs. 50,000
Cr Other comprehensive income (revaluation surplus) Rs. 200,000

3. An entity purchased property for Rs. 6 million on 1 July 2013. The land element of the purchase was Rs. 1 million. The expected life of the building was 50 years and its residual value nil. On 30 June 2015 the property was revalued to Rs. 7 million, of which the land element was Rs. 1.24 million and the buildings Rs. 5.76 million. On 30 June 2017, the property was sold for Rs. 6.8 million.

What is the gain on disposal of the property that would be reported in the statement of profit or loss for the year to 30 June 2017?

- a) Gain Rs. 40,000
- b) Loss Rs. 200,000
- c) Gain Rs. 1,000,000
- d) Gain Rs. 1,240,000

4. Which of the following statements are correct?
- If the revaluation model is used for property, plant and equipment, revaluations must subsequently be made with sufficient regularity to ensure that the carrying amount does not differ materially from the fair value at each reporting date.
 - When an item of property, plant and equipment is revalued, there is no requirement that the entire class of assets to which the item belongs must be revalued.
- Only statement i is correct
 - Only statement ii is correct
 - Both statements are correct
 - None of the statement is correct

5. The following trial balance extract relates to a property which is owned by Maira Limited as at 1 April 2014.

	Dr	Cr
	Rs. 000	Rs. 000
Property at cost (20 year original life)	12,000	
Accumulated depreciation as at 1 April 2014		3,600

On 1 October 2014, following a sustained increase in property prices, Maira Limited revalued its property to Rs. 10.8 million.

What will be the depreciation charge in Maira Limited's statement of comprehensive income for the year ended 31 March 2015?

- Rs. 540,000
 - Rs. 570,000
 - Rs. 700,000
 - Rs. 800,000
6. A company purchased a building on 1 April 2007 for Rs. 10,000,000. The asset had a useful economic life at that date of 40 years. On 1 April 2009 the company revalued the building to its current fair value of Rs. 12,000,000.

What is the double entry to record the revaluation?

- Dr. Building 1,500,000
Dr. Accumulated depreciation 500,000
Cr. Other comprehensive income 2,000,000
- Dr. Building 2,000,000
Dr. Accumulated depreciation 500,000
Cr. Profit or loss 2,500,000
- Dr. Building 2,000,000
Dr. Accumulated depreciation 500,000
Cr. Other comprehensive income 2,500,000
- Dr. Building 1,500,000
Dr. Accumulated depreciation 500,000
Cr. Profit or loss 2,000,000

7. The carrying value of property at the end of the year amounted to Rs. 108 million. On this date the property was revalued and was deemed to have a fair value of Rs. 95 million. The balance on the revaluation reserve relating to the original gain of the property was Rs. 10 million.

What is the double entry to record the revaluation?

- a) Dr. Profit or loss 3 million
Dr. Other comprehensive income 10 million
Cr. Property 13 million
 - b) Dr. Profit or loss 10 million
Dr. Other comprehensive income 3 million
Cr. Property 13 million
 - c) Dr. Profit or loss 13 million
Dr. Other comprehensive income 3 million
Cr. Property 16 million
 - d) Dr. Profit or loss 13 million
Cr. Property 13 million
8. A company revalued its property on 1 April 2009 to Rs. 20m (Rs. 8m for the land). The property originally cost Rs. 10m (Rs. 2m for the land) 10 years ago. The original useful economic life of 40 years is unchanged. The company's policy is to make a transfer to realized profits in respect of excess depreciation.

At which amount the property be presented at as at 31 March 2010?

- a) Rs. 20 million
 - b) Rs. 19.6 million
 - c) Rs. 12 million
 - d) Rs. 11.6 million
9. A company revalued its property on 1 April 2009 to Rs. 20m (Rs. 8m for the land). The property originally cost Rs. 10m (Rs. 2m for the land) 10 years ago. The original useful economic life of 40 years is unchanged. The company's policy is to make a transfer to realized profits in respect of excess depreciation.

What is amount of balance in revaluation surplus account as at 31 March 2010?

- a) Rs. 12 million
 - b) Rs. 10 million
 - c) Rs. 9.8 million
 - d) Rs. 11.8 million
10. Which of the following is an optional disclosure requirement of IAS 16?
- a) Measurement bases for determining gross carrying amount
 - b) Depreciation method
 - c) Useful lives or depreciation rates
 - d) The carrying amount of temporarily idle PPE

11. Following information is available for equipment account of a business on 1st January 2018:

Opening balance of equipment, a/c (Revalued amount)	Rs. 7,500,000
Surplus on revaluation of equipment a/c	Rs. 2,000,000
At start of year company sold equipment for	Rs. 90,000,000

Company has a policy of charging 20% depreciation on straight line basis.

What will be treatment of revaluation surplus at disposal of asset?

- Dr Surplus on revaluation Rs. 2,000,000
Cr Retained earnings Rs. 2,000,000
 - Dr Retained earnings Rs. 2,000,000
Cr Surplus on revaluation Rs. 2,000,000
 - Dr Surplus on revaluation Rs. 3,500,000
Cr Retained earnings Rs. 3,500,000
 - Dr Surplus on revaluation Rs. 2,000,000
Cr Equipment account Rs. 2,000,000
12. A non-current asset costing Rs. 216,000 and carrying value Rs. 145,000 is revalued to Rs. 291,000.

How should revaluation be recorded?

- Dr Asset a/c Rs. 75,000
Cr Surplus on revaluation Rs. 75,000
 - Dr Asset a/c Rs. 75,000
Dr Accumulated Depreciation Rs. 71,000
Cr Surplus on revaluation Rs. 146,000
 - Dr Surplus on revaluation Rs. 146,000
Cr Asset a/c Rs. 75,000
Cr Accumulated Depreciation Rs. 71,000
 - Dr Accumulated depreciation Rs. 146,000
Cr Surplus on revaluation Rs. 146,000
13. When items of property, plant and equipment are stated at revalued amounts the following must be disclosed:
- the effective date of the revaluation
 - whether an independent valuer was involved
 - for each revalued class of property, plant and equipment, the carrying amount that would have been recognised had the assets been carried under the cost model;
 - the revaluation surplus, indicating the change for the period and any restrictions on the distribution of the balance to shareholders.
- (i), (ii) and (iv) only
 - (i), (ii), and (iii) only
 - (ii), (iii) and (iv) only
 - (i) to (iv) all

14. IAS 16 encourages disclosure of the following information as users of financial statements might find it to be useful.
- the carrying amount of temporarily idle property, plant and equipment
 - the gross carrying amount of any fully depreciated property, plant and equipment that is still in use
 - the carrying amount of property, plant and equipment retired from active use and held for disposal
 - when the cost model is used, the fair value of property, plant and equipment when this is materially different from the carrying amount
 - (i), (ii) and (iii) only
 - (i), (ii) and (iv) only
 - (i), (iii) and (iv) only
 - (i) to (iv) all
15. Which of the following statements is correct?
- An entity may present PPE at gross carrying amount or net carrying amount under IAS 16
 - Either useful lives or depreciation rates are to be disclosed, both are not required.
 - Under revaluation model, PPE are revalued at end of each year
 - If an entity chooses revaluation model, it must apply revaluation model to all of its PPE.
16. Waqas Limited purchased a machine for Rs. 30,000 on 1 January 2015 and assigned it a useful life of 12 years. On 31 March 2017 it was revalued to Rs. 32,000 with no change in useful life.
- What will be depreciation charge in relation to this machine in the financial statements for the year ending 31 December 2017?
- Rs. 2,462
 - Rs. 2,500
 - Rs. 2,667
 - Rs. 3,087
17. A business purchased building costing Rs. 7,500,000 on 1 January 2018.
- The policy of business is to charge straight line depreciation over its useful life of 20 years.
- On 31 December 2020, building was revalued to Rs. 7,650,000.
- What is the amount of incremental depreciation to be transferred to retained earnings at year ending 31 December 2021?
- Rs. 25,000
 - Rs. 50,000
 - Rs. 75,000
 - Rs. 100,000

18. A business purchased an asset on 1 January 2016 costing Rs. 5,000,000 having a useful life of 10 years with nil residual value. On 1 January 2018 balance of accumulated depreciation was Rs. 1,000,000. Asset is revalued to Rs. 4,500,000 on 1 January 2018 (start of the year).
- Business has a policy to charge straight line depreciation.
- What is the depreciation charge for the year ended 31 December 2018?
- a) Rs. 450,000
 - b) Rs. 500,000
 - c) Rs. 555,555
 - d) Rs. 562,500
19. A business purchased an asset on 1 January 2016 costing Rs. 5,000,000 having a useful life of 10 years with nil residual value. On 1 January 2018 balance of accumulated depreciation was Rs. 1,000,000. Asset is revalued to Rs. 4,500,000 on 1 January 2018 (start of the year).
- Business has a policy to charge straight line depreciation.
- What is the amount of revaluation surplus at the date of revaluation?
- a) Rs. Nil
 - b) Rs. 500,000
 - c) Rs. 1,000,000
 - d) Rs. 1,500,000
20. A business purchased an asset on 1 January 2016 costing Rs. 5,000,000 having a useful life of 10 years with nil residual value. On 1 January 2018 balance of accumulated depreciation was Rs. 1,000,000. Asset is revalued to Rs. 4,500,000 on 1 January 2018 (start of the year).
- Business has a policy to charge straight line depreciation.
- What is the amount of incremental depreciation for the year ended 31 December 2018?
- a) Rs. 50,000
 - b) Rs. Nil
 - c) Rs. 55,555
 - d) Rs. 62,500
21. A revaluation gain is credited into?
- a) Revaluation reserve
 - b) Capital reserve
 - c) Profit and loss
 - d) Any of the above
22. After initial recognition, an entity has a choice to choose cost and?
- a) Realizable model
 - b) Replacement model
 - c) Revaluation model
 - d) Carrying value model

23. When an item of property, plant and equipment is revalued, what should be revalued?
- A selection of assets decided by management
 - The whole class of assets to which it belongs
 - The individual asset
 - A selection of assets picked at random
24. If an asset increases in value, the increase is noted as?
- An increase in net profit in the SOCI
 - An increase in retained earnings in SOFP
 - An increase in revaluation surplus in the SOFP and other comprehensive income in the SOCI
 - An increase in "other profit" in SOCI
25. Which of the following is not a valid reason for reporting non-current assets at revaluation amount rather than cost?
- To prevent long life assets from being reported at out of date historical costs
 - To keep owners of the business better informed of their equity in the business.
 - To report performance correctly by matching earnings with the proper costs of assets used.
 - To avoid having to pay higher taxes
26. An entity has a policy of revaluing its PPE. An asset cost Rs.5m on 1 January 2020 and has a useful life of five years and is depreciated on a straight-line basis to a zero residual value. The value of the asset at 31 December 2020 was Rs.3.8m. The fall in value will be accounted for as follows?
- Depreciation Rs.1m and fall in value of Rs.200,000 both to the reserves
 - Depreciation Rs.1m to the income statement and fall in value of Rs.200,000 ignored until there is a revaluation surplus
 - Depreciation Rs.1m to income statement and fall in value of Rs.200,000 to the reserves
 - Depreciation Rs.1m and fall in value of Rs.200,000 both to the income statement
27. Which TWO of these items would be recognised in other comprehensive income?
- Gain of Rs. 10million arising on the revaluation of freehold land. The land has been revalued for the first time
 - Gain of Rs. 10 million arising on the revaluation of freehold land, upon previous revaluation a loss of Rs. 15 million was recognised in profit or loss
 - Loss of Rs. 10 million arising on revaluation of freehold land, upon previous revaluation a gain of Rs. 15 million was recognised in other comprehensive income
 - Loss of Rs. 10 million arising on revaluation of freehold land. The land has been revalued for the first time
28. The following gains may legally be withdrawn from the company by shareholders:
- gains that arise from the upward revaluation of non-current assets
 - gains that arise from the sale of non-current assets

What is the validity of each statement?

- a) Both i. and ii are true
- b) i. is true and ii. is false
- c) Both i. and ii are false
- d) ii. is true and i. is false

29. The financial statements of Saadi Limited for the most recent year indicated the following:

- i. Revaluation loss on property, plant and equipment
- ii. Transfer of revaluation surplus to retained earnings
- iii. Revaluation gain on non-current assets
- iv. Disposal of property, plant and equipment

Which of the above involved a movement of cash?

- a) i. and ii
- b) ii. and iii.
- c) iii only
- d) iv only

30. An apartment is revalued upwards by Rs. 1 million. It was acquired 5 years ago for Rs. 5 million. Its useful life remains same as 10 years.

What is the revised depreciation charge for the year after revaluation?

- a) Rs. 500,000
- b) Rs. 600,000
- c) Rs. 700,000
- d) Rs. 800,000

31. A building is revalued upwards by Rs. 2 million. It was acquired five years ago for Rs.10 million. Its useful life remains same as 20 years. What is the incremental depreciation charge for the year?

- a) Rs.100,000
- b) Rs.133,333
- c) Rs.166,667
- d) Rs.200,000

32. An IT equipment being carried at revaluation model has revaluation reserve balance of Rs. 50,000. During the year, it reduces its value due to technological obsolescence. It has Rs. 70,000 decrease in value. What would be the impact of this revaluation decrease?

- a) The decrease of Rs.50,000 is debited to revaluation reserve and Rs.20,000 to profit or loss for the year
- b) The decrease of Rs.50,000 is debited to profit and loss account and Rs.20,000 to revaluation reserve for the year
- c) The whole decrease is debited to revaluation reserve
- d) The whole decrease is debited to profit or loss for the year

33. The correct accounting treatment of initial operating losses incurred during the commercial production due to under-utilization of the plant would be to:
- a) capitalise as a directly attributable cost
 - b) defer and charge to profit or loss account when profit is earned from the plant
 - c) charge directly to retained earnings since these are not considered to be normal operating losses
 - d) charge to profit or loss account

34. Which of the following is NOT considered as an item of property, plant and equipment?

- a) A standby generator expected to be used for seven years
- b) A plot of land held for resale
- c) A bus for pick and drop of staff members
- d) A generator for rental to others

35. An entity acquires a plant in exchange of old machinery which has carrying amount of Rs. 760,000 and fair value of Rs. 750,000 at the date of exchange. The list price of plant acquired is Rs. 850,000. The entity is also required to pay cash of Rs. 55,000 in this exchange transaction.

At which amount the acquired plant should be initially recognised?

- a) Rs. 850,000
- b) Rs. 760,000
- c) Rs. 815,000
- d) Rs. 805,000

36. An item of plant was purchased on 1 April 2008 for Rs. 2,000,000 and is being depreciated at 25% on a reducing balance basis. What would be its residual value after its useful life of 5 years?

- a) Rs. 632,809
- b) Rs. NIL
- c) Rs. 474,609
- d) Rs. 400,000

37. A non-current asset cost Rs. 96,000 and was purchased on 1 June Year 1. Its expected useful life was five years and its expected residual value was Rs. 16,000. The asset is depreciated by the straight-line method.

The asset was sold on 1 September Year 3 for Rs. 68,000. There were no disposal costs. It is the company policy to charge depreciation on a monthly basis. The financial year runs from 1 January to 31 December.

What was the gain or loss on disposal?

- a) Rs. 8,000 gain
- b) Rs. 8,000 loss
- c) Rs. 12,000 gain
- d) Rs. 12,000 loss

38. A non-current asset was purchased on 1 June Year 1 for Rs. 216,000. Its expected life was 8 years and its expected residual value was Rs. 24,000. The asset is depreciated by the straight-line method. The financial year is from 1 January to 31 December.

The asset was sold on 1 September Year 4 for Rs. 163,000. Disposal costs were Rs. 1,000.

It is the company policy to charge a proportionate amount of depreciation in the year of acquisition and in the year of disposal, in accordance with the number of months for which the asset was held.

What was the gain or loss on disposal?

- a) Rs. 24,000 gain
 - b) Rs. 24,000 loss
 - c) Rs. 32,000 gain
 - d) Rs. 32,000 loss
39. A change in depreciation method is a?
- a) Change in accounting policy
 - b) Change in accounting estimate
 - c) Change in accounting method
 - d) Change in accounting standard
40. When an asset is sold or disposed of, where is the gain or loss recognised?
- a) Asset disposal account
 - b) Profit and loss
 - c) Revaluation reserve
 - d) Depreciation
41. How often should the useful life of an asset be reviewed?
- a) Every six months
 - b) As and when the market value will significantly change
 - c) At least at each financial year end
 - d) Never
42. An entity acquired laptops in exchange of desktops which have carrying amount of Rs. 450,000 and fair value of Rs. 300,000 at the date of exchange. The list price of the laptops acquired is Rs. 600,000. The entity is also required to pay cash of Rs. 275,000 in this exchange transaction.
- The laptops should be initially recognised at:
- a) Rs. 300,000
 - b) Rs. 575,000
 - c) Rs. 450,000
 - d) Rs. 600,000

43. During the year 2019, an entity purchased a machine for Rs. 20 million to be used for 6 years. Which of the following would represent residual value of this machine in 2019?
- a) Rs. 15 million can be currently obtained from disposal of the machine in present condition
 - b) Rs. 4 million can be currently obtained from disposal of a 6 year old similar machine
 - c) Rs. 18 million can be obtained in 2025 from disposal of the machine in present condition
 - d) Rs. 7 million can be obtained in 2025 from disposal of a 6 year old similar machine
44. An asset was purchased on 1 January 2017 for Rs. 100 million with useful life of 6 years and residual value of Rs. 10 million. On 1 January 2020, it is revalued to Rs. 120 million with remaining useful life of 3 years and expected residual value of Rs. 15 million. How much excess depreciation will be charged for the year ended 31 December 2020?
- a) Rs. 15 million
 - b) Rs. 35 million
 - c) Rs. 20 million
 - d) Rs. 25 million
45. When items of property, plant and equipment are stated at revalued amounts, which of the following disclosures shall be made?
- a) Any restrictions on the distribution of the revaluation surplus to shareholders
 - b) The carrying amount of temporarily idle property, plant and equipment
 - c) The gross carrying amount of any fully depreciated property, plant and equipment that is still in use
 - d) All of the above

ANSWERS

01.	(d)			Rs.	
		Current value		500,000	
		Carrying amount (100,000 – (100,000 × 2% × 15 years))		(70,000)	
		Revaluation gain		430,000	
02.	(a)				
			Building A	Building B	
		Current value	400,000	250,000	
		Carrying amount	(170,000)	(330,000)	
		Revaluation gain/(loss)	230,000	(80,000)	
		The gain on Building A will be credited to other comprehensive income and the revaluation surplus. The loss on Building B will be debited to the statement of profit or loss expenses because we do not have a balance on the revaluation surplus in respect of building B to offset the loss. We make an overall debit to non-current assets of Rs. 230,000 – Rs. 80,000 = Rs. 150,000			
03.	(a)		Land	Buildings	Total
			Rs.	Rs. m	Rs. M
		Cost 1 July 2013	1.00	5.00	6.00
		Building depreciation Rs. 5 million/50 years x 2 years		(0.2)	(0.2)
		Carrying amount 30 June 2015	1.00	4.80	5.80
		Revaluation gain	0.24	1.96	1.20
		Revalued amount	1.24	5.76	7.00
		Building depreciation Rs. 5.76m/48 years x 2 years		(0.24)	(0.24)
		Carrying amount 30 June 2017	1.24	5.52	6.76
		Disposal proceeds			6.80
		Gain on disposal			0.04
		The gain on disposal is Rs. 40,000. The Rs. 1.2 million balance on the revaluation reserve is transferred from the revaluation reserve to another reserve account (probably retained earnings) but is not reported through the statement of profit or loss for the year.			
04.	(a)	IAS 16 (para 31) states that when the revaluation model is used, revaluations should be made with sufficient regularity to ensure that the carrying value of the assets remains close to fair value. IAS 16 also states (para 36) that, if one item in a class of assets is revalued, all the assets in that class must be revalued.			
05.	(c)	Six months’ depreciation to the date of the revaluation will be Rs. 300,000 (12,000/20 years × 6/12). Six months’ depreciation from the date of revaluation to 31 March 2015 would be Rs. 400,000 (10,800/13.5 years remaining life × 6/12). Total depreciation is Rs. 700,000.			

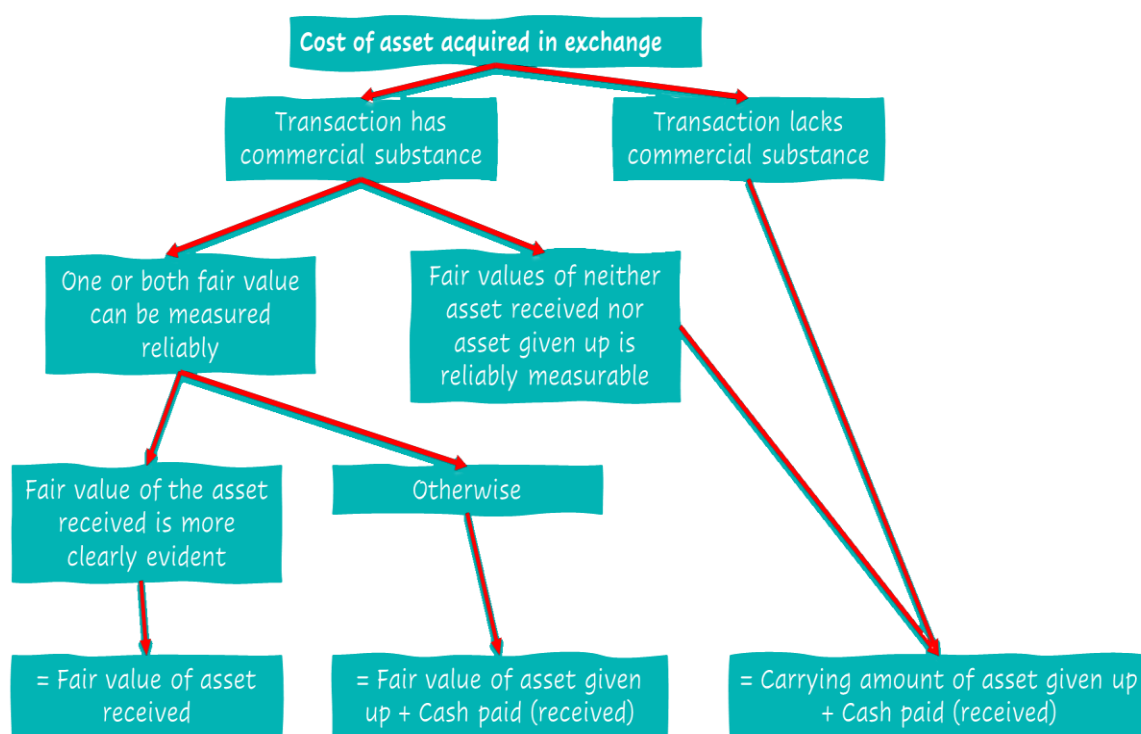
06.	(c)	Building a/c				
		Particulars	Rs.		Particulars	Rs.
		b/d	10,000,000		Acc. dep	500,000
		Surplus	2,500,000		c/d	12,000,000
			12,500,000			12,500,000
		Building net debited by Rs. 2,000,000 (2,500,000 – 500,000)				
07.	(a)	Total loss Rs. 13 million, Rs. 10 will be charged to revaluation surplus and remaining to profit or loss.				
08.	(b)	Depreciation (20 – 8) / 30 years = Rs. 0.4 million Carrying amount Rs. 20 million less 0.4 million = Rs. 19.6 million				
09.	(d)	Depreciation Now (20 – 8) / 30 years = Rs. 0.4 million Depreciation Cost (10 – 2) / 40 years = Rs. 0.2 million Revaluation surplus = Land Rs. 6 million + Building Rs. 6 million - incremental depreciation 0.2 million = Rs. 11.8 million				
10.	(d)					
11.	(a)	On disposal of a revalued asset, the full balance of surplus on revaluation is transferred to retained earnings.				
12.	(b)	Accumulated depreciation = Rs. 216,000-Rs. 145,000=Rs. 71,000 Surplus = Rs. 291,000-Rs. 145,000=Rs. 146,000 Net amount debited to asset = Rs. 146,000-Rs. 71,000=Rs. 75,000				
13.	(d)	(i) to (iv) all				
14.	(d)	(i) to (iv) all				
15.	(b)	Either useful lives or depreciation rates are to be disclosed, both are not required.				
16.	(d)	The machine has been owned for 2 years 3 months, so the remaining useful life at 31 March 2017 was 9 years 9 months. Prior to revaluation it was being depreciated at Rs. 2,500 pa (30,000/12), so the charge for the first three months of 2017 was Rs. 625. The machine will now be depreciated over the remaining 9 years 9 months = 117 months. So the charge for the remaining 9 months of 2017 is Rs. 2,462 ((32,000 / 117) × 9). So total depreciation for the year ended 31.12.17 is (625 + 2,462) = Rs. 3,087				
17.	(c)	Incremental depreciation = depreciation on revalued amount – depreciation at cost Dep. before revaluation = Rs. 7,500,000 / 20 years = Rs. 375,000 Dep. after revaluation = Rs. 7,650,000 / 17 years = Rs. 450,000 Incremental depreciation = Rs. 75,000				
18.	(d)	Depreciation = Rs. 4,500,000/8= Rs. 562,500				
19.	(b)	Revaluation surplus = Rs. 4,000,000 – 4,500,000= Rs. 500,000				
20.	(d)	Incremental depreciation = Dep on revalued amount – Dep on cost = (4,500,000/8)– (5,000,000/10) =Rs. 562,500 – 500,000 = 62,500 Alternatively, Rs. 500,000 surplus / 8 years = Rs. 62,500				

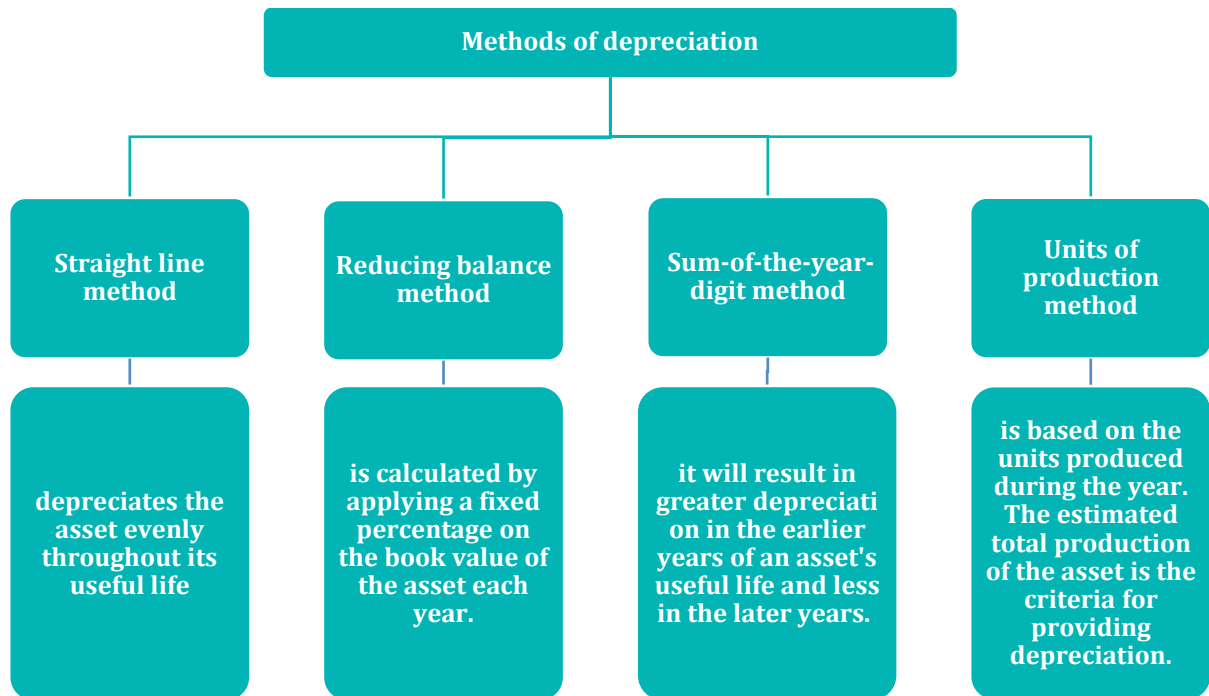
21.	(a)	Revaluation reserve												
22.	(c)	Revaluation model												
23.	(b)	The whole class of assets to which it belongs												
24.	(c)	An increase in revaluation surplus in the SOFP and other comprehensive income in SOCI												
25.	(d)	To avoid having to pay higher taxes												
26.	(d)	Depreciation Rs. 1 million in PL Revaluation loss Rs. 0.2 million in PL												
27.	(a) & (c)	In case of (a) & (c) Rs. 10 million gain or loss effect will be included in other comprehensive income. However, in case of (b) and (d), the Rs. 10 million gain or loss effect will be included in profit or loss.												
28.	(d)	Distribution of dividend from revaluation surplus is prohibited												
29.	(d)	Revaluation gain (loss) or its transfer does not involve movement of cash.												
30.	(c)	Rs. 3.5 million / 5 years = Rs. 700,000												
31.	(b)	Rs. 9.5 million / 15 years = Rs. 633,333 Rs. 10 million / 20 years = Rs. 500,000 Incremental Rs. 133,333												
32.	(a)	Upto balance in revaluation surplus Rs. 50,000 in OCI Remaining Rs. 20,000 in profit or loss												
33.	(d)	Charge to profit or loss account												
34.	(b)	A plot of land held for resale												
35.	(d)	Fair value of asset given up + cash paid = Rs. 750,000 + 55,000 = Rs. 805,000												
36.	(c)	Rs. 2,000,000 x (0.75) ⁵ = 474,609												
37.	(a)	Net sale proceeds = Rs. 68,000 Accumulated depreciation = Rs. 80,000 / 5 years x 2.25 years = Rs. 36,000 Carrying amount = Rs. 96,000 – 36,000 = Rs. 60,000 Gain on disposal = Rs. 68,000 – 60,000 = Rs. 8,000												
38.	(a)	Net sale proceeds = Rs. 163,000 – 1,000 = Rs. 162,000 <table><tr><th>Accumulated depreciation</th><th>Rs.</th></tr><tr><td>Depreciation year 1 (Rs. 216,000 – 24,000) / 8 years = 24,000 x 7/12</td><td>14,000</td></tr><tr><td>Depreciation year 2 → Rs. 24,000 x 12/12</td><td>24,000</td></tr><tr><td>Depreciation year 3 → Rs. 24,000 x 12/12</td><td>24,000</td></tr><tr><td>Depreciation year 4 → Rs. 24,000 x 8/12</td><td>16,000</td></tr><tr><td></td><td>78,000</td></tr></table> Carrying amount = Rs. 216,000 – 78,000 = Rs. 138,000 Gain on disposal = Rs. 162,000 – 138,000 = Rs. 24,000	Accumulated depreciation	Rs.	Depreciation year 1 (Rs. 216,000 – 24,000) / 8 years = 24,000 x 7/12	14,000	Depreciation year 2 → Rs. 24,000 x 12/12	24,000	Depreciation year 3 → Rs. 24,000 x 12/12	24,000	Depreciation year 4 → Rs. 24,000 x 8/12	16,000		78,000
Accumulated depreciation	Rs.													
Depreciation year 1 (Rs. 216,000 – 24,000) / 8 years = 24,000 x 7/12	14,000													
Depreciation year 2 → Rs. 24,000 x 12/12	24,000													
Depreciation year 3 → Rs. 24,000 x 12/12	24,000													
Depreciation year 4 → Rs. 24,000 x 8/12	16,000													
	78,000													
39.	(b)	Change in depreciation method is change in accounting estimate.												

40.	(b)	Gain or loss is recognised in profit or loss
41.	(c)	Useful life is reviewed annually at each financial year end, at least.
42.	(b)	Rs. 575,000
43.	(b)	Rs. 4 million can be currently obtained from disposal of 6 year old similar machine
44.	(c)	Previous depreciation expense $(100 - 10) / 6 \text{ years}$ = Rs. 15m Depreciation expense now $(120 - 15) / 3 \text{ years}$ = Rs. 35m Excess depreciation $35 - 15$ = Rs. 20m
45.	(a)	Other items are also disclosure requirement but not for revalued assets.

STICKY NOTES

Elements of cost	
Purchase price	Including non-refundable taxes Excluding discounts, rebates and interest due to deferred settlement terms (cost is cash price equivalent)
Directly attributed costs	Costs for bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management. Examples: - Employee benefits costs (construction or acquisition); - costs of site preparation; - initial delivery and handling costs; - installation and assembly costs; - costs of testing; and - professional fees.
Dismantling	the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located.





Formula of methods of Depreciation

Formula: Straight-line method

$$\text{Depreciation charge} = \frac{\text{Cost of asset less expected residual value}}{\text{Expected useful life (years)}}$$

Formula: Reducing balance method

$$\text{Depreciation charge} = \text{Carrying amount at the start of the year} \times \text{Fixed \%}$$

Formula: Sum of the years digits method

$$\text{Sum of digits} = \frac{n(n+1)}{2}$$

Where:

n = the useful life at the start of ownership

Formula: Units of production method

$$\text{Depreciation charge} = \frac{\text{Cost of asset less expected residual value}}{\text{Expected total output of asset over its life}} \times \text{Output this year}$$

Accounting entries with disposal account

1.	Transfer the cost of non-current asset disposed (or given in exchange)	Debit Disposal account Credit PPE (old)
2.	Transfer the accumulated depreciation of asset disposed (or given in exchange)	Debit Accumulated depreciation Credit Disposal account
3.	Disposal proceeds / cash received from disposal or part exchange	Debit Bank / Receivable Credit Disposal account
4.	Part-exchange (asset received)	Debit PPE (new) Credit Disposal account
5.	Disposal costs incurred	Debit Disposal account Credit Bank / payable
6.	Cash paid in part exchange	Debit Disposal account Credit Bank / payable
7.	Gain on disposal	Debit Disposal account Credit Gain (profit or loss)
	Loss on disposal	Debit Loss (profit or loss) Credit Disposal account

Recognition of gain (loss) on revaluation (Summary)

RECOGNITION OF GAIN / LOSS

Asset carried at cost revalued upwards	OCI (and added to Revaluation Surplus)
Asset carried at surplus revalued downwards	OCI [<i>up to the balance in revaluation surplus account*</i>] SPL [Remaining amount, if any] <i>*Consider impact of incremental depreciation.</i>
Asset carried at cost revalued downwards	SPL
Asset carried at deficit revalued upwards	SPL [<i>up to the reversal of impairment/revaluation loss*</i>] OCI [Remaining amount, if any] *= Loss recognised in PL – depreciation decrease due to loss

Key disclosure categories

1.	General disclosures with reconciliation of each class of PPE
2.	Disclosures in specific circumstances (restrictions on title, capital work in progress, contractual commitment, compensation from third parties)
3.	Specific disclosures for revalued assets (carrying amount under cost model, effective date of revaluation, independent valuer, movement in revaluation surplus).
4.	Additional disclosures (temporarily idle PPE, fully depreciated PPE, retired from use PPE and fair value)

IAS 40 INVESTMENT PROPERTY

IN THIS CHAPTER:

AT A GLANCE

SPOTLIGHT

1. Definitions and classification
2. Recognition and measurement
3. Transfers
4. Disclosure
5. Comprehensive Examples
6. Objective Based Q&A

STICKY NOTES

AT A GLANCE

Investment property is land or building or any part of land and building held for capital appreciation or rental to others or both.

Investment property is classified and presented separately from other non-current assets because it generates cash flows that are largely independent of other assets held by an entity.

The investment property is initially measured at cost which is sum of the purchase price and other directly attributable cost incurred at the time of acquisition.

There is choice of accounting policy for subsequent measurement:

- Cost model: measured at cost less accumulated depreciation and accumulated impairment losses (same as IAS 16).
- Fair value model: measured at fair value at each reporting date and fair value gain or loss is charged to profit or loss account. No depreciation is charged (different from revaluation model under IAS 16).

The investment property will be derecognised when sold and gain or loss on disposal will be charged to profit or loss.

IAS 40 also prescribes accounting treatment of transfers of investment property to/from owner-occupied property (IAS 16) and inventory (IAS 2).

Such transfer is allowed only when there is change in use of property i.e., when the property meets or ceases to meet the definition of investment property.

When an entity uses the cost model for investment property, transfers to/from investment property do not change the carrying amount of the property transferred. However, in case fair value model is used for investment property, IAS 40 provides guidance on deemed transfer value and accounting treatment of difference arising on such transfer.

1 DEFINITIONS AND CLASSIFICATION

1.1 Definitions [IAS 40: 5, 8 & 9]

Investment property is:

- property (land or a building—or part of a building—or both);
- held to earn rentals or for capital appreciation or both;
- rather than for use in the production or supply of goods or services or for administrative purposes, or sale in the ordinary course of business.

Owner-occupied property is property held:

- for use in the production or supply of goods or services; or
- for administrative purposes.

The following are examples of investment property:

- a) land held for long-term capital appreciation rather than for short-term sale in the ordinary course of business.
- b) land held for a currently undetermined future use i.e., if an entity has not determined that it will use the land as owner-occupied property or for short-term sale in the ordinary course of business, the land is regarded as held for capital appreciation.
- c) a building owned by the entity and leased out under one or more operating leases (rental arrangement).
- d) a building that is vacant but is held to be leased out under one or more operating leases.
- e) property that is being constructed or developed for future use as investment property.

The following are examples of items that are not investment property and are therefore outside the scope of IAS 40:

- a) property intended for sale in the ordinary course of business;
- b) property in the process of construction or development for sale in the ordinary course of business;
- c) property acquired exclusively with a view to subsequent disposal in the near future;
- d) property acquired exclusively for development and resale;
- e) owner-occupied property;
- f) property held for future use as owner-occupied property;
- g) property held for future development and subsequent use as owner-occupied property;
- h) property occupied by employees (whether or not the employees pay rent at market rates); and
- i) owner-occupied property awaiting disposal.

1.2 Why separate classification is necessary? [IAS 40: 7]

Investment property is held to earn rentals or for capital appreciation or both. Therefore, an investment property generates cash flows largely independently of the other assets held by an entity. This distinguishes investment property from owner-occupied property.

The production or supply of goods or services (or the use of property for administrative purposes) generates cash flows that are attributable not only to property, but also to other assets used in the production or supply process. IAS 16 applies to owned owner-occupied property.

1.3 Property portions held for different purposes [IAS 40: 10]

Some properties comprise a portion that is held to earn rentals or for capital appreciation and another portion that is held for use in the production or supply of goods or services or for administrative purposes.

Separable portions	If these portions could be sold separately, an entity accounts for the portions separately.
Non-separable portions	If the portions could not be sold separately, the property is investment property only if an insignificant portion is held for use in the production or supply of goods or services or for administrative purposes.

1.4 Impact of ancillary services [IAS 40: 11 to 14]

In some cases, an entity provides ancillary services to the occupants of a property it holds.

If the Services are Insignificant to the arrangement as a whole	Classification: Investment Property Example: The owner of an office building provides security and maintenance services to the tenants who occupy the building.
If the Services are Significant to the arrangement as a whole	Classification: Not Investment Property Example: An entity owns and manages a hotel and services provided to guests are significant to the arrangement as a whole.

It may be difficult to determine whether ancillary services are significant to the arrangement as a whole and judgement is needed to determine whether a property qualifies as investment property. Therefore, an entity is required to develop (and disclose) criteria for investment property classification so that it can exercise that judgement consistently.

2 RECOGNITION AND MEASUREMENT

2.1 Recognition principle [IAS 40: 16 to 19]

The recognition principle is similar to that of property, plant and equipment. An owned investment property shall be recognised as an asset when, and only when:

- a) it is probable that the future economic benefits that are associated with the investment property will flow to the entity; and
- b) the cost of the investment property can be measured reliably.

These costs include costs incurred initially to acquire an investment property and costs incurred subsequently to add to, replace part of, or service a property. The costs of the day-to-day servicing 'repairs and maintenance' of an investment property are recognised in profit or loss as incurred.

Parts of investment properties may have been acquired through replacement. For example, the interior walls may be replacements of original walls. In this case, recognise the new parts (if it meets recognition criteria) and derecognize the replaced parts.

2.2 Measurement at recognition [IAS 40: 20 to 27]

An owned investment property shall be measured initially at its cost. Transaction costs shall be included in the initial measurement.

The cost of a purchased investment property comprises its purchase price and any directly attributable expenditure. Directly attributable expenditure includes, for example, professional fees for legal services, property transfer taxes and other transaction costs.

The cost of an investment property is not increased by:

- a) start-up costs (unless necessary to bring the property to the condition necessary for it to be capable of operating in the manner intended by management);
- b) operating losses incurred before the investment property achieves the planned level of occupancy; or
- c) abnormal waste incurred in constructing or developing the property.

The accounting treatment for exchange of assets is same as those applied under IAS 16.

2.3 Measurement after recognition [IAS 40: 30, 31 & 56]

After initial recognition an entity may choose as its accounting policy:

- the fair value model; or
- the cost model (in accordance with the requirements of IAS 16).

The chosen policy must be applied to all the investment property. A voluntary change in policy shall be made only if the change results in financial statement providing reliable and more relevant information, and such change shall be retrospectively adjusted in accordance with the requirements of IAS 8. IAS 40 states that a change from the fair value model to the cost model is unlikely to result in a more appropriate presentation.

2.4 Fair value model [IAS 40: 32 & 35]

Under the fair value model:

- all investment property is remeasured at fair value at the end of each period;
- any resulting fair value gain or loss is recognised in profit or loss for the period; and
- the property would not be depreciated.

This is different to the revaluation model of IAS 16, where gains are reported in other comprehensive income and accumulated as a revaluation surplus.

► **Example 01:**

On 1 January Year 1 Entity P purchased a building for its investment potential. The building cost Rs. 1,000,000 with transaction costs of Rs. 10,000. The depreciable amount of the building component of the property at this date was Rs. 300,000. The property has a useful life of 50 years.

At the end of Year 1 the property's fair value had risen to Rs. 1,300,000.

Required:

How the above property shall be presented at the end of year 1 under:

- cost model; and
- fair value model.

► **Answer:****Part (a) Cost model**

SFP (extracts)		Rs.
Cost	[Rs. 1,000,000 + 10,000]	1,010,000
Accumulated depreciation	[Rs. 300,000 / 50 years]	(6,000)
Investment property		1,004,000

SPL (extracts)		Rs.
Depreciation	[Rs. 300,000 / 50 years]	(6,000)

Part (b) Fair value model

SFP (extracts)		Rs.
Investment property	[at fair value]	1,300,000

SPL (extracts)		Rs.
Gain on property valuation	[Rs. 1,300,000 – 1,010,000]	290,000

IAS 40 requires all entities to measure the fair value of investment property, for the purpose of either measurement (if the entity uses the fair value model) or disclosure (if it uses the cost model). An entity is encouraged, but not required, to measure the fair value of investment property on the basis of a valuation by an independent valuer who holds a recognised and relevant professional qualification and has recent experience in the location and category of the investment property being valued.

2.5 Disposal [IAS 40: 66 & 69]

An investment property shall be derecognised:

- on disposal; or
- when the investment property is permanently withdrawn from use and no future economic benefits are expected from its disposal.

Gains or losses arising from the retirement or disposal of investment property shall be determined as the difference between the net disposal proceeds and the carrying amount of the asset and shall be recognised in profit or loss in the period of the retirement or disposal.

► **Example 02:**

Continuing the same data as given in *Example 01*. The investment property was sold in early Year 2 for Rs. 1,550,000, selling costs were Rs. 50,000.

Required:

Calculate the gain on disposal under:

- a) cost model; and
- b) fair value model.

► **Answer:****Part (a) Cost model**

		Rs.
Net sale proceeds	Rs. 1,550,000 – 50,000	1,500,000
Carrying amount	[Example 01]	1,004,000
Gain on disposal	Rs. 1,500,000 – 1,004,000	496,000

Part (b) Fair value model

		Rs.
Net sale proceeds	Rs. 1,550,000 – 50,000	1,500,000
Carrying amount	[Example 01]	1,300,000
Gain on disposal	Rs. 1,500,000 – 1,300,000	200,000

2.6 Inability to measure fair value reliably [IAS 40: 53 & 55]

There is a rebuttable presumption that an entity can reliably measure the fair value of investment property on a continuing basis. However, in exceptional cases following guidance is applicable:

Investment property under construction	If an entity determines that the fair value of investment property under construction is not reliably measurable but expects the fair value of the property to be reliably measurable when construction is complete, it shall measure that investment property under construction at cost until either its fair value becomes reliably measurable, or construction is completed (whichever is earlier).
Investment property (not under construction)	If an entity determines that the fair value of an investment property (other than an investment property under construction) is not reliably measurable on continuing basis, the entity shall measure that investment property using the cost model in IAS 16. The residual value of such investment property shall be assumed to be zero. The entity shall continue to apply IAS 16 until disposal of such investment property.
Previously measured at Fair value	If an entity has previously measured an investment property at fair value, it shall continue to measure the property at fair value until disposal (or transfer to owner-occupied or Inventory) even if comparable market transactions become less frequent or market prices become less readily available.

► *Example 03:*

Victoria owns several properties and has a year end of 31 December. Wherever possible, Victoria carries investment properties under the fair value model.

Property 1 was acquired on 1 January Year 1. It had a cost of Rs. 1 million, comprising Rs. 500,000 for land and Rs. 500,000 for buildings. The buildings have a useful life of 40 years. Victoria uses this property as its head office.

Property 2 was acquired many years ago for Rs. 1.5 million for its investment potential. On 31 December Year 7 it had a fair value of Rs. 2.3 million. By 31 December Year 8 its fair value had risen to Rs. 2.7 million. This property has a useful life of 40 years.

Property 3 was acquired on 30 June Year 2 for Rs. 2 million for its investment potential. The directors believe that the fair value of this property was Rs. 3 million on 31 December Year 7 and Rs. 3.5 million on 31 December Year 8. However, due to the specialised nature of this property, these figures cannot be corroborated. This property has a useful life of 50 years.

Required:

- For each of the above properties briefly state how it would be treated in the financial statements of Victoria for the year ended 31 December Year 8, identifying any impact on profit or loss.
- Produce an analysis of non-current assets for Victoria for the year ended 31 December Year 8, showing each of the above properties separately (total column not required).

► *Answer:*

Part (a) Treatment in the financial statements for the year ended 31 December Year 8

Property 1

This property is used by Victoria as its head office and therefore cannot be treated as an investment property. It will be treated as property, plant and equipment and will be stated at cost minus accumulated depreciation in the statement of financial position. The depreciation for the year will be charged in the statement of profit or loss.

Property 2

This is held for its investment potential and should be treated as an investment property. It will be carried at fair value i.e., Victoria's policy of choice for investment properties. It will be revalued to fair value at period-end and any resultant gain or loss shall be taken to the statement of profit or loss (Rs. 400,000 gain in Year 8).

Property 3

This is held for its investment potential and should be treated as an investment property. However, since its fair value cannot be arrived at reliably it will be held at cost minus accumulated depreciation in the statement of financial position. The depreciation for the year will be an expense in the statement of profit or loss.

This situation provides the exception to the rule whereby all investment properties must be held under either the fair value model, or the cost model.

Part (b)

Analysis on non-current assets for the year ended 31 December Year 8	Property, plant & equipment	Investment property	
	Cost model	Fair value model	Cost model
	Rs. 000	Rs. 000	Rs. 000
Cost/valuation			
On 1 January	1,000	2,300	2,000
Fair value gain	-	400	-
On 31 December	1,000	2,700	2,000
Accumulated depreciation			
On 1 January W1	87.5	-	220
For the year W1	12.5	-	40
On 31 December	100	-	260
Carrying amount	900	2,700	1,740

Note: In practice, disclosure note for property, plant and equipment and investment property are separately presented in financial statements.

W1: Depreciation		Rs. 000
Property 1 (Year 8)	Rs. 500 / 40 years	12.5
Property 1 (brought forward)	Rs. 12.5 x 7 years	87.5
Property 3 (Year 8)	Rs. 2,000 / 50 years	40
Property 3 (brought forward)	Rs. 40 x 5.5 years	220

3 TRANSFERS

3.1 Change is use [IAS 40: 57 & 58]

An entity shall transfer a property to, or from, investment property when, and only when, there is a change in use.

A change in use occurs when the property meets, or ceases to meet, the definition of investment property and there is evidence of the change in use. In isolation, a change in management's intentions for the use of a property does not provide evidence of a change in use.

Examples of evidence of a change is use	Transfer from	Transfer to
Commencement of owner-occupation, or of development with a view to owner-occupation.	Investment property	Owner-occupied property
Commencement of development with a view to sale.	Investment property	Inventories
End of owner-occupation.	Owner-occupied property	Investment property
Inception of an operating lease (rental arrangement) to another party.	Inventories	Investment property

When an entity decides to dispose of an investment property without development, it continues to treat the property as an investment property until it is derecognised (eliminated from the statement of financial position) and does not reclassify it as inventory.

3.2 Transfer to/from investment property (cost model) [IAS 40: 59]

When an entity uses the cost model, transfers between investment property, owner-occupied property and inventories do not change the carrying amount of the property transferred and they do not change the cost of that property for measurement or disclosure purposes.

3.3 Transfer to/from investment property (fair value model) [IAS 40: 60, 61, 62 & 63]

From	To	Accounting treatment
IAS 40 (at FV)	IAS 16	Fair value at the date of change of use becomes the deemed cost for future accounting purposes.
IAS 40 (at FV)	IAS 2	Fair value at the date of change of use becomes the deemed cost for future accounting purposes.
IAS 16	IAS 40 (at FV)	Apply IAS 16 revaluation model (even if policy is cost model) on the date of transfer and treat the difference in accordance with IAS 16. On subsequent disposal of the investment property, the revaluation surplus included in equity may be transferred to retained earnings.
IAS 2	IAS 40 (at FV)	Measure investment property at fair value at the date of the transfer, and any difference compared to previous carrying amount is recognised in profit or loss.

► Example 04:

Entity A has investment property carried at its fair value of Rs. 1,000,000 on 1 January 2019 with remaining useful life of 10 years. Entity A uses fair value model under IAS 40.

On 30 June 2019, it was decided to use the building for administration rather than keeping it for investment potential. At this date the fair value was Rs. 1,200,000.

Entity A uses cost model under IAS 16. On 31 December 2019 (year-end), the value of property has increased to Rs. 1,300,000.

Required:

Journal entries for the year ended 31 December 2019.

► *Answer:*

Journal entries

Date	Particulars	Debit Rs.	Credit Rs.
30 Jun 2019	Investment property	200,000	
	Investment income/gain (PL)		200,000
30 Jun 2019	Property, plant and equipment	1,200,000	
	Investment property		1,200,000
31 Dec 2019	Depreciation [Rs. 1,200,000 / 9.5 x 6/12]	63,158	
	Accumulated depreciation		63,158

Here, Entity A applies cost model. In case Entity A had policy of applying revaluation model, the gain of Rs. 163,158 (i.e., Rs. 1,300,000 – (1,200,000 – 63,158)) would be recognised in other comprehensive income.

► *Example 05:*

Entity B has investment property carried at its fair value of Rs. 1,000,000 on 1 January 2019 with remaining useful life of 10 years. Entity B uses fair value model under IAS 40.

On 30 June 2019, board of directors decided to develop the property and started commencement of development and use it for sale of plots. At this date the fair value was Rs. 1,200,000. On 31 December 2019 (year-end), the value of property has increased to Rs. 1,300,000.

Required:

Journal entries for the year ended 31 December 2019.

► *Answer:*

Journal entries

Date	Particulars	Debit Rs.	Credit Rs.
30 Jun 2019	Investment property	200,000	
	Investment income/gain (PL)		200,000
30 Jun 2019	Inventories	1,200,000	
	Investment property		1,200,000

No adjustment required at year-end unless NRV of inventory is lower as compared to its cost of Rs. 1,200,000.

► *Example 06:*

Entity C has property being used as warehouse carried at Rs. 1,000,000 on 1 January 2019 with remaining useful life of 10 years. Entity C uses cost model under IAS 16 for its properties.

On 30 June 2019, property was vacated, and management decided to keep it for investment potential. At this date the fair value was Rs. 1,200,000. Entity C uses fair value model under IAS 40.

On 31 December 2019 (year-end), the value of property has increased to Rs. 1,300,000. Transfer from revaluation surplus to retained earnings is made at the time of disposal only.

Required:

Journal entries for the year ended 31 December 2019.

► *Answer:*

Journal entries

Date	Particulars	Debit Rs.	Credit Rs.
30 Jun 2019	Depreciation [Rs. 1,000,000 / 10 x 6/12]	50,000	
	Accumulated depreciation (PPE)		50,000
30 Jun 2019	PPE [Rs. 1,200,000 – (1,000,000 – 50,000)]	250,000	
	Gain on revaluation (OCI)		250,000
30 Jun 2019	Investment property	1,200,000	
	Property, plant and equipment		1,200,000
31 Dec 2019	Investment property	100,000	
	Investment income/gain (PL)		100,000

► *Example 07:*

Entity D has commercial shop held for resale in its ordinary course of property business carried at Rs. 1,000,000 on 1 January 2019.

On 30 June 2019, it was given on rent to a local business rather than keeping it for resale. At this date the fair value was Rs. 1,200,000. On 31 December 2019 (year-end), the value of property has increased to Rs. 1,300,000. Entity D uses fair value model under IAS 40.

Required:

Journal entries for the year ended 31 December 2019.

► *Answer:*

Journal entries

Date	Particulars	Debit Rs.	Credit Rs.
30 Jun 2019	Investment property	1,200,000	
	Inventory		1,000,000
	Profit or loss		200,000
31 Dec 2019	Investment property	100,000	
	Investment income / gain (PL)		100,000

Note: The rent income shall also be recognised in profit or loss.

3.4 Completion of self-constructed investment property [IAS 40: 65]

When an entity completes the construction or development of a self-constructed investment property that will be carried at fair value, any difference between:

- the fair value of the property at that date; and
- its *previous carrying amount*

shall be recognised in profit or loss.

4 DISCLOSURE

4.1 General disclosure (both models) [IAS 40: 75]

An entity shall disclose:

- a) whether it applies the fair value model or the cost model;
- b) when classification is difficult, the criteria it uses to distinguish investment property from owner-occupied property or inventory;
- c) the extent to which the fair value (as measured or disclosed in the financial statements) of investment property is based on a valuation by an independent valuer who holds a recognised and relevant professional qualification and has recent experience in the location and category of the investment property being valued. If there has been no such valuation, that fact shall be disclosed;
- d) the existence and amounts of restrictions on the realisability of investment property or the remittance of income and proceeds of disposal; and
- e) contractual obligations to purchase, construct or develop investment property or for repairs, maintenance or enhancements.

An entity shall also disclose the amounts recognised in profit or loss for:

- a) rental income from investment property; and
- b) direct operating expenses (including repairs and maintenance) arising from investment property:
 - that generated rental income during the period; and
 - that did not generate rental income during the period.

4.2 Additional disclosure (fair value model only) [IAS 40: 76 & 78]

An entity shall disclose a reconciliation between the carrying amounts of investment property at the beginning and end of the period, showing the following:

- a) additions (acquisitions & subsequent expenditure separately);
- b) disposals;
- c) net gains or losses from fair value adjustments;
- d) transfers; and
- e) other changes.

For investment properties included at cost model because fair value cannot be measured reliably, in addition, an entity shall disclose:

- a description of the investment property;
- an explanation of why fair value cannot be measured reliably;
- if possible, the range of estimates within which fair value is highly likely to lie; and
- the fact of disposal of such investment property, its carrying amount and gain or loss on disposal.

4.3 Additional disclosure (cost model only) [IAS 40: 79]

An entity shall disclose:

- the depreciation methods used;
- the useful lives or depreciation rates used; and
- gross carrying amounts and accumulated depreciation at the beginning and at the end of the period.

reconciliation between opening and closing values showing:

- additions (acquisitions & subsequent expenditure separately);
- depreciation;
- disposals;
- impairment losses and reversal thereof;
- transfers; and
- other changes.

When the cost model is used, the fair value of investment property shall be disclosed. If the fair value cannot be estimated reliably, the same additional disclosures should be made as are disclosed under the fair value model for investment properties included at cost model because fair value cannot be measured reliably.

5 COMPREHENSIVE EXAMPLES

► Example 08:

You have recently joined as the finance manager of Corv Limited (CL). While reviewing the draft financial statements for the year ended 31 December 2020 prepared by the junior accountant, you have noted that CL acquired a three-story building on 1 March 2020. CL uses the ground floor for its marketing department while remaining two floors were in excess of CL's need and therefore were rented out. The first floor was rented out on 1 June 2020 and the second floor was rented out on 1 December 2020.

The accountant has recorded the building as property, plant and equipment. The depreciation on ground, first and second floors has been computed from 1 March 2020, 1 June 2020 and 1 December 2020 respectively.

The accounting policy of CL is to carry land and building at fair value (wherever permitted by IFRS).

Required: Discuss how the above issue should be dealt in the financial statements of CL for the year ended 31 December 2020 in accordance with the requirements of IFRSs.

► Answer:

The accounting treatment adopted by accountant to record complete building under PPE head is incorrect. Two floors which have been leased/rented out separately should be accounted for as investment property. While ground floor used by marketing department should be recorded as property, plant and equipment under IAS 16 and depreciated over its useful life and any revaluation surplus on this floor should be recorded in OCI.

As per CL policy, investment property should be recorded at fair value and changes in fair value should be taken to statement of profit or loss. Any depreciation already charged on these floors should be reversed.

► Example 09:

Both IAS 16 'Property, Plant and Equipment' and IAS 40 'Investment Property' deal with tangible non-current assets of an entity. Discuss any four differences between IAS 16 and IAS 40.

► Answer:

Sr#	IAS 16	IAS 40
(i)	Applicable to tangible assets held for use in business including owner occupied property.	Applicable to property held to earn rental or for capital appreciation.
(ii)	Allows cost or revaluation model for subsequent remeasurement.	Allows cost or fair value model for subsequent remeasurement.
(iii)	Changes in fair value are taken to other comprehensive income and/or profit or loss.	Changes in fair value are taken to profit or loss only.
(iv)	Assets under revaluation model are depreciated.	Assets under fair value model are not depreciated.

► Example 10:

Following information pertains to non-current assets of Distaghil Limited (DL):

- DL purchased specialised vehicles for Rs. 370 million on 1 July 2017. The vehicles have an estimated useful life of 10 years with residual value of Rs. 30 million.

The revalued amounts of the vehicle as at 31 December 2018 and 2019 were determined at Rs. 302 million and Rs. 290 million respectively. There was no change in useful life or residual value.

- DL setup a manufacturing plant in a remote area at a cost of Rs. 280 million. The plant had a useful life of 8 years. The plant was purchased on 1 January 2018 and was available for use on 1 April 2018. The commercial production started on 1 June 2018.

On 1 July 2018, DL received a government grant of Rs. 120 million towards the cost of the plant. The sanction letter states that if DL ceases to use the plant in the remote area before 31 December 2021, DL would be required to repay the grant in full.

- iii. A warehouse was given on rent on 1 January 2018. Previously, the warehouse was in use of DL.

On 1 January 2018, carrying value and remaining useful life of the warehouse was Rs. 80 million and 16 years respectively. Fair value of the warehouse on various dates are as follows:

	Rs. in million
01 January 2018	104
31 December 2018	96
31 December 2019	115

Other information:

- DL uses cost model for subsequent measurement of property, plant and equipment except for specialised vehicles for which revaluation model is used.
- DL transfers the maximum possible amount from the revaluation surplus to retained earnings on an annual basis.
- Government grant is recorded as deferred income and a part of it is transferred to income each year.
- Investment property is carried at fair value model.

Required:

Prepare relevant extracts from DL's statement of profit or loss and other comprehensive income for the year ended 31 December 2019 and statement of financial position as on that date. *(Show comparative figures)*

► *Answer:*

Distaghil Limited

Extracts from statement of financial position as on 31 December 2019

	2019	2018
	---- Rs. in million ----	
Non-current assets:		
Property, plant and equipment:		
• Vehicles (W-1)	290.00	302.00
• Plant (W-2)	218.75	253.75
Investment property	115.00	96.00
Share capital and reserves:		
Revaluation surplus:		
• Vehicles	5.00	-
• Warehouse	24	24

	2019	2018
	---- Rs. in million ----	
Non-current liabilities:		
Deferred government grant (W-2)	78.75	93.75
Current liabilities		
Deferred government grant	15	15

Extracts from statement of profit or loss and other comprehensive income

For the year ended 31 December 2019

	2019	2018
	----- Rs. in million -----	
Profit or loss:		
Depreciation:		
• Vehicles (W-1)	(32.00)	(34.00)
• Plant (W-2)	(35.00)	(26.25)
Impairment / Revaluation loss – vehicles (W-1)	-	(17.00)
Revaluation gain - vehicles (W-1)	15.00	
Grant income – Plant (W-2)	15.00	11.25
Fair value gain (2019: 115–96), (2018: 96–104)	19.00	(8.00)
Other comprehensive income:		
Revaluation surplus:		
• Vehicles (W-1)	5.00	
• Warehouse (104–80)	-	24.00

W-1: Vehicles	Rs. in million
Purchased on 1 July 2017	370
Depreciation for 2017 $(370-30) \div 10 \times (6 \div 12)$	(17)
Book value on 31 December 2017	353
Depreciation for 2018 $(370-30) \div 10$	(34)
Book value on 31 December 2018 before revaluation	319
Revaluation loss Balancing	(17)
Revalued amount on 31 December 2018	302
Depreciation for 2019 $(302-30) \div 8.5$	(32)
Book value on 31 December 2019 before revaluation	270

W-1: Vehicles		Rs. in million
Revaluation gain to P&L	$[17-(34-32) \times 1]$ Or $17 \times (7.5 \div 8.5)$	15
Revaluation surplus	Balancing	5
Revalued amount on 31 December 2019		290

W-2: Plant and government grant		Plant	Gov. grant
		---- Rs. in million ----	
Initial balance		280.00	120.00
Depreciation for 2018	$(280 \div 8) \times (9 \div 12)$	(26.25)	
Grant income for 2018	$(120 \div 8) \times (9 \div 12)$		(11.25)
Balance on 31 December 2018		253.75	108.75
Depreciation for 2019	$280 \div 8$	(35.00)	
Grant income for 2019	$120 \div 8$		(15.00)
Balance on 31 December 2019		218.75	93.75

► **Example 11:**

Following information pertains to non-current assets of GnuCash Limited (GL):

- GL purchased a manufacturing plant for Rs. 340 million on 1 January 2021. On that date, the plant had an estimated useful life and residual value of 13 years and Rs. 60 million respectively. The revalued amounts and residual value were as follows:

	Revalued amount	Residual value
	----- Rs. in million -----	
30 June 2021	304	54
30 June 2022	315	44

- A warehouse owned by GL was given on rent on 1 January 2022. Previously, the warehouse was in use of GL.

The warehouse was acquired by GL on 1 July 2019 at a cost of Rs. 200 million and is being depreciated @ 10% per annum on reducing balance method.

Fair value of the warehouse on various dates are as follows:

	Rs. in million
1 January 2022	206
30 June 2022	214

Rentals earned for the year ended 30 June 2022 amounted to Rs. 10 million out of which Rs. 6 million is still outstanding.

- iii. GL acquired a property comprising of three similar showrooms at a total cost of Rs. 900 million on 1 October 2021. 40% of the cost of property is attributable to the value of land. Each of the showroom can be leased out separately and has a useful life of 15 years with no residual value.

GL is using one showroom for its own products while the other showrooms were held to be leased out. On 1 March 2022, the two showrooms were given on monthly rent of Rs. 4 million.

The fair value of each showroom is increasing by Rs. 3 million each month.

Other information:

- Cost model is used for subsequent measurement of all property, plant and equipment except for manufacturing plant for which revaluation model is used.
- Maximum possible amount is transferred from the revaluation surplus to retained earnings on an annual basis.
- Fair value model is used for subsequent measurement of all investment properties.

Required:

Prepare notes on 'Property, Plant and Equipment' and 'Investment Property', for inclusion in GL's financial statements for the year ended 30 June 2022. *(Comparative figures and column for total are not required)*

► *Answer:*

GnuCash Limited

Notes to the financial Statements for the year ended 30 June 2022

	Manufacturing plant (W1)	Ware house (W2)	Showroom land (W3)	Showroom building (W3)
Note 1: Property, plant and equipment	Rs. m	Rs. m	Rs. m	Rs. M
Gross carrying amount				
1 July	304	200	-	-
Additions	-	-	120	180
Revaluation (Adj)	(20.8)	(46.1)	-	-
Revaluation gain (loss)	31.8	52.1	-	-
Transfer to investmetn property	-	(206)	-	-
30 June	315	0	120	180
Accumulated depreication				
1 July	0	38	-	-
For the year	20.8	8.1	-	9
Revaluation (Adj)	(20.8)	(46.1)	-	-
30 June	0	0	0	9
Carrying amount	315	0	120	171

	Manufacturing plant (W1)	Ware house (W2)	Showroom land (W3)	Showroom building (W3)
Note 1: Property, plant and equipment	Rs. m	Rs. m	Rs. m	Rs. M
Measurement model	Revaluation	Cost	Cost	Cost
Depreciation method	Straight line	Reducing balance	N/A	Straight line
Useful life / Dep. rate	12.5 years	10%	N/A	15 years
Carrying value: cost model	Rs. 306.2 m			
Effective date of revaluation	30 June 2022			
Independent valuer				
Movement in revaluation surplus				
1 July 2021	0			
Revaluation gain (OCI)	8.8			
30 June 2022	8.8			

	Warehouse (W2)	Showrooms (W3)
Note 2: Investment property	Rs. m	Rs. m
1 July 2021	-	-
Transfer from owner-occupied property	206	-
Additions	-	600
Fair value gain	8	54
30 June 2022	214	654

The company uses fair value model for subsequent measurement of all assets in investment property.

The valuation of investment property was performed by _____.

The rental income from investment properties during the year amounted to Rs. 26 million (i.e. Rs. 10 million + Rs. 4 million x 4 months).

W1 - Manufacturing plant	Rs. m
Carrying amount 30 June 2021 $[340 - ((340-54)/13 \times 6/12)]$	329
Carrying amount 30 June 2022 $[329 - ((329-44) / 12.5 \text{ years})]$ Cost model	306.2
Revaluation loss (PL) 2021 $[304 - 329]$	25
Depreciation 2022 $[(304 - 44) / 12.5 \text{ years}]$	20.8
Revaluation gain (OCI) 2022 $[315 - 306.2]$	8.8
W1 - Manufacturing plant (Alternative calculation)	Rs. m
Total gain $[315 - (304 - 20.8)]$	31.8
Reversal in PL $[25 - 25/12.5 \text{ years}]$	23
Gain in OCI $[31.8 - 23]$	8.8

W2 – Warehouse		Rs. m
Accumulated dep. 1 July 2021	$[200 - (200 \times 90\% \times 90\%)]$	38
Depreciation year 2022	$[(200 - 38) \times 10\% \times 6/12]$	8.1
Revaluation gain at transfer	$[206 - (200 - 38 - 8.1)]$	52.1
Gain on investment property	$[214 - 206]$	8

W3 – Showroom		Rs. m
PPE (land)	$[900 \times 1/3 \times 40\%]$	120
PPE (building)	$[900 \times 1/3 \times 60\%]$	180
Depreciation	$[180 / 15 \text{ years} \times 9/12]$	9
Investment property	$[900 \times 2/3]$	600
Gain on fair value	$[3 \times 2 \text{ showrooms} \times 9 \text{ months}]$	54

► **Example 12:**

Following information pertains to non-current assets of Mesopotamia Limited (ML):

Asset (i)

On 1 July 2019, ML acquired a warehouse at a cost of Rs. 300 million and was immediately given on rent to a third party. On 1 January 2022, ML commenced the development work on its warehouse with a view to put it in own use. The development work was completed on 31 March 2022 at a cost of Rs. 50 million. ML started using the warehouse for its inventory on 1 May 2022. Fair value of the warehouse on various dates are as follows:

	31 Dec 2020	31 Dec 2021	31 Mar 2022	31 Dec 2022
Rs. in million	316	344	352	366

Depreciation is charged on warehouse at a rate of 10% per annum using the reducing balance method.

Asset (ii)

On 1 January 2020, ML purchased a heavy duty vehicle for Rs. 360 million. On purchase date, the vehicle had an estimated useful life and residual value of 5 years and Rs. 72 million respectively.

During 2022, ML has decided to change the depreciation method for vehicles from reducing balance to straight line.

Asset (iii)

On 1 June 2021, ML started construction of an office building. The building was available for use on 1 October 2022 and was immediately put into use. Details of the construction costs incurred are as under:

Payment date	Rs. in million	Sources (See below)
1 May 2021	140	A
1 January 2022	*100	A & B
1 April 2022	70	C
1 August 2022	160	D
		470

*The bill from the contractor was received on 1 December 2021.

These payments were financed through the following sources:

(A)	A short term loan of Rs. 200 million obtained on 1 April 2021 from Bank A at the rate of 16% per annum. The surplus funds available from the loan were invested in a saving account at 10% per annum. On 1 March 2022, ML repaid the loan using the proceeds received from a right issue of shares.
(B)	Excess cash available with ML in current bank accounts.
(C)	Withdrawals from its short term investments earning a profit of 12% per annum.
(D)	Withdrawals from a running finance facility from Bank B carrying interest at 14% per annum. The facility is also used for working capital needs.

Depreciation is charged on office building using straight line method over the estimated useful life of 20 years.

Additional information:

- Cost model is used for subsequent measurement of all property, plant and equipment.
- Fair value model is used for subsequent measurement of all investment properties.

Required:

Prepare relevant extracts **(including comparative figures)** from ML's statement of profit or loss for the year ended 31 December 2022 and statement of financial position as on that date.

► *Answer:*

Mesopotamia Limited			
Statement of profit or loss		2022	2021
For the year ended 31 December 2022		Rs. m	Rs. m
Fair value gain: Warehouse	W1A	-	28
Depreciation: Warehouse	W1B	(29.55)	-
Depreciation: Vehicle	W2	(39.04)	(71.81)
Depreciation: Building	W3	(6.18)	-
Interest expense	W3	-	(5.33)
Interest income	W3	-	2.17
Statement of financial position			
Mesopotamia Limited (ML):			
As at 31 December 2022			
Non-current assets			
Investment property: warehouse	W1A	-	344
Property, plant and equipment			
Warehouse	W1B	364.45	-
Vehicle	W2	150.08	189.12
Office building	W3	488.05	-
Capital work in progress (building)	W3	-	255.17
Current liabilities			
Loan from Bank A	W3	-	200
Other payables (for building)		-	100

Working 1A: Warehouse (Investment property: Fair value model)		Rs. m
Cost [1 July 2019]		300
Fair value gain	[till 31 December 2020]	16
31 December 2020		316
Fair value gain		28
31 December 2021		344
Working 1B: Warehouse (Property, plant and equipment: Cost model)		Rs. m
Cost [fair value is deemed transfer value]		344
Development costs		50
		394
Depreciation	[394 x 10% x 9/12]	(29.55)
31 December 2022		364.45
Note: Fair value not used because cost model is applicable for PPE.		
Working 2: Vehicle		Rs. m
Cost [1 Jan 2020]		360
Depreciation (RBM)	[360 x 27.52%]	(99.07)
31 December 2020		260.93
Depreciation (RBM)	[260.93 x 27.52%]	(71.81)
31 December 2021		189.12
Depreciation (SLM)	[(189.12 - 72) / 3 years]	(39.04)
31 December 2022		150.08

$$\text{Depreciation \%} = 1 - \sqrt[5]{\frac{72}{360}} = 27.52\%$$

Working 3: CWIP & Building		Rs. m
Expenditure 2021	[140 paid + 100 accrued]	240
Borrowing costs: (Jun to Dec)	Specific [200 x 16% x 7/12]	18.67
	Temp income [60 x 10% x 7/12]	(3.50)
		255.17
Depreciation	[not yet available for use]	0
31 December 2021		255.17
Expenditure 2022	[70 + 160]	230
Borrowing costs: (Jan & Feb)	Specific [200 x 16% x 2/12]	5.33
	Temp income [no amount left]	0
(Aug & Sep)	General [160 x 14% x 2/12]	3.73
		494.23
Depreciation	[494.23 / 20 years x 3/12]	(6.18)
31 December 2022		488.05

In profit or loss:		Rs. m
Interest expense (Apr & May 2021)	$[200 \times 16\% \times 2/12]$	5.33
Interest income (April 2021)	$[200 \times 10\% \times 1/12]$	1.67
Interest income (May 2021)	$[(200-140) \times 10\% \times 1/12]$	0.50
		2.17

► **Example 13:**

The following information pertains to non-current assets of Trout Limited (TL):

Property, plant and equipment

Details of the property, plant and equipment as at 1 January 2022 are as follows:

Assets	Cost/revalued amount	Accumulated depreciation	Depreciation method	Rate/ life	Subsequent measurement
	----- Rs. in million -----				
Equipment	360	110	Reducing balance	20%	Cost
Office building	280	56	Straight line	10 years*	Revaluation

*Remaining life at the date of last revaluation

As at 1 January 2022, the revaluation surplus related to the office building amounted to Rs. 32 million. However, on 31 December 2022, due to a slump in the market, the building was again revalued by an independent valuer, and this time, the office building was valued at only Rs. 156 million.

Equipment

On 1 July 2022, a new equipment was acquired by making payment of Rs. 50 million to the supplier. In addition, an old equipment was given in exchange to the supplier. The fair values of the old and new equipment were assessed at Rs. 60 million and Rs. 105 million, respectively. The old equipment had been acquired at a cost of Rs. 80 million on 1 July 2019.

Warehouse

On 1 January 2022, TL completed construction of the warehouse at a cost of Rs. 55 million for subsequent sale to customer. However, warehouse was given on rent at an annual rent of Rs. 8 million on 1 April 2022. The fair value of the warehouse on various dates are as follows:

	Rs. in million
1 January 2022	65
1 April 2022	73
31 December 2022	80

Other information:

- TL accounts for revaluation using the net replacement value method and transfers the maximum possible amount from revaluation surplus to retained earnings on an annual basis.
- The fair value model is used for the subsequent measurement of all investment properties.

Required:

Prepare the notes on 'Property, plant and equipment' and 'Investment property' to be included in TL's financial statements for the year ended 31 December 2022.

(Comparative figures and a column for the total are not required)

► Answer:

Trout Limited

Notes to the financial statements

For the year ended 31 December 2022

N1: Property, plant and equipment	Equipment	Office building
Cost	Rs. m	Rs. m
1 Jan	360	280
Addition	110	
Disposal	(80)	
Revaluation adjustment		(84)
Revaluation loss		(40)
31 December	390	156
Accumulated depreciation		
1 Jan	110	56
For the year	56.4	28
Disposal	(38.5)	
Revaluation adjustment		(84)
31 December	127.9	0
Carrying amount	262.1	156
Measurement base	Cost	Revaluation
Useful life/ depreciation rate	20%	10 years
Depreciation method	Reducing balance	Straight line
Effective date of revaluation		31 December 2022
Valuer		Independent
Carrying amount under cost model [Rs. 156m + 12 loss]		Rs. 168 m
Revaluation surplus		Rs. m
Opening balance		32
Transfer to retained earnings	32 / 8 years	(4)
		28
Loss on revaluation		(28)
Closing balance		0

Charge to PL = Total loss 40 – charged to OCI 28 = 12

N2: Investment property		Rs. m
1 Jan		0
Transfer from inventory		73
Fair value gain (balancing)		7
31 December		80
Measurement base		Fair value
Rental income Rs. 8m x 9/12		Rs. 6m

W1: Accumulated depreciation of old equipment		Rs. m
Depreciation 2019	$[80 \times 20\% \times 6/12]$	8.0
Depreciation 2020	$[(80 - 8) \times 20\% \times 6/12]$	14.4
Depreciation 2021	$[(80 - 8 - 14.4) \times 20\% \times 6/12]$	11.5
		33.9
Depreciation 2022	$[(80 - 33.9) \times 20\% \times 6/12]$	4.6
		38.5

W2: Depreciation expense (equipment)		Rs. m
On disposed	$[(80 - 33.9) \times 20\% \times 6/12]$	4.6
On remaining	$[(360 - 110) - (80 - 33.9) \times 20\%]$	40.8
On addition	$[110^* \times 20\% \times 6/12]$	11.0
		56.4

*New asset = fair value of asset given up 60 + Cash paid 50 = 110

W3: Office building		
Annual depreciation	$[280 / 10 \text{ years}]$	Rs. 28 million
Year passed	$[\text{Acc. Dep. } 56 / 28 \text{ annual depreciation}]$	2 years
Years remaining	$[10 - 2 \text{ years}]$	8 years
		Rs. m
Cost		280
Accumulated depreciation	$[56 + 28 \text{ for the year}]$	(84)
		196
Revaluation loss	(balancing)	40
Fair value		156

► **Example 14:**

You are the finance manager of Paradox Limited (PL). The financial statements of PL for the year ended 31 December 2023 are under preparation. In the beginning of 2023, PL adopted the revaluation model for the subsequent measurement of property, plant and equipment. A new CEO has recently joined PL. He has pointed out the following non-compliances of IFRSs after reviewing the draft financial statements of PL:

- IAS 16 does not allow selective revaluation, so all classes of property, plant and equipment should have been revalued.
- The adoption of the revaluation model has been accounted for as a 'Change in estimate' (i.e. prospectively) though it is a 'Change in accounting policy'.
- IAS 16 requires that incremental depreciation must be transferred from revaluation surplus to retained earnings but the transfer has not been made in the draft financial statements.
- Some vehicles have been given on rent by PL; these should have been included in investment property, but instead, they are included in property, plant and equipment.

Required:

Briefly respond to the non-compliances pointed out by the CEO.

► **Answer:**

- The point raised by CEO is not correct. It is not necessary that all items of property, plant and equipment (PPE) are revalued, if an item of PPE is revalued, the entire class of PPE to which that asset belongs shall be revalued. So, selected classes of assets can be revalued but selected assets within a class cannot be revalued.
- The point raised by CEO is not correct. Adoption of revaluation model for property, plant and equipment is a change in accounting policy. As per IAS 8, the initial application of a policy to revalued assets in accordance with IAS 16 is not accounted for retrospectively.
- The point raised by CEO is not correct. The transfer of incremental depreciation each year is not compulsory. The entity can choose to transfer the whole revaluation surplus to retained earnings upon disposal of assets or as incremental depreciation over the useful life of the assets.
- The point raised by CEO is not correct. As per IAS 40, only land or a building can be investment property. So, vehicles whether used in business or given for rentals, should be classified as property, plant and equipment.

► **Example 15:**

Following information pertains to properties of Synthesia Limited (SL):

Information (i)

SL obtained possession of property A from tenants on 30 April 2023 when SL shifted its head office from property B to property A. Property B was rented out immediately. On 30 April 2023, the fair value of property A was Rs. 740 million, while the fair value of property B was determined as equal to its carrying amount.

The details of properties A and B are as follows:

Property	Date of purchase	Cost	Fair value as on 31 December	
			2023	2022
		----- Rs. in million -----		
A	1 January 2021	750	750	720
B	1 July 2021	500	480	440

60% of costs and fair values of both properties refer to the land element.

Information (ii)

On 1 February 2023, SL started construction of property C with a view to earn rentals in the future. The construction was completed on 30 September 2023 at a total cost of Rs. 430 million. This included Rs. 7 million and Rs. 12 million for professional fees for legal services and abnormal wastage of material during construction respectively.

Operating losses of Rs. 10 million were also incurred before the property was rented out on 1 December 2023.

Fair value of property C was determined as Rs. 380 million, Rs. 390 million and Rs. 395 million as at 30 September 2023, 1 December 2023 and 31 December 2023 respectively.

Other information:

- Fair value model is used for subsequent measurement of all investment properties.
- Cost model is used for subsequent measurement of all property, plant and equipment.
- Depreciation is charged using the reducing balance method at a rate of 10%.
- Rental revenue received during 2023 and accrued at 31 December 2023 are Rs. 45 million and Rs. 6 million respectively.
- Repair and maintenance expenses related to investment property amounted to Rs. 25 million.
- All fair values are determined by Alpha Brothers, an independent firm of valuers.

Required:

- Prepare the note on 'Investment property' to be included in SL's financial statements for the year ended 31 December 2023.
 - Show each property in a separate column.
 - Columns for total and comparative are not required.
- Assuming that SL follows cost model for investment properties, prepare journal entry to record transfer of property A on 30 April 2023.

► **Answer:**

Part (a)**Synthesia Limited****Notes to the financial statements for the year ended 31 December 2023**

Note: Investment properties	A	B	C
	Rs. m	Rs. m	Rs. m
At 1 January 2023	720		
Addition [430 – 12]			418
Transfer from owner occupied property		465.3 W1	
Fair value gain (loss) (balancing)	20	14.7	(23)
Transfer to owner occupied property	(740)		
At 31 December 2023	0	480	395

1.1	Fair value model is used for the subsequent measurement of all investment properties.
1.2	The valuation of investment properties was performed by Alpha Brothers, an independent firm of valuers.
1.3	The rental income from investment properties during the year amounted to Rs. 51 million (i.e. Rs. 45 million received + Rs. 6 million accrued).
1.4	Direct operating expenses (repairs and maintenance) of Rs. 25 million were incurred during the year to generate rental income.

W1: Fair value / Carrying amount of property B on transfer		Rs. in million
Cost		500.0
Accumulated depreciation:		
Depreciation for 2021	$500 \times 40\% = 200 \times 10\% \times 6 \div 12$	10.0
Depreciation for 2022	$(200 - 10) \times 10\%$	19.0
Depreciation for 2023	$(200 - 10 - 19) \times 10\% \times 4 \div 12$	5.7
		(34.7)
Carrying amount		465.3

Part (b)

Date	Particulars	Debit Rs. m	Credit Rs. m
30 Apr 2023	Property, plant and equipment (balancing)	684.9	
	Accumulated depreciation W2	65.1	
	Investment property		750.0

W2: Accumulated depreciation for Property A		Rs. in million
Accumulated depreciation:		
Depreciation for 2021	$750 \times 40\% = 300 \times 10\%$	30.0
Depreciation for 2022	$(300 - 30) \times 10\%$	27.0
Depreciation for 2023	$(300 - 30 - 27) \times 10\% \times 4 \div 12$	8.1
		65.1

► **Example 16:**

Pipri Limited (PL) constructed a warehouse at a cost of Rs. 102 million, which was completed on 30 June 2022. The warehouse has a useful life of 12 years. Upon completion, 95% of the warehouse was rented out, while the remaining 5% was allocated for PL's administrative use. The warehouse's design prohibits the sale of these portions separately.

On 1 July 2023, PL discovered that the warehouse's cost mistakenly included abnormal wastage of Rs. 6 million in March 2022. PL corrected this error immediately and also changed the warehouse's subsequent measurement to the fair value model.

On 1 April 2024, PL started using the entire warehouse for its inventory storage. The fair values of the warehouse on various dates are as follows:

	1 July 23	1 April 2024	30 June 2024
Rs. in million	108	114	117

Other information:

- Depreciation is applied using the straight-line method.
- All items of property, plant and equipment are subsequently measured using the cost model.

Required:

Prepare the journal entries **with narrations** to be recorded in the books of PL during the year ended 30 June 2024. (Show relevant computations).

► **Answer:**

Pipri Limited's General Journal

Date	Particulars	Debit Rs. m	Credit Rs. m
1 Jul 2023	Retained earnings (abnormal wastage)	6	
	Investment property		6
	<i>(To record correction of abnormal wastage capitalised in previous year)</i>		
1 Jul 2023	Accumulated depreciation [6m / 12 years]	0.5	
	Retained earnings (Depreciation)		0.5
	<i>(To reverse depreciation charged due to incorrect amount capitalised in previous year)</i>		
1 Jul 2023	Accumulated depreciation [(102 – 6) / 12 years]	8	
	Retained earnings (Depreciation)		8
	<i>(To reverse depreciation in previous years due to change of policy to fair value model)</i>		
1 Jul 2023	Investment property [108 – (102 – 6)]	12	
	Retained earnings (fair value gain)		12
	<i>(To record increase in fair value of investment property relating to previous year)</i>		
1 Apr 2024	Investment property	6	
	Profit or loss (fair value gain)		6
	<i>(To record increase in fair value of investment property in current year upto the date of transfer)</i>		
1 Apr 2024	Property, plant and equipment	114	
	Investment property		114
	<i>(To record transfer of warehouse from investment property to property, plant and equipment)</i>		
30 Jun 2024	Depreciation [Rs, 114m / 10.25* years x 3/12]	2.78	
	Accumulated depreciation		2.78
	<i>(To record depreciation at year-end)</i>		

*Original life 12 years – 1.75 years till 1 April 2024 = 10.25 years remaining

1. OBJECTIVE BASED Q&A

1. An entity purchased an investment property on 1 January 2013 for a cost of Rs. 35m. The property had an estimated useful life of 50 years, with no residual value, and at 31 December 2015 had a fair value of Rs. 42m.

On 1 January 2016 the property was sold for net proceeds of Rs. 40m.

Calculate the profit or (loss) on disposal under both the cost and fair value (FV) model.

- a) Cost model: Rs. 7.1 m and FV model: (Rs. 2.0 m)
- b) Cost model: Rs. 2.0 m and FV model: Rs. 2.0 m
- c) Cost model: Rs. 5.0 m and FV model: (Rs. 2.0 m)
- d) Cost model: Rs. 7.1 m and FV model: Rs. 5.0 m

2. An investment property with a useful life of 10 years was purchased by Akram Limited on 1 January 2019 for Rs. 200 million. By 31 December 2019 the fair value of the property had risen to Rs. 300 million. Akram Limited measures its investment properties under the fair value model.

What values would go through the statement of profit or loss in the year?

- a) Gain: Rs. 100 million and Depreciation Rs. 30 million
- b) Gain: Rs. 0 and Depreciation of Rs. 30 million
- c) Gain: Rs. 100 million and Depreciation of 0
- d) Gain: Rs. 120 million and Depreciation of Rs. 20 million

3. Which of the following properties owned by an entity would be classified as an investment property?

- a) A property that was previously in use of the entity but recently vacated for disposal
- b) Land purchased for its investment potential. Planning permission has not been obtained for building construction of any kind
- c) A new office building used as entity's head office, purchased specifically in order to exploit its capital gains potential
- d) A bungalow used for executive training

4. Sarfraz Limited (SL) uses fair value accounting where possible and has an office building used by SL for administrative purposes. At 1 April 2012 it had a carrying amount of Rs. 20 million and a remaining life of 20 years. On 1 October 2012, the property was let to a third party and reclassified as an investment property. The property had a fair value of Rs. 23 million at 1 October 2012, and Rs. 23.4 million at 31 March 2013.

What is the correct treatment when the above property is reclassified as an investment property?

- a) Take Rs. 3,500,000 gain to other comprehensive income
- b) Take Rs. 3,500,000 gain to the statement of profit or loss
- c) Take Rs. 4,000,000 gain to other comprehensive income
- d) Take Rs. 4,000,000 gain to the statement of profit or loss

5. Cool Limited acquired a building with a 40-year life for its investment potential for Rs. 8 million on 1 January 2013. At 31 December 2013, the fair value of the property was estimated at Rs. 9 million with costs to sell estimated at Rs. 200,000.

If Cool Limited uses the fair value model for investment properties, what gain should be recorded in the statement of profit or loss for the year ended 31 December 2013?

- a) Rs. 800,000
- b) Rs. 1,000,000
- c) Rs. 1,200,000
- d) Rs. 8,800,000

6. Under IAS 40 – Investment Property, where should a gain or loss on disposal be recognised?
 - a) Statement of Financial Position
 - b) Profit and loss statement
 - c) Statement of changes in equity
 - d) None
7. If an entity uses part of a building for their own use and rents the remainder. How should this be treated?
 - a) All as investment property under IAS 40 – Investment Property
 - b) All under IAS 16 – Property, Plant and Equipment
 - c) Account for separately under ‘IAS - 16 Property, Plant and Equipment’ and ‘IAS - 40 Investment Property’
 - d) None of these
8. An investment property should initially be measured at?
 - a) Cost
 - b) Fair value
 - c) Market value
 - d) Net realizable value
9. If an entity wishes to change from a cost model to fair value model under IAS 40 – Investment Property, when may it do so?
 - a) When the board of directors approves a change
 - b) When the value of the assets will improve with a revised model
 - c) When a change will result in a more appropriate presentation
 - d) When the market for these properties is fluctuation
10. Which two of the following properties fall under the definition of investment property and therefore within the scope of IAS 40?
 - a) Property occupied by an employee paying market rent
 - b) A building owned by an entity and rented out to various tenants
 - c) Property being developed with a view to resale in the ordinary course of business
 - d) Land held for a currently undetermined future use
11. Afternoon Limited (AL) uses cost model for its property, plant and equipment and fair value model for its investment property. AL has an office building which was being used for administrative purposes. At 1 July 2018, the building had a carrying amount of Rs. 20 million. On that date, the building was let out to a third party and therefore reclassified as an investment property. The building had a fair value of Rs. 23 million on 1 July 2018 and Rs. 23.4 million on 30 June 2019.

What would be the increase in the profit or loss and other comprehensive income for the year ended 30 June 2019?

Profit or loss	Other comprehensive income
a) Nil	Rs. 3.4 million
b) Rs. 0.4 million	Rs. 3 million
c) Rs. 3.4 million	Nil
d) Rs. 3 million	Rs. 0.4 million

12. Which TWO of the following fall under the definition of investment property?
- Property occupied by an employee
 - A building owned by an entity and leased out under an operating lease
 - Property being constructed on behalf of third party
 - Land held for long term appreciation
13. Under IAS 40 'Investment property', which of the following disclosures is NOT required to be made under cost model?
- Fair value of the property
 - Depreciation method
 - Reconciliation of carrying amounts at the beginning and end of a period
 - Residual value of the property
14. Which of the following should be included in the initial cost of investment property?
- Cost incurred on opening ceremony to celebrate completion of property
 - Operating losses incurred before the property achieves the planned level of occupancy
 - Abnormal waste of materials incurred in construction of property
 - Property transfer taxes
15. An entity purchased an investment property on 1 January 2018 for Rs. 35 million. The property had an estimated useful life of 35 years with no residual value. At 31 December 2020, the property had a fair value of Rs. 42 million. On 1 January 2021, the property was sold for net proceeds of Rs. 40 million. Calculate the profit or loss on disposal under both the cost and fair value models.
- | | Cost model | Fair value model |
|----|-----------------------|-------------------------|
| a) | Gain of Rs. 2 million | Gain of Rs. 2 million |
| b) | Gain of Rs. 8 million | Loss of Rs. 2 million |
| c) | Gain of Rs. 7 million | Loss of Rs. 2 million |
| d) | Gain of Rs. 8 million | Gain of Rs. 5 million |
16. Which of the following falls under the definition of investment property?
- Owner occupied property awaiting disposal
 - Property occupied by an employee
 - Land held for undetermined use
 - Property held for future development and subsequent use as owner-occupied property
17. Which TWO of the following properties owned by a company would be classified as investment properties?
- Property occupied by an employee paying market rent
 - Land held by a company for undetermined future use
 - Machinery held for short-term sale in the ordinary course of business
 - Building held by a company for long-term capital appreciation

ANSWERS

01.	(a)	Under the cost model the property will be depreciated over 50 years for 3 years up to the date of disposal. Therefore, at the disposal date the carrying value would have been Rs. 35m – (Rs. 35m/50 × 3 years) = Rs. 32.9m and the profit on disposal Rs. 7.1m (Rs. 40m – Rs. 32.9). Under the fair value model, the property will not be depreciated hence the loss on disposal would be Rs. 2m (Rs. 40m – Rs. 42m).
02.	(c)	Under the fair value model, the property will not be depreciated hence the gain on valuation would be Rs. 100 million (Rs. 300 million – Rs. 200 million).
03.	(b)	Asset A is to be classified as PPE until disposal. Assets C and D would also be classified as property, plant and equipment under IAS 16.
04.	(a)	As SL uses the fair value model for investment properties, the asset should be revalued to fair value before being classed as an investment property. The gain on revaluation should be taken to other comprehensive income, as the asset is being revalued while held as property, plant and equipment. At 1 October, the carrying amount of the asset is Rs. 19.5 million, being Rs. 20 million less 6 months' depreciation. As the fair value at 1 October is Rs. 23 million, this leads to a Rs. 3,500,000 gain which will be recorded in other comprehensive income.
05.	(b)	The fair value gain of Rs. 1 million (Rs. 9m – Rs. 8m) should be taken to the statement of profit or loss. Costs to sell are ignored and, since entity uses the fair value model, no depreciation will be charged on the building.
06.	(b)	Gain or loss on disposal is recognised in profit or loss.
07.	(c)	Each portion is classified separately when separable.
08.	(a)	Initial measurement is at cost. Subsequently there is choice of cost model and fair value model.
09.	(c)	This is change in policy and will be justified only if it would result in more appropriate presentation.
10.	(b) & (d)	Property occupied by employees is considered owner occupied property and property being developed for resale is inventory.
11.	(b)	Profit or loss Rs. 0.4 million and Other comprehensive income Rs. 3 million
12.	(b) & (d)	A building owned by an entity and leased out under an operating lease & Land held for long term appreciation
13.	(d)	Residual value of the property
14.	(d)	Property transfer taxes are a directly attributable cost.
15.	(b)	Cost model Rs. 40 – (35 – 35/35 years × 3 years) = Rs. 8 million gain Fair value model Rs. 40 – 42 = Rs. 2 million loss
16.	(c)	Land held for undetermined use
17.	(b) & (d)	Land held by a company for undetermined future use Building held by a company for long-term capital appreciation

STICKY NOTES

Investment property is:

- property (land or a building—or part of a building—or both)
- held to earn rentals or for capital appreciation or both,
- rather than for use in the production or supply of goods or services or for administrative purposes, or sale in the ordinary course of business.

Fair value model

Under the fair value model:

- all investment property is remeasured at fair value at the end of each period;
- any resulting gain or loss is recognised in profit or loss for the period; and
- the property would not be depreciated.

This is different to the revaluation model of IAS 16, where gains are reported as other comprehensive income and accumulated as a revaluation surplus.

Transfers**Transfer to/from Investment property (fair value model)**

Change in use	From	To	Deemed transfer value
Commencement of or development with a view to owner-occupation	IAS 40 (at FV)	IAS 16	Fair value at the date of change of use becomes the deemed cost for future accounting purposes
Commencement of development with a view to sale	IAS 40 (at FV)	IAS 2	Fair value at the date of change of use becomes the deemed cost for future accounting purposes
End of owner-occupation	IAS 16	IAS 40 (at FV)	Apply IAS 16 revaluation model (even if policy is cost model) on the date of transfer and treat the difference in accordance with IAS 16.
Inception of an operating lease to another party	IAS 2	IAS 40 (at FV)	Measure the investment property at fair value at the date of the transfer, and any difference compared to previous carrying amount is recognised in profit or loss

Transfer to/from Investment property (cost model)

When an entity uses the cost model, transfers between investment property, owner-occupied property and inventories do not change the carrying amount of the property transferred and they do not change the cost of that property for measurement or disclosure purposes.

IAS 36 IMPAIRMENT OF ASSETS

IN THIS CHAPTER:

AT A GLANCE

SPOTLIGHT

1. Introduction
2. Measuring recoverable amount
3. Recognition
4. Comprehensive Examples
5. Objective Based Q&A

STICKY NOTES

AT A GLANCE

IAS 36 prescribes the procedures that an entity applies to ensure that its assets are carried at no more than their recoverable amount. An asset is carried at more than its recoverable amount if its carrying amount exceeds the amount to be recovered through use or sale of the asset. If this is the case, the asset is described as impaired, and IAS 36 requires the entity to recognise an impairment loss.

An entity is required to assess at the end of each reporting period whether there is any indication (through internal or external sources) that an asset may be impaired. If any such indication exists, the entity shall estimate the recoverable amount of the asset. Certain assets are required to be tested for impairment irrespective of whether there is any indication of impairment.

The recoverable amount of an asset is the higher of its fair value less costs of disposal and its value in use. It is not always necessary to determine both amounts. If either of these amounts exceeds the asset's carrying amount, the asset is not impaired, and it is not necessary to estimate the other amount.

An impairment loss shall be recognised immediately in profit or loss, unless the asset is carried at revalued amount (e.g., in accordance with IAS 16). Any impairment loss of a revalued asset shall be treated as a revaluation decrease in accordance with applicable IFRS (e.g., IAS 16).

A reversal of an impairment loss for an asset shall be recognised immediately in profit or loss, unless the asset is carried at revalued amount under other IFRS (e.g., in accordance with IAS 16). Any reversal should not lead to a carrying amount of the asset in excess of what the carrying amount would have been without the recognition of impairment loss (net of depreciation).

Any increase above this amount is revaluation and shall be recognised in accordance with applicable IFRS (e.g., IAS 16). Any reversal of an impairment loss of a revalued asset shall be treated as a revaluation increase in accordance with applicable IFRS (e.g., IAS 16).

1 INTRODUCTION

1.1 Prudence concept

The concept of prudence requires that assets must not be overstated, and accordingly, IAS 36 ensures that an asset's carrying amount must not exceed its recoverable amount. Therefore, IAS 36 requires that if an asset's carrying amount exceeds its recoverable amount, then it is written down to recoverable amount by recognising impairment loss.

1.2 Key definitions [IAS 36: 6]

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

Carrying amount is the amount at which an asset is recognised after deducting any accumulated depreciation (amortisation) and accumulated impairment losses thereon.

Recoverable amount of an asset is the higher of its fair value less costs of disposal and its value in use.

Value in use is the present value of the future cash flows (net) expected to be derived from an asset, including its eventual disposal.

Fair value is the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date.

Costs of disposal are incremental costs directly attributable to the disposal of an asset, excluding finance costs and income tax expense.

► Example 01:

An asset has carrying amount of Rs. 530,000. Its value in use is Rs. 500,000 and fair value less costs of disposal is Rs. 470,000.

Required:

Calculate recoverable amount, impairment loss (if any) and carrying amount after impairment review.

► Answer:

Recoverable amount Rs. 500,000 (i.e., higher of Rs. 500,000 and Rs. 470,000).

Impairment loss Rs. 30,000 (i.e., Rs. 530,000 – 500,000)

Carrying amount after impairment review Rs. 500,000 (i.e., Rs. 530,000 – 30,000 impairment)

► Example 02:

An asset has carrying amount of Rs. 490,000. Its value in use is Rs. 500,000 and fair value less costs of disposal is Rs. 470,000.

Required:

Calculate recoverable amount, impairment loss (if any) and carrying amount after impairment review.

► Answer:

Recoverable amount Rs. 500,000 (i.e., higher of Rs. 500,000 and Rs. 470,000).

Impairment loss Rs. Nil (asset's carrying amount of Rs. 490,000 is not in excess of its recoverable amount of Rs. 500,000).

Carrying amount after impairment review Rs. 490,000 (same, no impairment).

1.3 Scope [IAS 36: 2 & 5]

IAS 36 is not applicable to various assets because IFRSs applicable to those assets have mechanism to ensure that the relevant asset is not overstated, for example:

- Inventories are measured at lower of cost and net realisable value (IAS 2)
- Investment property measured at fair value.

However, IAS 36 is applicable to certain assets including, but not limited to:

- Property, plant and equipment (IAS 16)
- Investment property measured using cost model (IAS 40)
- Intangible assets (IAS 38)
- Purchased goodwill (IFRS 3)

IAS 36 is also applied to assets that are carried at revalued amount and it provides following guidance in this regard:

If the disposal costs are negligible	The recoverable amount of the revalued asset is necessarily close to, or greater than, its revalued amount. In this case, after the revaluation requirements have been applied, it is unlikely that the revalued asset is impaired and recoverable amount need not be estimated.
If the disposal costs are not negligible	The fair value less costs of disposal of the revalued asset is necessarily less than its fair value. Therefore, the revalued asset will be impaired if its value in use is less than its revalued amount. In this case, after the revaluation requirements have been applied, an entity applies IAS 36 to determine whether the asset may be impaired.

► **Example 03:**

Consider the following three independent scenarios related to revalued assets:

Scenario	(a)	(b)	(c)
Carrying amount i.e., fair value	Rs. 500,000	Rs. 500,000	Rs. 500,000
Costs of disposal	Negligible	Negligible	Negligible
Value in use	Rs. 600,000	Rs. 480,000	Rs. 100,000

Required:

Discuss whether IAS 36 needs to be applied and calculate the impairment loss (if any).

► **Answer:**

There is no need to apply IAS 36 and even if we do, no impairment loss would arise.

Scenario	(a)	(b)	(c)
Carrying amount i.e., fair value	Rs. 500,000	Rs. 500,000	Rs. 500,000
Fair value less costs of disposal	Rs. 500,000	Rs. 500,000	Rs. 500,000
Value in use	Rs. 600,000	Rs. 480,000	Rs. 100,000
Recoverable amount (higher)	Rs. 600,000	Rs. 500,000	Rs. 500,000
Impairment loss (RA > CA)	Nil	Nil	Nil

► *Example 04:*

Consider the following three independent scenarios related to revalued assets:

Scenario	(a)	(b)	(c)
Carrying amount i.e., fair value	Rs. 500,000	Rs. 500,000	Rs. 500,000
Costs of disposal	Rs. 50,000	Rs. 50,000	Rs. 50,000
Value in use	Rs. 600,000	Rs. 480,000	Rs. 100,000

Required:

Discuss whether IAS 36 needs to be applied and calculate the impairment loss (if any).

► *Answer:*

IAS 36 needs to be applied, however, there may or may not arise an impairment loss.

Scenario	(a)	(b)	(c)
Carrying amount i.e., fair value	Rs. 500,000	Rs. 500,000	Rs. 500,000
Fair value less costs of disposal	Rs. 450,000	Rs. 450,000	Rs. 450,000
Value in use	Rs. 600,000	Rs. 480,000	Rs. 100,000
Recoverable amount (higher)	Rs. 600,000	Rs. 480,000	Rs. 450,000
Impairment loss (RA > CA)	Nil	Rs. 20,000	Rs. 50,000

1.4 Identifying an asset that may be impaired [IAS 36: 9, 10 & 12]

Constraints	IAS 36 does not require to test every asset for impairment in each period as it is usually not practical to determine recoverable amount of every asset due to: • Time constraints • Cost constraints
Requirement	An entity shall assess at the end of each reporting period whether there is any indication that an asset may be impaired. If any such indication exists, the entity shall estimate the recoverable amount of the asset. Where there is no indication of impairment, then no further action needs to be taken.
Exceptions	Irrespective of whether there is any indication of impairment, an entity shall also annually test for impairment following assets: • Intangible asset not yet available for use • Intangible asset having indefinite life • Goodwill

In assessing whether there is any indication that an asset may be impaired, an entity shall consider, as a minimum, the following indications:

External sources	Internal sources
The asset's value has declined during the period significantly more than would be expected as a result of the passage of time or normal use.	Evidence is available of obsolescence or physical damage of an asset.

External sources	Internal sources
Significant changes in technology, markets, economic factors or laws and regulations that have an adverse effect on the entity.	Significant adverse changes including the asset becoming idle, plans to discontinue or restructure the operation to which an asset belongs.
An increase in market interest rates or rate of return on investments, affecting the value in use of the asset.	Significant adverse changes including plans to dispose of an asset before the previously expected date and reassessing the useful life of an asset as finite rather than indefinite.
The entity's net assets have a higher carrying value than its market capitalisation indicating that assets might be overvalued. Market capitalisation is total market value of equity of the entity and is usually computed as market value per share x number of shares .	There is evidence that the asset's expected economic performance is, or will be, worse than expected.

1.5 Depreciation [IAS 36: 63 & 121]

After the recognition of an impairment loss, or reversal of impairment loss, the depreciation (amortisation) charge for the asset shall be adjusted in future periods to allocate the asset's revised carrying amount, less its residual value (if any), on a systematic basis over its remaining useful life.

► Example 05:

Premier Limited (PL) owns a plant which has a carrying amount of Rs.248 million as at 1 April 2019. It is being depreciated at 12.5% per annum on a reducing balance basis.

The plant is used to manufacture a specific product which has been suffering a decline in sales due to obsolescence. Therefore, the plant is being tested for impairment on 1 April 2020.

PL has estimated that the plant will be retired from use on 31 March 2023.

The estimated net cash flows from the use of the plant and their present values are:

	Net cash flows	Present values
	Rs. In million	
Year to 31 March 2021	120	109.2
Year to 31 March 2022	80	66.4
Year to 31 March 2023	52	39
	252	214.6

On 1 April 2020, PL had an alternative offer from the competitor to purchase the plant for Rs.200 million.

Required:

Calculate the impairment loss.

► Answer:

Carrying amount = Rs.217 million $[248 \text{ m} - (248 \text{ m} \times 12.5\%)]$

Recoverable amount Rs. 214.6 million (higher of Rs, 214.6m and Rs. 200m)

Impairment loss Rs. 2.4 million (i.e., Rs.217 million – Rs.214.6 million)

► Example 06:

On 1 January Year 1 Entity Q purchased for Rs.240,000 a machine with an estimated useful life of 20 years and an estimated zero residual value.

Depreciation is charged on a straight-line basis.

On 1 January Year 4 an impairment review showed the machine's recoverable amount to be Rs.100,000 and its remaining useful life to be 10 years.

Required:

Calculate:

- The carrying amount of the machine on 31 December Year 3 (immediately before the impairment).
- The impairment loss recognised in the year to 31 December Year 4
- The depreciation charge in the year to 31 December Year 4

► *Answer:*

Part (a)

Carrying amount of the machine on 31 December Year 3	Rs.
Cost	240,000
Accumulated depreciation ($3 \times (240,000 \div 20 \text{ years})$)	(36,000)
Carrying amount	204,000

Part (b)

Impairment loss at the beginning of Year 4 is Rs.104,000 (Rs.204,000 – Rs.100,000). This is charged to profit or loss.

Part (c)

Depreciation charge in Year 4 is Rs.10,000 ($= \text{Rs.}100,000 \div 10 \text{ years}$). The depreciation charge is based on the recoverable amount of the asset.

2 MEASURING RECOVERABLE AMOUNT

2.1 No need to calculate both amounts in certain cases [IAS 36: 19]

It is not always necessary to determine both an asset's fair value less costs of disposal and its value in use. If either of these amounts exceeds the asset's carrying amount, the asset is not impaired, and it is not necessary to estimate the other amount.

► **Example 07:**

An asset's carrying amount is Rs. 500,000 and its fair value less costs of disposal is Rs. 600,000.

Required:

Calculate impairment loss if value in use is:

- a) Rs. 700,000
- b) Rs. 600,000
- c) Rs. 400,000

► **Answer:**

There would be no impairment loss in any scenario since fair value less costs of disposal is higher than carrying amount.

Scenario	(a)	(b)	(c)
Carrying amount	Rs. 500,000	Rs. 500,000	Rs. 500,000
Fair value less costs of disposal	Rs. 600,000	Rs. 600,000	Rs. 600,000
Value in use	Rs. 700,000	Rs. 600,000	Rs. 400,000
Recoverable amount (higher)	Rs. 700,000	Rs. 600,000	Rs. 600,000
Impairment loss (RA > CA)	Nil	Nil	Nil

2.2 Value in use [IAS 36: 30, 32, 33, 39, 44, 47, 50 & 55]

The following elements shall be reflected in the calculation of an asset's value in use:

- an estimate of the future cash flows the entity expects to derive from the asset;
- expectations about possible variations in the amount or timing of those future cash flows;
- the time value of money, represented by the current market risk-free rate of interest;
- the price for bearing the uncertainty inherent in the asset; and
- other factors, such as illiquidity, that market participants would reflect in pricing the future cash flows the entity expects to derive from the asset.

The elements identified above can be reflected either as adjustments to the future cash flows or as adjustments to the discount rate.

Estimates of future cash flows should be based on reasonable and supportable assumptions that represent management's best estimate of the economic conditions that will exist over the remaining useful life of the asset.

Include in future cash flows	Estimates of future cash flows must include: • cash inflows from the continuing use of the asset; • cash outflows that will be necessarily incurred to generate the cash inflows from continuing use of the asset; and • net disposal proceeds at the end of the asset's useful life. The future cash flows from continuing use are estimated for the asset in its current condition.
Exclude from future cash flows	Estimates of future cash flows must not include: • cash inflows or outflows from financing activities; or • income tax receipts or payments. Any estimate of future cash flows should not include estimated future cash flows that are expected to arise from: • a future restructuring to which an entity is not yet committed; or • improving or enhancing the asset's performance. Once the entity is committed to the restructuring, its estimates of future cash inflows and cash outflows for the purpose of determining value in use reflect the cost savings and other benefits from the restructuring.
Discounting	Present value is calculated by applying a suitable discount rate to the cash flows. The discount rate must be a pre-tax rate that reflects current market assessments of: • the time value of money; and • the risks specific to the asset for which the future cash flow estimates have not been adjusted.

2.3 Fair value less costs of disposal [IAS 36: 20 & 28]

It may be possible to measure fair value less costs of disposal, even if there is not a quoted price in an active market for an identical asset. However, sometimes it will not be possible to measure fair value less costs of disposal because there is no basis for making a reliable estimate of the price at which an orderly transaction to sell the asset would take place between market participants at the measurement date under current market conditions. In this case, the entity may use the asset's value in use as its recoverable amount.

Costs of disposal might include legal costs, stamp duty, costs of removing the asset, and direct incremental costs to bring an asset into condition for its sale. Redundancy and restructuring costs (to be incurred after the sale of business) are not costs of disposal.

► Example 08:

Sky-Line Limited (SL) operates a 4 Star Hotel facility in Murree. The hotel was constructed at a cost of Rs.300 million, 5 years back and it has been depreciated on a straight-line basis (total useful life of 15 years and residual value of 20%).

There are indications that the property is not performing as expected due to;

- opening of a competing hotel nearby,
- a significant drop in number of tourists to the area because of terrorism.

There is a 40% probability that the hotel will generate net cash flows of Rs. 40 million per annum and 60% probability that the cash flows would only be Rs. 20 million per annum for its remaining useful life and it is now estimated that net disposal proceeds at the end of useful life will be negligible.

The property's fair value has been estimated at Rs. 200 million and 5% of the proceeds from sale would be expended in closing the deal.

Required:

Calculate the impairment loss if the appropriate discount rate is 10%.

► **Answer:**

Carrying value of asset = Rs.300 million – [(300 – 60) / 15 years x 5 years] = Rs.220 million

Fair value less costs of disposal = Rs. 200 million x 95% = Rs. 190 million

Value in use = (Rs.40 m x 40% + Rs.20 m x 60%) x 6.145 **W1** = Rs.172 million

Recoverable amount is Rs. 190 million (higher)

Impairment loss = Rs. 220m – 190m = Rs.30 million

$$\text{W1 Annuity factor} = \frac{1 - 1.10^{-10}}{0.10} = 6.145$$

► **Example 09:**

Naveed Limited has an item of plant which has a carrying value of Rs.1,800,000 as at the end of the year December 2020. It has undergone an impairment review and the following estimates were produced:

Fair value of plant is Rs.1,400,000 and costs of disposal are 2% of selling price.

Revenue and associated costs per annum for remaining useful life (assume all cash flows occur at the end of the year):

	Revenue	Costs
2021	Rs.960,000	Rs.240,000
2022	Rs.880,000	Rs.220,000
2023	Rs.700,000	Rs.290,000

The plant has estimated disposal proceeds at the end of useful life of Rs. 50,000.

A discount rate of 10% is applicable to investments equivalent in risk to this plant.

Required:

Calculate the impairment loss if the appropriate discount rate is 10%.

► **Answer:**

Value in use	2021	2022	2023
	----- Amount in Rs. -----		
Revenue	960,000	880,000	700,000
Costs	(240,000)	(220,000)	(290,000)
Disposal proceeds	-	-	50,000
Net Cash Inflow	720,000	660,000	460,000
Discount factor	0.9091	0.8264	0.7513
Present Value	654,545	545,457	345,605
Value in use			1,545,607

Fair value less costs of disposal = Rs.1,400,000 x 98% = Rs.1,372,000

Recoverable amount is Rs. 1,545,607 (higher)

Impairment loss = Rs. 1,800,000 carrying amount – Rs. 1,545,607 = Rs.254,393

► **Example 10:**

The assistant financial controller of the Hussain Associates Limited has identified the following issue which she believes may indicate impairment of an asset:

Hussain Associates Limited owns and operates an item of plant that cost Rs. 640,000 and had accumulated depreciation of Rs. 400,000 at 1 October 2015. It is being depreciated at 12.5% on cost.

On 1 April 2016 (exactly halfway through the year) the plant was damaged when a factory vehicle collided into it. Due to the unavailability of replacement parts, it is not possible to repair the plant, but it still operates, albeit at a reduced capacity. It is also expected that as a result of the damage the remaining life of the plant from the date of the damage will be only two years.

Based on its reduced capacity, the estimated present value of the plant in use is Rs. 150,000. The plant has a current disposal value of Rs. 20,000 (which will be nil in two years' time), but Hussain Associates Limited has been offered a trade-in value of Rs. 180,000 against a replacement machine which has a cost of Rs. 1 million (there would be no disposal costs for the replaced plant). Hussain Associates Limited is reluctant to replace the plant as it is worried about the long-term demand for the product produced by the plant. The trade-in value is only available if the plant is replaced.

Required:

Prepare extracts from the statement of financial position and statement of profit or loss of Hussain Associates Ltd in respect of the plant for the year ended 30 September 2016.

► **Answer:**

Statement of financial position (extracts) as at 30 September 2016		Rs.
Plant	[Rs. 150,000 – 37,500]	112,500

Statement of profit or loss (extracts) For the year ended 30 September 2016		Rs.
Depreciation	October to March [640,000 x 12.5% x 6/12]	(40,000)
	April to September [150,000 / 2 years x 6/12]	(37,500)
		(77,500)
Impairment loss	[200,000 W1 – 150,000 see note below]	(50,000)

W1: Carrying amount on 1st April 2016 = Rs. 640,000 – 400,000 – 40,000 = Rs. 200,000

Note: recoverable amount is higher of value in use (Rs. 150,000) and fair value less cost of disposal (Rs. 20,000). The trade in value of Rs. 180,000 in conditional exchange is not appropriate fair value.

3 RECOGNITION

3.1 Impairment loss [IAS 36: 61]

An impairment loss on a non-revalued asset is recognised in profit or loss. However, an impairment loss on a revalued asset is recognised in other comprehensive income to the extent that the impairment loss does not exceed the amount in the revaluation surplus for that same asset. Such an impairment loss on a revalued asset reduces the revaluation surplus for that asset.

In practice, variety of journal entries may be passed for this, as follows:

Journal entries	Method 1:	Method 2:
Non-revalued asset	Debit Impairment loss (PL)	Debit Accumulated depreciation
	Credit Accumulated impairment losses	Credit Asset
		Debit Impairment loss (PL)
		Credit Asset
Revalued asset	Debit Impairment loss (OCI*)	Debit Accumulated depreciation
	Debit Impairment loss (PL**)	Credit Asset
	Credit Accumulated impairment losses	
		Debit Impairment loss (OCI*)
		Debit Impairment loss (PL**)
		Credit Asset

*to the extent of balance in revaluation surplus.

**amount of loss (if any) in excess of balance in revaluation surplus

► Example 11:

An asset has cost of Rs. 500,000 and accumulated depreciation of Rs. 200,000. Its recoverable amount has been estimated at Rs. 280,000.

Required:

Journal entries to record the impairment loss.

► Answer:

Journal entries

Date	Particulars	Debit Rs. 000	Credit Rs. 000
	Impairment loss (PL)	20*	
	Accumulated impairment losses		20
Alternative:			
	Accumulated depreciation	200	
	Asset		200
	Impairment loss (PL)	20*	
	Asset		20

*[(500 – 200) – 280]

► **Example 12:**

An asset has cost of Rs. 500,000 and accumulated depreciation of Rs. 200,000. Its recoverable amount has been estimated at Rs. 280,000. Asset has balance of Rs. 7,000 in revaluation surplus arising from previous revaluation.

Required:

Journal entries to record the above.

► **Answer:****Journal entries**

Date	Particulars	Debit Rs. 000	Credit Rs. 000
	Impairment loss (OCI)	7	
	Impairment loss (PL) [20* – 7]	13	
	Accumulated impairment losses		20
Alternative:			
	Accumulated depreciation	200	
	Asset		200
	Impairment loss (OCI)	7	
	Impairment loss (PL) [20* – 7]	13	
	Asset		20

*[(500 – 200) – 280]

3.2 Reversal of impairment loss [IAS 36: 110 & 117 to 120]

An entity shall assess at the end of each reporting period whether there is any indication that an impairment loss recognised in prior periods for an asset other than goodwill may no longer exist or may have decreased. If any such indication exists, the entity shall estimate the recoverable amount of that asset.

A reversal of an impairment loss for an asset shall be recognised immediately in profit or loss to the extent that increased carrying amount of such asset does not exceed the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior years.

Any increase in the carrying amount of an asset above the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior years is a revaluation and shall be recognised in other comprehensive income (and accumulated as revaluation surplus) only if entity uses revaluation model for such asset.

Journal entries	Method 1:	Method 2:
Non-revalued asset	Debit Accumulated impairment losses	Debit Accumulated depreciation
	Credit Reversal of loss (PL*)	Credit Asset
Revalued asset	Debit Accumulated impairment losses	Debit Accumulated depreciation
	Credit Reversal of loss (PL*)	Credit Asset

Journal entries	Method 1:	Method 2:
	Debit Asset	Debit Asset
	Credit Gain on revaluation (OCI**)	Credit Reversal of loss (PL*)
		Credit Gain on revaluation (OCI**)
*to the extent of previously recognised impairment loss net of depreciation decrease		
**amount in excess (if any) of above (only under revaluation model)		

► **Example 13:**

An asset was purchased for Rs. 100,000 on 1 January 2021 with 10 years useful life and nil residual value. Depreciation is charged on straight line basis.

On 31 December 2021, Depreciation of Rs. 10,000 was recorded. On this date, the recoverable amount of asset was determined to be Rs. 72,000 and therefore impairment loss of Rs. 18,000 was recognised.

On 31 December 2022, the depreciation of Rs. 8,000 [i.e., Rs.72,000 / 9 years] was recorded and asset now has carrying amount of Rs. 64,000.

On this date, the recoverable amount has been estimated at Rs. 95,000.

Required:

Journal entry to record the reversal if entity uses cost model.

► **Answer:****Journal entry**

Date	Particulars	Debit Rs. 000	Credit Rs. 000
	Accumulated impairment losses	16	
	Reversal of loss (PL)		16

Note: The recoverable amount of asset exceeds its carrying amount by Rs. 31,000 reversal of impairment loss would be restricted to only Rs. 16,000, because, had the asset been never impaired its carrying amount would have been Rs. 80,000 (i.e., 100,000 – (10,000 x 2 years)), therefore, asset's carrying amount can be increased from Rs. 64,000 to Rs. 80,000 (i.e., by Rs. 16,000). Alternatively, Rs. 16,000 may be calculated as Rs. 18,000 loss previously recognised less depreciation decrease of Rs. 2,000 (i.e., 10,000 – 8,000).

► **Example 14:**

An asset was purchased for Rs. 100,000 on 1 January 2021 with 10 years useful life and nil residual value. Depreciation is charged on straight line basis.

On 31 December 2021, Depreciation of Rs. 10,000 was recorded. On this date, the recoverable amount of asset was determined to be Rs. 72,000 and therefore impairment loss of Rs. 18,000 was recognised.

On 31 December 2022, the depreciation of Rs. 8,000 [i.e., Rs.72,000 / 9 years] was recorded. On this date, the recoverable amount has been estimated at Rs. 95,000.

Required:

Journal entry to record the reversal if entity uses revaluation model.

► *Answer:***Journal entry**

Date	Particulars	Debit Rs. 000	Credit Rs. 000
	Accumulated impairment losses	16	
	Reversal of loss (PL)		16
	Asset	15	
	Gain on revaluation (OCI)		15

Note: The recoverable amount of asset exceeds its carrying amount by Rs. 31,000 reversal of impairment loss in profit or loss would be restricted to only Rs. 16,000, because, had the asset been never impaired its carrying amount would have been Rs. 80,000 (i.e., $100,000 - (10,000 \times 2 \text{ years})$), therefore, asset's carrying amount can be increased from Rs. 64,000 to Rs. 80,000 (i.e., by Rs. 16,000). Alternatively, Rs. 16,000 may be calculated as Rs. 18,000 loss previously recognised less depreciation decrease of Rs. 2,000 (i.e., $10,000 - 8,000$).

The additional increase of Rs. 15,000 (from Rs. 80,000 to Rs. 95,000) shall be recognised in OCI as gain on revaluation because entity uses revaluation model.

► *Example 15:*

A company has a machine in its statement of financial position at a carrying amount of Rs. 300,000. The machine is used to manufacture the company's best-selling product range, but the entry of a new competitor to the market has severely affected sales.

As a result, the company believes that the future net cash flows from the machine over the next three years will be only Rs. 150,000, Rs. 100,000 and Rs. 50,000. The asset will then be sold for Rs. 25,000. An offer has been received to buy the machine immediately for Rs. 240,000, but the company would have to pay shipping costs of Rs. 5,000. The applicable discount rate is 10%.

Required:

Calculation and journal entry for impairment loss.

► *Answer:*

Computation of impairment of plant	Rupees	
Carrying value		300,000
Less: Recoverable amount		
Value in use (W-1)	275,358	
Fair value less costs of disposal [240,000 – 5,000]	235,000	
Higher of above		275,358
Impairment loss		24,642

W-1: Value in use	Year 1	Year 2	Year 3
	Rupees		
Net cash inflow from use	150,000	100,000	50,000
Cash inflow from disposal	-	-	25,000
Cash flows undiscounted	150,000	100,000	75,000
Discount factor @ 10%	0.909	0.826	0.751
PV of cash flows	136,364	82,645	56,349
Value in use			275,358

Journal entry

Date	Particulars	Debit Rs.	Credit Rs.
	Impairment loss (PL)	24,642	
	Accumulated impairment loss		24,642

► **Example 16:**

On 1 January Year 1 Entity Q purchased for Rs.240,000 a machine with an estimated useful life of 20 years and an estimated zero residual value. Depreciation is on a straight-line basis.

The asset had been re-valued on 1 January Year 3 to Rs.250,000, but with no change in useful life at that date.

On 1 January Year 4 an impairment review showed the machine's recoverable amount to be Rs.100,000 and its remaining useful life to be 10 years.

Required:

Calculate:

- The carrying amount of the machine on 31 December Year 2 and hence the revaluation surplus arising on 1 January Year 3.
- The carrying amount of the machine on 31 December Year 3 (immediately before the impairment).
- The impairment loss recognised in the year to 31 December Year 4.
- The depreciation charge in the year to 31 December Year 4.

► **Answer:****Part (a)**

Carrying amount of the machine & revaluation	Rs.
Cost	240,000
Accumulated depreciation ($2 \times (240,000 \div 20 \text{ years})$)	(24,000)
Carrying amount	216,000
Revaluation gain / surplus (balancing)	34,000
Revalued amount on 1 January Year 3	250,000

Part (b)

When the asset is revalued on 1 January Year 3, depreciation is charged on the revalued amount over its remaining expected useful life.

Carrying amount of the machine 31 December Year 3	Rs.
Cost/revalued amount	250,000
Accumulated depreciation ($\text{Rs.}250,000 \div 18 \text{ years}$)	(13,889)
Carrying amount	236,111

Note: The depreciation charge of Rs.13,889 is made up of Rs.12,000 (being that part of the charge that relates to the original historical cost) and Rs.1,889 being the incremental depreciation. Rs.1,889 would be transferred from the revaluation surplus into retained earnings.

Part (c)

On 1 January Year 4 the impairment review shows an impairment loss of Rs. 136,111 (Rs.236,111 – Rs.100,000).

An impairment loss of Rs.32,111 (Rs.34,000 – Rs.1,889) will be taken to other comprehensive income (reducing the revaluation surplus for the asset to zero).

The remaining impairment loss of Rs.104,000 (Rs.136,111 – Rs.32,111) is recognised in the statement of profit or loss for Year 4.

Part (d)

Year 4 depreciation charge is Rs.10,000 (Rs.100,000 ÷ 10 years).

4 COMPREHENSIVE EXAMPLES

► Example 17:

On 1 March 2017, Zarmony Limited imported an automatic plant for Rs. 130 million. The commissioning of the plant was completed on 1 January 2018 at a cost of Rs. 10 million. The economic life of the plant was estimated as 12 years and useful life of the plant was estimated as 8 years. The plant is being depreciated at 20% per annum using reducing balance method.

Due to declining demand for the product manufactured from this plant, an impairment test was carried out at 31 December 2021. Following information has been gathered for impairment testing of the plant:

- The current selling price of a similar plant in the local market is Rs. 50 million. The present decommissioning cost of the plant is estimated at Rs. 2 million.
- The plant's net disposal proceeds at the end of the useful life is estimated at Rs. 4 million.
- The current market risk-free rate of interest is 8% per annum, however, an investor would ask additional return of 2% for bearing the uncertainty inherent in such a plant.
- A junior accountant has calculated following net cash flows from operating the plant:

Year	2022	2023	2024	2025
Net cash inflow (Rs. in million)	11	7	3	1

However, a review of accountant's working has revealed the following:

- Depreciation of the plant has been included as an outflow in each year.
- Tax payments of Rs. 2 million has been included as an outflow in each year.
- Inflows from plant in 2022 include receipts from sale of existing inventory amounting to Rs. 3 million

Required:

Compute the impairment loss (if any) in the value of the plant to be recognised on 31 December 2021. (Show all necessary workings)

► Answer:

Computation of impairment of plant	----- Rs. in million -----	
Carrying value $130+10 = 140 \times (0.8)^4$		57.3
Less: Recoverable amount		
Value in use (W-1)	52.6	
Fair value less cost of sell $[50 - 2]$	48.0	
Higher of above		52.6
Impairment loss		4.7

W-1: Value in use	2022	2023	2024	2025
	----- Rs. in million -----			
Net cash inflow	11.0	7.0	3.0	1.0
Depreciation	11.5	9.2	7.4	5.9
Income tax	2.0	2.0	2.0	2.0
Sale of inventory	(3.0)	-	-	-
Disposal value	-	-	-	4.0
Cash flows undiscounted	21.5	18.2	12.4	12.9
Discount factor @ 10%	0.909	0.826	0.751	0.683
PV of cash flows	19.5	15.0	9.3	8.8
Value in use				52.6

► **Example 18:**

The draft financial statements of Barbary Cement Limited (BCL) for the year ended 31 December 2020 include a plant having a carrying value of Rs. 400 million. Due to technological change, the remaining useful life of the plant has been reduced to 4 years.

Following information has been gathered for impairment testing of the plant:

- Inflows from sale of product to be manufactured by the plant for the year 2021 are estimated at Rs. 200 million. These inflows are subject to 10% decrease in each subsequent year due to declining demand.
- Outflows from operational cost for 2021 are estimated at Rs. 80 million. These outflow would increase by 5% in each subsequent year despite decline in demand due to inflation and increase in plant's wear and tear.
- BCL's net profit is subject to income tax of 20%.
- Depreciation on plant is calculated using straight line method.
- The plant's net disposal proceeds at the end of the useful life is estimated at Rs. 100 million.
- Pre-tax and post-tax discount rates are 12% and 9.6% per annum respectively.
- A technologically advanced plant with similar capacity can be purchased at Rs. 350 million. BCL has received an offer to buy the existing plant for Rs. 250 million. BCL will have to incur shipping cost of Rs. 7 million, to dispatch the existing plant to the purchaser.

Required:

Compute the impairment loss to be recognised as at 31 December 2020.

► **Answer:**

Computation of impairment of plant	----- Rs. in million -----	
Carrying value		400.0
Recoverable amount		
Value in use (W-1)	333.6	
Fair value less cost of sell 250-7	243.0	
Higher of above		(333.6)
Impairment loss		66.4

W-1: Value in use	2021	2022	2023	2024
	----- Rs. in million -----			
Inflows from sale	200	180	162	145.80
Operational cost	(80)	(84)	(88.2)	(92.61)
Disposal value	-	-	-	100
Cash flows undiscounted	120	96	73.8	153.19
Discount factor @ 12%	0.8929	0.7972	0.7118	0.6355
PV of cash flows	107.2	76.5	52.5	97.4
Value in use				333.6

► **Example 19:**

Property, plant and equipment as disclosed in the draft financial statements of Apricot Pakistan Limited (APL) for the year ended 30 June 2018 include a plant having a carrying value of Rs. 610 million. The performance of the plant has been deteriorating since last year which is affecting APL's sales.

Following information/estimates relate to the plant for the year ending 30 June 2019:

	Rs. in million
Inflows from sale of product under existing condition of the plant	250
Operational cost other than depreciation	25
Depreciation	170
Expenses to be paid in respect of 30 June 2018 accruals	8
Cost of increasing the plant's capacity	60
Additional inflows (net) expected from the upgrade	40
Interest on finance lease	30
Maintenance cost	15
Tax payment on profits	18

Cash flows from the plant are expected to decrease by 15% each year from 2020 and onward. The plant's residual value after its remaining useful life of 3 years is estimated at Rs. 100 million.

An offer has been received to buy the plant immediately for Rs. 570 million but APL has to incur the following costs.

	Rs. in million
Cost of delivery to the customer	45
Legal cost	10
Costs to re-organize the production process after disposal of plant	50

Applicable discount rate is 9%.

Required:

Calculate the amount of impairment loss (if any) on plant, for the year ended 30 June 2018.

► *Answer:*

	Rs. in million	
Carrying value		610
<u>Recoverable amount</u>		
Value in use W1	537	
Fair value less costs of disposal [570 – 45 – 10]	515	
Higher of above		537
Impairment loss		73

W1 – Value in Use	2019	2020	2021
Description	Rs. in million		
Inflows from sale of product	250		
Operational cost	(25)		
Maintenance cost	(15)		
Cash flows from use (yearly decreased by 15%)	210	178.5	151.73
Cash flows from ultimate disposal			100
Cash flows undiscounted	210	178.5	251.73
Discount factor @9%	0.9174	0.8416	0.7720
PV of cash flows	192.6	150.2	194.38
Value in use			537

► *Example 20:*

On 1 January 2021, Jazib Limited (JL) purchased an asset at a cost of Rs. 100,000 and it is being depreciated over 10 years on straight line basis. JL uses cost model for measurement of property, plant and equipment.

On 31 December 2022, there are indications of impairment and recoverable amount has been estimated at Rs. 64,000.

On 31 December 2024, there are indications of reversal of impairment and recoverable amount has been estimated at Rs. 70,000.

Required:

Journal entries (by elimination of accumulated depreciation) for:

- impairment loss on 31 December 2022
- reversal of impairment loss on 31 December 2024

► *Answer:*

Journal entries

Date	Particulars	Debit Rs.	Credit Rs.
31 Dec 2022	Accumulated depreciation W1	20,000	
	Asset (PPE)		20,000
	Impairment loss (PL) W2	16,000	
	Asset (PPE)		16,000
31 Dec 2024	Accumulated depreciation W3	16,000	
	Asset (PPE)		16,000
	Asset (PPE) W4	12,000	
	Reversal of impairment loss (PL)		12,000

W1: Depreciation Rs. 100,000 / 10 years x 2 years = Rs. 20,000

W2: Impairment loss Rs. 64,000 – (100,000 – 20,000) = Rs. 16,000

W3: Depreciation Rs. 64,000 / 8 years x 2 years = Rs. 16,000

W4: Reversal of impairment loss Rs. 16,000 – (16,000/8 x 2 years) = Rs. 12,000

Alternative: (Rs. 100,000 – 100,000/10 x 4 years) – (Rs. 64,000 – 16,000) = Rs. 12,000

► *Example 21:*

On 1 January 2021, Ghalib Limited (GL) purchased an asset at a cost of Rs. 100,000 and it is being depreciated over 10 years on straight line basis.

On 31 December 2021, the fair value of the asset was determined to be Rs. 121,500 as GL applies revaluation model to its property, plant and equipment.

On 31 December 2023, there are indications of impairment and recoverable amount has been estimated at Rs. 65,100.

On 31 December 2025, there are indications of reversal of impairment and recoverable amount has been estimated at Rs. 55,000.

Required:

Journal entries (by elimination of accumulated depreciation) for:

- revaluation on 31 December 2021
- impairment loss on 31 December 2023
- reversal of impairment loss on 31 December 2025

► *Answer:*

Journal entries

Date	Particulars	Debit Rs.	Credit Rs.
31 Dec 2021	Accumulated depreciation W1	10,000	
	Asset (PPE)		10,000
	Asset (PPE) W2	31,500	
	Gain on revaluation (OCI)		31,500
31 Dec 2023	Accumulated depreciation W3	27,000	
	Asset (PPE)		27,000
	Impairment loss (OCI) W4	24,500	
	Impairment loss (PL) (balancing)	4,900	
	Asset (PPE) W4		29,400
31 Dec 2023	Accumulated depreciation W5	18,600	
	Asset (PPE)		18,600
	Asset (PPE)	8,500	
	Reversal of impairment loss (PL) W6		3,500
	Gain on revaluation (OCI) W7		5,000

W1: Depreciation Rs. 100,000 / 10 years = Rs. 10,000

W2: Revaluation gain Rs. 121,500 – (100,000 – 10,000) = Rs. 31,500

W3: Depreciation Rs. 121,500 / 9 years x 2 years = Rs. 27,000

W4: Impairment loss Rs. 65,100 – (121,500 – 27,000) = Rs. 29,400

Charge to OCI = Rs. 31,500 – (31,500 / 9 years x 2 years) = Rs. 24,500

W5: Depreciation Rs. 65,100 / 7 years x 2 years = Rs. 18,600

W6: Reversal of impairment loss in PL Rs. 4,900 – (4,900/7 x 2 years) = Rs. 3,500

Alternative: (Rs. 100,000 – 100,000/10 x 5 years) – (Rs. 65,100 – 18,600) = Rs. 3,500

W7: Gain on revaluation Rs. 55,000 – (Rs. 100,000 – 100,000/10 x 5 years) = Rs. 5,000

► *Example 22:*

On 1 July 2014, Indus Pharma Limited (IPL) received a government grant of Rs. 280 million to setup a plant in an under-developed rural area. The grant is repayable in full if the conditions attached to the grant are not met for a period of five years from the date of commencement of the production. At the inception, it was highly probable that IPL would comply with the conditions for the required period.

IPL incurred total cost of Rs. 630 million on plant and it started production on 1 January 2015. Useful life of the plant was estimated at 7 years. IPL deducted government grant in arriving at the carrying amount of the asset.

In January 2019, IPL showed its inability to comply with the conditions attached to the grant and regulatory authority issued a notice to IPL for repayment of the grant in full. Accordingly, the grant was repaid by IPL.

In view of repayment of the grant, IPL carried out an impairment review of the plant on 31 December 2019. Net annual cash inflows for the remaining life of the plant have been estimated at Rs. 90 million and Rs. 80 million for 2020 and 2021 respectively. These cash inflows are net of annual interest and maintenance cost of Rs. 10 million and Rs. 6 million respectively for both years. Applicable discount rate is 12%.

On the date of impairment review, the existing plant can be sold in the local market for Rs. 160 million. Estimated cost of disposal would be Rs. 5 million.

Required:

Prepare journal entries for the year ended 31 December 2019 in respect of the above information. (Show all necessary workings. Narrations are not required)

► *Answer:*

Indus Pharma Limited

General Journal

Date	Description	Debit	Credit
		Rs. in million	
Jan. 2019	Plant	280	
	Cash/Bank		280
Jan. 2019/ 31-12-2019	Depreciation expense/Profit or loss $280 \div 7 \times 4$	160	
	Accumulated depreciation – Plant		160
31-12-2019	Depreciation expense $630 \div 7$	90	
	Accumulated depreciation - Plant		90
31-12-2019	Impairment loss (PL) (W1)	19	
	Accumulated impairment - Plant		19

W1: Impairment review as on 31 December 2019				Rs. in million
Year	Net inflows		Discounting at 12%	Present value
2020	(90+10)	100	0.8929	89
2021	(80+10)	90	0.7972	72
Value in use				161
Fair value less costs of disposal $160-5$				155
Recoverable amount (Higher of both)				161
WDV of the plant as on 31 December 2019 $630 \div 7 \times 2$				180
Impairment loss $180-161$				19

► **Example 23:**

The following information pertains to Monday Limited (ML):

- i. The balances of property, plant and equipment as on 1 January 2018:

Assets	Cost/Revalued amount	Accumulated depreciation
	----- Rs. in million -----	
Office building	240	36
Equipment	190	60

Revaluation surplus related to the office building as at 1 January 2018 amounted to Rs. 8.5 million.

- ii. On 1 September 2018, a new equipment was acquired by making payment of Rs. 70 million to the supplier. An old equipment was also given in exchange to the supplier. The fair values of the old and new equipment were assessed at Rs. 21 million and Rs. 93 million respectively. The old equipment had been acquired at a cost of Rs. 40 million on 1 July 2016. Cost incurred on installing the new equipment amounted to Rs. 5 million.
- iii. On 1 January 2018, ML commenced construction of a manufacturing plant. The whole process of assembling and installation was completed on 31 October 2018. However, the work was stopped from 16 to 31 August 2018 due to unexpected rains.

The total cost of Rs. 660 million incurred on the plant was paid as under:

Description	Payment date	Rs. in million
1st payment	1 February 2018	140
2nd payment	1 April 2018	214
3rd payment	1 September 2018	146
4th payment	1 December 2018	160

The plant was financed through a bank loan of Rs. 500 million obtained on 1 March 2018. The loan carries a mark-up of 18% payable annually. The surplus funds available from the loan were invested in a saving account and earned Rs. 17 million during capitalization period.

- iv. On 31 December 2018, the revalued amount of office building was assessed at Rs. 178 million by Precise Valuers, an independent valuation firm. Value in use of the office building as at 31 December 2018 was estimated at Rs. 186 million.
- v. Other relevant details are as follows:

Assets	Depreciation method	Life/rate	Subsequent measurement
Office building	Straight line	20 years*	Revaluation
Equipment	Reducing balance	20%	Cost
Manufacturing plant	Straight line	15 years	Cost

*** Remaining life at the date of last revaluation**

ML accounts for revaluation on net replacement value method and transfers the maximum possible amount from revaluation surplus to retained earnings on an annual basis.

Required:

In accordance with IFRSs, prepare a note on 'Property plant and equipment' for inclusion in ML's financial statements for the year ended 31 December 2018. *(Comparatives figures and column for total are not required)*

► Answer:

Monday Limited**Notes to the financial statement for the year ended 31 December 2018**

Property, plant and equipment	Office building	Equipment	Manufacturing plant
Cost	Rs. million		
At 1 Jan 2018	240	190	-
Acquisition	-	96 W4	-
Transfer from CWIP	-	-	699.25 W6
Revaluation (Adj.)	(48)		
Revaluation loss	(14) W2	-	-
Disposals	-	(40)	-
At 31 Dec 2018	178	246	699.25
<i>Accumulated depreciation</i>			
At 1 Jan 2018	36	60	-
For the year	12 W1	30.48 W5	7.77 W6
Revaluation (Adj.)	(48)	-	-
Disposals	-	(15.04) W3	-
At 31 Dec 2018	0	75.44	7.77
Carrying amount 2018	178	170.56	691.48
Carrying amount 2017	204	130	0

The entity uses the following subsequent measurement bases to value its Property, plant and equipment, and methods to calculate its depreciation.

Assets	Depreciation method	Useful life / Rate	Subsequent Measurement
Office building	Straight line	20 years / 5%	Revaluation model
Equipment	Reducing balance	20%	Cost model
Manufacturing plant	Straight line	15 years	Cost model

The revaluation of building took place on 31 December 2018. The value was determined by an independent valuation firm, Precise Valuers. The carrying amount of office building had the revaluation not taken place, would be Rs. 184 million (i.e. Rs. 178 + 6 **W2**).

Movement of Revaluation surplus	Rs. Million
At 1 Jan 2018	8.5
Incremental depreciation [8.5 / 17 years]	(0.5)
Revaluation loss charged to OCI	(8)
At 31 December 2018	Nil

Manufacturing plant was constructed during the year. The cost includes Rs. 39.25 capitalised for borrowing costs (w6).

W1: Rs. 240m / 20 years = Rs. 12 million

W2: Rs. 178m – (Rs. 240m – 36m – 12m) = Rs. (14m) [OCI Rs. 8m and PL Rs. 6m]

W3: Disposal		Rs. in million
2016	$40 \times 20\% \times 6 \div 12$	4.00
2017	$36 \times 20\%$	7.20
2018	$28.8 \times 20\% \times 8 \div 12$	3.84
Accumulated depreciation		15.04

W4: Fair value of asset given up 21 + Cash 70 + Installation 5 = 96

W5: Depreciation for the year – equipment		Rs. in million
Disposal	$28.8 \times 20\% \times 8 \div 12$	3.84
Others	$[(190 - 40) - (60 - 11.2)] \times 20\%$	20.24
Addition	$96 \times 20\% \times 4 \div 12$	6.40
		30.48

W6: Manufacturing plant	Rs. in million
Construction cost	660
Interest on specific loan $500 \times 18\% \times 7.5/12$	56.25
Less: Temporary investment income	(17)
	39.25
	699.25
Depreciation $699.25 / 15 \text{ years} \times 2/12$	(7.77)
	691.48

Note: Office buildings are not impaired since value in use of Rs. 186 million is more than the carrying amount of Rs. 178 million.

► **Example 24:**

The following information pertains to property, plant and equipment of Orchid Limited (OL), a listed company:

Description	Date of purchase	Cost Rs. m	Original useful life	Depreciation method	Subsequent measurement model
Buildings	1-Jan-15	600	30 years	Straight line	Revaluation
Plant	1-Jan-15	475	25 years	Straight line	Cost

Buildings

The revalued amount of buildings as determined by Shabbir Associates, an independent valuer, on 31 December 2015 and 2017 was Rs. 700 million and Rs. 463 million respectively.

On 30 June 2017 a building having original cost of Rs. 66 million was sold to Baqir Limited for Rs. 85 million. It was last revalued at Rs. 87 million. OL incurred a cost of Rs. 2 million on disposal.

OL transfers the maximum possible amount from revaluation surplus to retained earnings on an annual basis.

Plant

On 31 December 2016 the recoverable amount of the plant was assessed at Rs. 360 million with no change in useful life.

During 2017, OL has decided to change the depreciation method for plant from straight line to reducing balance. The new depreciation rate would be 10%.

Required:

Prepare following disclosure note of property, plant and equipment (along with comparative figures) to be presented in the financial statements of OL for the year ended 31 December 2017. *(Total column is not required)*

► *Answer:*

Orchid Limited

Notes to the financial Statements for the year ended 31 December 2017

Property, plant & equipment	2017		2016	
	Building	Plant	Building	Plant
	Rs. m	Rs. m	Rs. m	Rs. M
<i>Cost / Revalued amount</i>				
1 Jan	700	475	700	475
Disposal	(87)			
Revaluation (Adj.)	(42.28)			
Revaluation loss W1	(107.72)			
31 December	463	475	700	475
<i>Accumulated depreciation and impairment losses</i>				
1 Jan	24.14	115	0	19
Disposal W2	(4.5)			
Depreciation W1	22.64	36	24.14	19
Revaluation (Cancellation)	(42.28)			
Impairment W1				77
31 Dec	0	151	24.14	115
Carrying amount	463	324	675.86	360
Carrying amount (cost model)				
Cost	534	[600 – 66]	600	
Accumulated Depreciation	(53.4)	[534/30x230x3]	(40)	[600/30x2]
	480.6		560	

	Building	Plant
Measurement basis	Revaluation model	Cost model
Useful life / depreciation rate	30 years	10%
Depreciation method	Straight line	Reducing balance
The last revaluation was performed on 31 December 2017 by Shabbir Associates, an independent firm of valuer.		

Movement of Revaluation surplus	Rs. m
At 1 Jan 2017 [120 – (120/29)]	115.86
Transfer on disposal W2	(22)
Incremental depreciation $[(115.86/28 \times 6/12) + (115.86 - 22)/27.5 \times 6/12]$	(3.76)
Revaluation loss charged to OCI	(90.12)
At 31 December 2017	Nil

W1 – Depreciation / Impairment / Revaluation Surplus	Rs. m
Building	
2015 – Depreciation [600 / 30 years]	20
2015 – Revaluation Gain [700 – (600 – 20)]	120
2016 – Depreciation [700 / 29 years]	24.14
2017 – Depreciation $[(700 - 24.14) - 84] / 28 + 1.5 \text{ W2}$	22.64
2017 – Revaluation 463 FV – [(700 – 87 Cost) – 42.28 Acc. Dep.]	(107.72)
Plant	
2015 – Depreciation [475 / 25 years]	19
2016 – Depreciation [475 / 25 years]	19
2016 – Impairment [475 – 19 – 19] – [360 Recoverable amount]	77
2017 – Depreciation [360 x 10% reducing balance]	36

W2 – Depreciation and Revaluation (disposed equipment)	Rs. m	Rs. m
Cost	66	
Depreciation 2015 [66 / 30 years]	(2.2)	
	63.8	
Revaluation gain	23.2	23.2
Revalued 31 Dec 2015	87	
Depreciation 2016 [87 / 29 years]	(3)	(0.8)
	84	
Depreciation 2017 [87 / 29 years x 6/12]	(1.5)	(0.4)
	82.5	22
Accumulated depreciation related to disposed equipment 3 + 1.5	4.5	

► **Example 25:**

On 1 July 2019, Sumerian Limited (SL) purchased a manufacturing plant for Rs. 570 million. The plant is being depreciated at a rate of 15% per annum using the reducing balance method. On 31 December 2021, the remaining life of the plant was estimated at 4 years resulting in an increase of 5% in depreciation rate.

SL carried out impairment testing of the plant on 31 December 2021 and also on 31 December 2022 using the following estimates:

	31 Dec 2021	31 Dec 2022
	----- Rs. in million -----	
Annual inflows from the sale of product	245	263
Annual outflows for operations	167	174
Annual interest on loan obtained for plant acquisition	14	14
Net sales proceeds at the end of useful life in current condition	142	140
Additional sale proceeds at the end of useful life if plant is modified at cost of Rs. 50 million	125	125
Current fair value less cost to sell	300	280
Applicable discount rate	12%	10%

Required:

Calculate the carrying value of the manufacturing plant as at 31 December 2021 and 2022.

► **Answer:**

Manufacturing plant:		Rs. in million
Cost		570.00
Depreciation for 2019	$570 \times 15\% \times 6 \div 12$	(42.75)
Carrying value at 31 December 2019		527.25
Depreciation for 2020	$527.25 \times 15\%$	(79.09)
Carrying value at 31 December 2020		448.16
Depreciation for 2021	$448.16 \times 20\%$	(89.63)
		358.53
Recoverable amount: Higher of 327.15 (W1) or 300	327.15	
Impairment	$358.53 - 327.15$	(31.38)
Carrying value at 31 December 2021		327.15
Depreciation for 2022	$327.15 \times 20\%$	(65.43)
		261.72
Recoverable amount: Higher of 326.51 (W2) or 280	326.51	
Carrying value without impairment ($358.53 \times 80\%$)	286.82	
Reversal of impairment based on lower of the two	$286.82 - 261.72$	25.10
Carrying value at 31 December 2022		286.82

	2022	2023	2024	2025
W-1: Value in use 2021	----- Rs. in million -----			
Annual inflows	245.00	245.00	245.00	245.00
Annual outflows	(167.00)	(167.00)	(167.00)	(167.00)
Disposal				142.00
	78.00	78.00	78.00	220.00
P.V. @ 12%	69.64	62.18	55.52	139.81
Total				327.15

	2023	2024	2025
W-2: Value in use 2022	----- Rs. in million -----		
Annual inflows	263.00	263.00	263.00
Annual outflows	(174.00)	(174.00)	(174.00)
Disposal			140.00
	89.00	89.00	229.00
P.V. @ 10%	80.91	73.55	172.05
Total			326.51

► **Example 26:**

Raj Shahi Limited (RSL) acquired a machinery on 1 January 2019 for Rs. 480 million. RSL uses cost model for subsequent measurement and depreciates the machinery on a straight-line basis over its estimated useful life of 8 years.

At the end of year 2021, the machinery had undergone an impairment review and was consequently impaired by Rs. 40 million.

At the end of year 2023, the machinery underwent another impairment review and the following estimates related to machinery were made on 31 December 2023:

	2024	2025	2026
	----- Rs. in million -----		
Revenues	140	120	120
Receipts from customers	122	134	124
Operating expenses	108	118	130
Payments for operating expenses	56	66	78
Repayment of the loan acquired for acquisition of the machinery:			
• Principal	20	15	-
• Interest	6	4	-

The machinery can be sold in its current condition for net proceeds of Rs. 135 million. However, this amount is expected to decrease by Rs. 45 million with the passing of each year.

Income tax is payable at 30%.

The applicable discount rate is 12% per annum.

Required:

Compute the impairment loss, if any, in the value of the machinery to be recognised on 31 December 2023. (Show all workings)

► Answer:

Impairment loss on 31 December 2023		Rs. in million
Carrying value on 31 December 2023	(W-1)	156.0
Recoverable amount:		
Fair value less cost to sell	135.0	
Value in use	(W-2)145.8	
Higher of the two		(145.8)
		10.2

W-1: Carrying value on 31 December 2023		Rs. in million
Cost		480.0
Depreciation for 2019, 2020, 2021	$480 \div 8 \times 3$	(180.0)
		300.0
Impairment on 31 December 2021		(40.0)
		260.0
Depreciation for 2022 and 2023	$260 \div 5 \times 2$	(104.0)
		156.0

W-2: Value in use	2024	2025	2026
	----- Rs. in million -----		
Receipts from customers	122.0	134.0	124.0
Payments for operating expenses	(56.0)	(66.0)	(78.0)
	66.0	68.0	46.0
Present value @ 12%	58.9	54.2	32.7
Total			145.8

1. OBJECTIVE BASED Q&A

1. If the fair value less costs of disposal cannot be determined:
 - a) The asset is not impaired
 - b) The recoverable amount is the value-in-use
 - c) The net realizable value is used
 - d) The carrying value of the asset remains the same
2. Which TWO of the following could be an indication that an asset may be impaired according to IAS 36 Impairment of Assets?
 - a) Decrease in market interest rates
 - b) Increase in market values for the asset
 - c) Damage caused to the asset
 - d) Management intention to reorganise the business

3. IAS 36 Impairment of Assets contains a number of examples of internal and external events which may indicate the impairment of an asset.

In accordance with IAS 36, which of the following would definitely NOT be an indicator of the potential impairment of an asset (or group of assets)?

- a) An unexpected fall in the market value of one or more assets
 - b) Adverse changes in the economic performance of one or more assets
 - c) A significant change in the technological environment in which an asset is employed making its software effectively obsolete
 - d) The carrying amount of an entity's net assets being below the entity's market capitalisation
4. A fire at the factory on 1 October 2016 damaged the machine, leaving it with a lower operating capacity. The accountant considers that entity will need to recognise an impairment loss in relation to this damage. The accountant has ascertained the following information at 1 October 2016:
 The carrying amount of the machine is Rs.60,750.
 An equivalent new machine would cost Rs.90,000.
 The machine could be sold in its current condition for a gross amount of Rs.45,000. Dismantling costs would amount to Rs.2,000.
 In its current condition, the machine could operate for three more years which gives it a value in use figure of Rs.38,685.
 What is the total impairment loss associated with the above machine at 1 October 2016?
 - a) Rs. Nil
 - b) Rs.17,750
 - c) Rs.22,065
 - d) Rs.15,750
 5. Which of the following is NOT an indicator of impairment?
 - a) Advances in the technological environment in which an asset is employed have an adverse impact on its future use
 - b) An increase in interest rates which increases the discount rate an entity uses
 - c) The carrying amount of an entity's net assets is higher than the entity's number of shares in issue multiplied by its share price
 - d) The estimated net realisable value of inventory has been reduced due to fire damage although this value is greater than its carrying amount

6. Cost of disposal are
 - a) Incremental costs, directly attributable to the disposal of an asset, excluding finance costs and income tax expense
 - b) Incremental costs, directly attributable to the disposal of an asset, plus finance costs, but excluding income tax expense
 - c) Incremental costs, directly attributable to the disposal of an asset, plus finance costs and income tax expense
 - d) Incremental costs, directly attributable to the disposal of an asset, plus tax expense, but excluding finance costs
7. An asset is impaired if:
 - a) Its carrying amount equals the amount to be recovered through use (or sale) of the asset
 - b) Its carrying amount exceeds the amount to be recovered through use (or sale) of the asset
 - c) The amount to be recovered through use (or sale) of the asset exceeds its carrying amount
 - d) If it has been damaged
8. Value in use is:
 - a) The market value
 - b) The discounted present value of future cash flows arising from use of the asset and from its disposal
 - c) The higher of an asset's fair value less costs of disposal and its market value
 - d) The amount at which an asset is recognised in the statement of financial position
9. IAS 36 applied to which of the following assets:
 - a) Inventories
 - b) Financial assets including property plant and equipment and intangible assets
 - c) Assets held for sale
 - d) Property, plant, and equipment and intangible assets
10. In accordance with IAS 36 Impairment of Assets which of the following statements are true?
 - i. An impairment review must be carried out annually on all intangible assets.
 - ii. If the fair value less costs of disposal of an asset exceed the carrying amount there is no need to calculate a value in use.
 - iii. Impairment is charged to the statement of profit or loss unless it reverses a gain that has been recognised in equity in which case it is offset against the revaluation surplus.
 - a) All three
 - b) 1 and 2 only
 - c) 1 and 3 only
 - d) 2 & 3 only
11. What is the recoverable amount of an asset?
 - a) Its current market value less costs of disposal
 - b) The lower of carrying amount and value in use
 - c) The higher of fair value less costs of disposal and value in use
 - d) The higher of carrying amount and market value

12. A machine has a carrying amount of Rs. 850,000 at the year end of 31 March 2019. Its market value is Rs. 780,000 and costs of disposal are estimated at Rs. 25,000. A new machine would cost Rs. 1,500,000. The company which owns the machine expects it to produce net cash flows of Rs. 300,000 per annum for the next three years. The company has a cost of capital of 8%.

What is the impairment loss on the machine to be recognised in the financial statements at 31 March 2019?

- a) Rs. 76,870
 - b) Rs. 95,000
 - c) Rs. 1,66,700
 - d) Rs. 220,000
13. IAS 36 Impairment of Assets suggests how indications of impairment might be recognised.
- Which TWO of the following would be external indicators that one or more of an entity's assets may be impaired?
- a) An unusually significant fall in the market value of one or more assets
 - b) Evidence of obsolescence of one or more assets
 - c) A decline in the economic performance of one or more assets
 - d) An increase in market interest rates used to calculate value in use of the assets

14. The following information relates to an item of plant.

Its carrying amount in the statement of the financial position is Rs. 3 million.

The company has received an offer of Rs. 2.7 million from a company in Karachi interested in buying the plant.

The present value of the estimated cash flows from continued use of the plant is Rs. 2.6 million.

The estimated cost of transport the plant to Karachi is Rs. 50,000.

What is the amount of the impairment loss that should be recognised on the plant?

- a) Rs. 300,000
 - b) Rs. 400,000
 - c) Rs. 350,000
 - d) Rs. 250,000
15. When calculating the estimates of the future cash flows, which of the following cash flows should not be included?
- a) Cash flows from disposal
 - b) Income tax payments
 - c) Cash flows from the sale of assets produced by the asset
 - d) Cash outflows on the maintenance of the asset

16. The following information relates to three assets held by a company:

	Asset A	Asset B	Asset C
	Rs. m	Rs. m	Rs. m
Carrying amount	200	100	80
Value in use	160	120	70
Fair value less costs of disposal	180	130	60

What is the total impairment loss?

- a) Rs. Nil
- b) Rs. 10 million
- c) Rs. 20 million
- d) Rs. 30 million

17. The following information relates to four assets held by the company:

	A	B	C	D
	Rs. m	Rs. m	Rs. m	Rs. m
Carrying amount	240	60	80	140
Value in use	160	140	160	40
Fair value less costs of disposal	180	80	140	60

What is the total impairment loss?

- a) Rs. Nil
b) Rs. 60 million
c) Rs. 80 million
d) Rs. 140 million
18. A vehicle was involved in an accident exactly halfway through the year. The vehicle cost Rs. 10 million and had a remaining life of 10 years at the start of the year. Following the accident, the expected present value of cash flows associated with the vehicle was Rs. 3.4 million and the fair value less costs of disposal was Rs. 6.5 million.

What is the recoverable amount of the vehicle following the accident?

- a) Rs. 10 million
b) Rs. 9 million
c) Rs. 6.5 million
d) Rs. 3.4 million
19. Radium Limited (RL) acquired a non-current asset on 1 October 2019 at a cost of Rs. 100 million which had a useful life of ten years and a nil residual value. The asset had been correctly depreciated up to 30 September 2024.

At that date the asset was damaged and an impairment review was performed. On 30 September 2024, the fair value of the asset less costs of disposal was Rs. 30 million and the expected future cash flows were Rs. 8.5 million per annum for the next five years.

The current cost of capital is 10% and a five year annuity of Rs. 1 per annum at 10% would have a present value of Rs. 3.79.

What amount would be charged to profit or loss for the impairment of this asset for the year ended 30 September 2024?

- a) Rs. 50 million
b) Rs. 32.215 million
c) Rs. 30 million
d) Rs. 17.785 million
20. Metal Limited (ML) owns an item of plant which has a carrying amount of Rs. 248 million as at 1 April 2013. It is being depreciated at 12.5% per annum on a reducing balance basis.

The plant is used to manufacture a specific product which has been suffering a slow decline in sales. ML has estimated that the plant will be retired from use on 31 March 2017.

The estimated net cash flows from the use of the plant and their present values are:

	Net cash flows	Present values
	Rs.000	Rs.000
Year to 31 March 2015	120,000	109,200
Year to 31 March 2016	80,000	66,400
Year to 31 March 2017	52,000	39,000
	252,000	214,600

On 1 April 2014, Metric had an offer from a rival to purchase the plant for Rs. 200 million

At what value should the plant appear in Metric's statement of financial position as at 31 March 2014?

- a) Cannot be determined
- b) Rs. 200 million
- c) Rs. 214.6 million
- d) Rs. 217 million

21. Which of the following is covered by IAS 36 – Impairment?

- a) Non-current assets held for sale
- b) Investment property carried at cost
- c) Investment property carried at fair value
- d) Inventories

22. Which of the following is not covered by IAS 36 – Impairment?

- a) Goodwill
- b) Investment property carried at cost
- c) Investment property carried at fair value
- d) Intangible assets

23. When should an impairment loss be recognised?

- a) Immediately
- b) Over a number of accounting periods
- c) At management's discretion
- d) When requested by the entity's auditors

24. Value in use is?

- a) The undiscounted present value of future cash flows expected to arise from continuing use of asset, and from its disposal at the end of its useful life
- b) The undiscounted future value of present cash flows expected to arise from continuing use of asset, and from its disposal at the end of its useful life
- c) The discounted present value of future cash flows expected to arise from continuing use of asset, and from its disposal at the end of its useful life
- d) The discounted present value of historical cash flows expected to arise from continuing use of asset, and from its disposal at the end of its useful life

25. Which of the following element is not considered while computing value in use?

- a) expectations about possible variations in the amount or timing of those future cash flows
- b) the time value of money, represented by the current market risk-free rate of interest
- c) the price for bearing the uncertainty inherent in the asset
- d) estimated future restructuring cost not yet committed

26. In measuring value in use, the discount rate used for discounting the cash flows should be the?

- a) Pre-tax rate that reflects the market assessment of time value of money and risks specific to the asset
- b) Pre-tax rate that reflects the market assessment of time value of money and risks specific to the entity's competitors
- c) Post-tax rate that reflects the entity's assessment of time value of money and risks specific to the asset
- d) Pre-tax rate that reflects the entity's assessment of time value of money and risks specific to the asset

27. When the recoverable amount of an asset is less than its carrying value in the Statement of Financial Position, the asset is?
- a) in a revaluation deficit
 - b) Flawed
 - c) In negative equity
 - d) Impaired
28. Which of the following is an internal indication of impairment?
- a) Decline in market value
 - b) Worse economic performance than expected
 - c) Increase in market interest rates
 - d) Technological obsolescence
29. Which of the following is an external indication of impairment?
- a) Physical damage
 - b) Worse economic performance than expected
 - c) Increase in market interest rates
 - d) Asset is part of a restructuring program
30. Under IAS 36, what is the recoverable amount of an asset?
- a) The lower of its cost and net realisable value
 - b) The higher of fair value less costs of disposal and value in use
 - c) The lower of net present value and cost
 - d) The higher of net present value and cost
31. Which of the following is not permitted as a costs of disposal under IAS 36?
- a) Cost to dismantle machine
 - b) Auctioneers fees
 - c) Standard wages for employees
 - d) Transport costs for machine
32. When calculating the estimates of future cash flows which of the following cash flows should not be included?
- a) Cash out flows on the maintenance of the asset
 - b) Cash flows from disposal
 - c) Cash flows from the sale of inventory produced by the asset
 - d) Benefits from future restructuring
33. Under IAS 36 Impairment of Assets, if the fair value less costs of disposal of an asset cannot be determined then:
- a) the asset is not impaired
 - b) the recoverable amount is the value in use
 - c) the net realizable value is used
 - d) the carrying value of the asset remains the same

34. A plant has a carrying amount of Rs. 1,500,000 as at 31 December 2019. Its fair value is Rs. 900,000 and costs of disposal are estimated at Rs. 50,000. A new plant would cost Rs. 2,500,000. Cash flows from the plant for the next four years are estimated at Rs. 350,000 per annum. Applicable discount rate is 10%.

What is the approximate impairment loss on the plant to be recognised in the financial statements as at 31 December 2019?

- a) Rs. 650,000
 - b) Rs. 390,000
 - c) Rs. 1,000,000
 - d) Nil
35. Which of the following future cash flows should NOT be included in the calculation of value in use of an asset?
- a) Cash flows on maintaining the asset's performance
 - b) Cash flows on enhancing the asset's performance
 - c) Cash flows from continuing use of the asset
 - d) Cash flows from disposal of the asset
36. When an impairment review is carried out, an impaired asset is measured at:
- a) Fair value less cost to sell
 - b) Value in use
 - c) Cost
 - d) Recoverable amount
37. Which of the following would be an external indicator that an asset of an entity may be impaired?
- a) Increase in central bank discount rates
 - b) Decline in economic performance of an asset
 - c) Physical obsolescence of an asset
 - d) Future restructuring plan of an asset
38. A plant has a carrying amount of Rs. 3.3 million as at 31 December 2021. Its fair value is Rs. 2.4 million and costs of disposal are estimated at Rs. 0.1 million. Cash flows from the plant for the next 4 years are estimated at Rs. 0.7 million per annum. It will be disposed of at the end of the 4th year for Rs. 0.6 million. Applicable discount rate is 10% per annum.
- What is the approximate impairment loss on the plant to be recognised in the financial statements for the year ended 31 December 2021?
- a) Rs. 1 million
 - b) Rs. 2.6 million
 - c) Rs. 0.7 million
 - d) Rs. 1.1 million
39. Which TWO of the following are internal sources of assessing whether there is an indication of impairment?
- a) An expected decline in the asset's market value
 - b) An increase in interest rates
 - c) Evidence that the asset is damaged
 - d) Evidence that the entity's performance is worse than expected

40. Which of the following statements is/are correct?

- i. It is always necessary to determine both an asset's fair value less costs of disposal and its value in use.
 - ii. An entity shall estimate the recoverable amount of the asset at each year-end.
- a) Only (I) is correct
 - b) Only (II) is correct
 - c) Both are correct
 - d) None is correct

41. The carrying value of a plant at 30 June 2023 is Rs. 26 million. The fair value of the plant is estimated at Rs. 25 million, while its disposal costs are estimated to be Rs. 3 million. The plant's cash flows for the next five years are estimated to be Rs. 7 million per annum. The pre-tax and post-tax discount rates per annum are 16% and 12%, respectively.

What is the approximate recoverable amount of the plant in the above case?

- a) Rs. 3 million
- b) Rs. 23 million
- c) Rs. 25 million
- d) Rs. 26 million

42. Which TWO of the following are correct in accordance with IAS 36?

- a) If impairment indicators are present, the entity shall estimate the recoverable amount of the asset
- b) While computing impairment loss, the asset's carrying value is compared with the lower of its fair value less costs of disposal and its value in use
- c) If the recoverable amount is lower than the carrying value, an impairment loss is always charged to the statement of profit or loss
- d) An impairment loss only arises if the fair value less costs of disposal as well as the value in use are lower than the carrying amount

43. On 1 January 2022, Gamma Limited (GL) purchased a manufacturing plant at a cost Rs. 240 million with a useful life of 5 years. GL uses straight-line method of depreciation. At 31 December 2023, GL determines that there are indications for impairment. The plant's value in use and fair value less costs of disposal are estimated to be Rs. 113 million and Rs. 108 million respectively.

Which of the following should be reported as impairment loss in GL's statement of profit or loss for 2023?

- a) Rs. 31 million
- b) Rs. 36 million
- c) Rs. 79 million
- d) Rs. 84 million

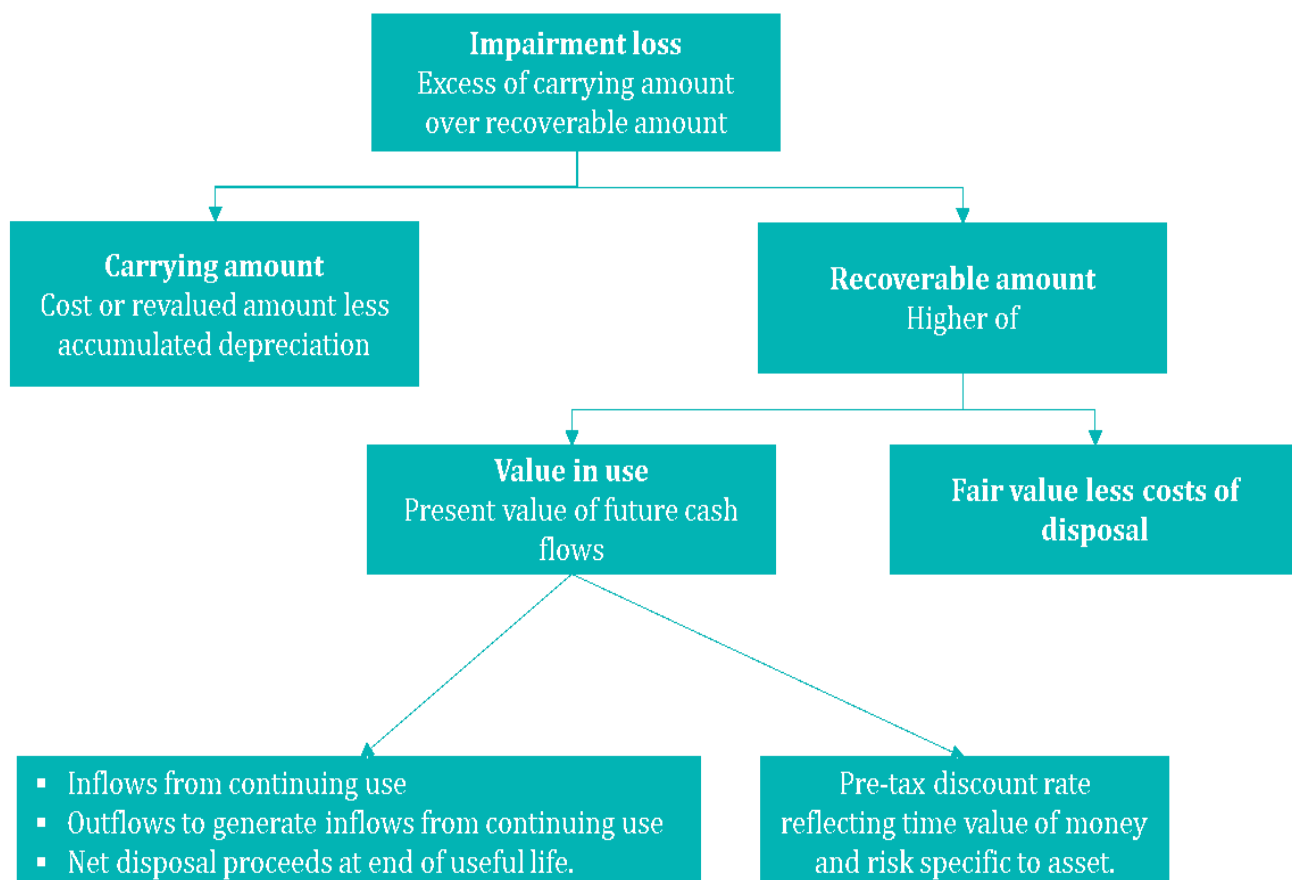
ANSWERS

01.	(b)	The recoverable amount is higher of value in use and fair value less costs of disposal and in case fair value cannot be measured reliably, the recoverable amount is value in use.															
02.	(c) & (d)	A decrease in interest rates would reduce the discount applied to future cash flows in calculating the value in use, therefore increasing the value in use. An increase in market values will lead to the asset value increasing rather than being impaired.															
03.	(d)	The entity's market capitalisation would not be reflected within the values on the statement of financial position.															
04.	(b)	Value in use of Rs.38,685 is lower than fair value less costs of disposal of Rs.43,000, so recoverable amount is Rs.43,000 and impairment is Rs.60,750 – Rs.43,000 = Rs.17,750.															
05.	(d)	Although the estimated net realisable value is lower than it was (due to fire damage), the entity will still make a profit on the inventory and thus it is not an indicator of impairment.															
06.	(a)	Tax and finance costs are not cost of disposal.															
07.	(b)	Asset may not be impaired even after damage. Impairment loss is excess of carrying amount over recoverable amount.															
08.	(b)	This is definition of value in use															
09.	(d)	(a), (b) and (c) are excluded from scope of IAS 36 as the prudence mechanism is already incorporated in the relevant standards of these items.															
10.	(d)	Item 1 is untrue. An annual impairment review is only required for intangible assets with an indefinite life.															
11.	(c)	The higher of fair value less costs of disposal and value in use.															
12.	(a)	<table><tr><th></th><th>Rs.</th></tr><tr><td>Fair value – costs of disposal (780,000 – 25,000)</td><td>755,000</td></tr><tr><td>Value in use:</td><td></td></tr><tr><td>300,000 × 1 / 1.08</td><td>277,780</td></tr><tr><td>300,000 × 1 / 1.08²</td><td>257,200</td></tr><tr><td>300,000 × 1 / 1.08³</td><td>238,150</td></tr><tr><td></td><td>773,130</td></tr></table> Recoverable amount is Rs. 773,130 and carrying amount is Rs. 850,000, so impairment is Rs. 76,870.			Rs.	Fair value – costs of disposal (780,000 – 25,000)	755,000	Value in use:		300,000 × 1 / 1.08	277,780	300,000 × 1 / 1.08 ²	257,200	300,000 × 1 / 1.08 ³	238,150		773,130
	Rs.																
Fair value – costs of disposal (780,000 – 25,000)	755,000																
Value in use:																	
300,000 × 1 / 1.08	277,780																
300,000 × 1 / 1.08 ²	257,200																
300,000 × 1 / 1.08 ³	238,150																
	773,130																
13.	(a & d)	The other options are internal indicators of impairment.															
14.	(c)	<table><tr><th></th><th>Rs.</th></tr><tr><td>Fair value less costs of disposal (2.7m – 50,000)</td><td>2,650,000</td></tr><tr><td>Value in use</td><td>2,600,000</td></tr><tr><td>Recoverable amount is therefore:</td><td>2,650,000</td></tr><tr><td>Impairment loss (balancing figure)</td><td>350,000</td></tr><tr><td>Carrying amount</td><td>3,000,000</td></tr></table>			Rs.	Fair value less costs of disposal (2.7m – 50,000)	2,650,000	Value in use	2,600,000	Recoverable amount is therefore:	2,650,000	Impairment loss (balancing figure)	350,000	Carrying amount	3,000,000		
	Rs.																
Fair value less costs of disposal (2.7m – 50,000)	2,650,000																
Value in use	2,600,000																
Recoverable amount is therefore:	2,650,000																
Impairment loss (balancing figure)	350,000																
Carrying amount	3,000,000																

15.	(b)	Cash flows related to taxations are ignored while calculating value in use.	
16.	(d)	20 + Nil + 10 = Rs. 30 million	
17.	(d)	60 + Nil + Nil +80 = Rs. 140 million	
18.	(c)	The recoverable amount of an asset is the higher of its value in use (being the present value of future cash flows) and fair value less costs of disposal. Therefore, the recoverable amount is Rs. 6.5 million.	
19.	(d)		
			Rs. m
		Cost 1 October 2019	100
		Depreciation (100 /10 x 5 years)	(50)
		Carrying amount	50
		The recoverable amount is the higher of fair value less costs to disposal (Rs. 30 million) and the value in use (Rs. 8,5 x 3.79 = Rs. 32.215). Recoverable amount is therefore Rs. 32.215.	
			Rs. m
		Carrying amount	50
		Recoverable amount	(32.215)
		Impairment to statement of profit or loss	17.785
20.	(c)	Is the lower of its carrying amount (Rs. 217 million) and recoverable amount (Rs. 214.6 million) at 31 March 2015. Recoverable amount is the higher of value in use (Rs. 214.6 million) and fair value less costs to (Rs. 200 million). Carrying amount = Rs. 217 million (248 million – (248 million × 12.5%)) Value in use is based on present values = Rs. 214.6 million	
21.	(b)	Investment property carried at cost	
22.	(c)	Investment property carried at fair value	
23.	(a)	Immediately	
24.	(c)	The discounted present value of future cash flows expected to arise from continuing use of asset, and from its disposal at the end of its useful life.	
25.	(d)	estimated future restructuring cost not yet committed	
26.	(a)	Pre-tax rate that reflects the market assessment of time value of money and risks specific to the asset	
27.	(d)	Impaired	
28.	(b)	Worse economic performance than expected	
29.	(c)	Increase in market interest rates	
30.	(b)	The higher of fair value less costs of disposal and value in use	
31.	(c)	Standard wages for employees	
32.	(d)	Benefits from future restructuring	
33.	(b)	the recoverable amount is the value in use	

34.	(b)	Rs. 390,000
35.	(b)	Cash flows on enhancing the asset's performance
36.	(d)	Recoverable amount
37.	(a)	Increase in central bank discount rates
38.	(c)	Value in use = $[0.7m \times (1 - 1.10^{-4})/0.10] + [0.6m \times 1.10^{-4}]$ = Rs. 2.6m Fair value less costs of disposal = Rs. 2.4m - 0.1m = Rs. 2.3m Recoverable amount (higher) = Rs. 2.6m Impairment loss = Carrying amount Rs. 3.3m - 2.6m = Rs. 0.7 m
39.	(c) & (d)	Evidence that the asset is damaged and evidence that the entity's performance is worse than expected.
40.	(d)	None is correct
41.	(b)	Fair value less cost of disposal [Rs. 25m - 3m] = Rs. 22m Value in use = $7m \times \frac{1 - 1.16^{-5}}{0.16} = Rs. 22.92m$ Higher Rs. 22.92 i.e. Rs. 23m approximately.
42.	(a) & (d)	If impairment indicators are present, the entity shall estimate the recoverable amount of the asset. An impairment loss only arises if the fair value less costs of disposal as well as the value in use are lower than the carrying amount.
43.	(a)	Carrying amount [Rs. 240m - (240/5 years x 2 years)] = Rs. 144 million Recoverable amount (higher of Rs. 113m & Rs. 108m) = Rs. 113m Impairment loss [Rs. 144m - 113m] = Rs. 31 million

STICKY NOTES



Summary of the approach

Impairment of an asset should be identified and accounted for as follows:

1. At the end of each reporting period, the entity should assess whether there are any indications that an asset may be impaired.
2. If there are such indications, the entity should estimate the asset's recoverable amount.
3. When the recoverable amount is less than the carrying value of the asset, the entity should reduce the asset's carrying value to its recoverable amount. The amount by which the value of the asset is written down is an impairment loss.
4. This impairment loss is recognised as a loss for the period. However, if the impairment loss relates to an asset that has previously been revalued upwards, it is first offset against any remaining revaluation surplus for that asset. When this happens it is reported as other comprehensive income for the period (a negative value) and not charged against profit.
5. A reversal of an impairment loss for an asset shall be recognised immediately in profit or loss to the extent that increased carrying amount of such asset does not exceed the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior years. Any increase in the carrying amount of an asset above the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior years is a revaluation and shall be recognised in other comprehensive income (and accumulated as revaluation surplus) only if entity uses revaluation model for such asset.
6. Depreciation in future periods (after impairment or reversal of impairment) should be adjusted to allocate the asset's revised carrying amount, minus any residual value, over its remaining useful life (revised if necessary).

IAS 38 INTANGIBLE ASSETS

IN THIS CHAPTER:

AT A GLANCE

SPOTLIGHT

1. Introduction
2. Recognition and initial measurement
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STICKY NOTES

AT A GLANCE

An intangible asset is a non-physical asset that has a useful life of greater than one year or has an indefinite useful life. IAS 38 Intangible assets sets out rules on the recognition, measurement and disclosure of intangible assets. It was developed from the viewpoint that there should be no real difference in how tangible and intangible assets are accounted for. However, there is an acknowledgement that it can be more difficult to identify the existence of an intangible asset so IAS 38 gives broader guidance on how to do this when an intangible asset is acquired through a variety of means.

IAS 38 requires intangible assets to be recognised in the financial statements if, and only if, specified criteria are met and explains how these are applied. A key issue with expenditure on 'intangible items' is whether it should be treated as an expense and included in full in profit or loss for the period in which incurred, or whether it should be capitalised and treated as a long-term asset. IAS 38 sets out criteria to determine which of these treatments is appropriate in given circumstances.

IAS 38 applies to, among other things, expenditure on advertising, training, start-up, research and development activities.

IAS 38 explains how to measure the carrying amount of intangibles assets when they are first recognised and how to measure them at subsequent reporting dates. Most types of long-term intangible asset are 'amortised' over their expected useful life. Amortisation of intangible assets is the equivalent of depreciation of tangible non-current assets.

IAS 38 also sets out disclosure requirements for intangible assets in the financial statements.

This chapter also covers SIC 32 that provides guidance on accounting treatment of web site costs in accordance with IAS 38.

1 INTRODUCTION

1.1 Scope [IAS 38: 2, 3, 6 & 9]

Entities frequently expend resources, or incur liabilities, on the acquisition, development, maintenance or enhancement of intangible resources such as scientific or technical knowledge, design and implementation of new processes or systems, licences, intellectual property, market knowledge and trademarks (including brand names and publishing titles).

Common examples of items encompassed by these broad headings are computer software, patents, copyrights, motion picture films, customer lists, mortgage servicing rights, fishing licences, import quotas, franchises, customer or supplier relationships, customer loyalty, market share and marketing rights.

IAS 38 is required to be applied in accounting for intangible assets, except:

- a) intangible assets that are within the scope of another Standard;

If another Standard prescribes the accounting for a specific type of intangible asset, an entity applies that Standard instead of this Standard. For example, this Standard does not apply to:

- a) intangible assets held for sale in the ordinary course of business (IAS 2 is applicable).
- b) deferred tax assets (IAS 12 is applicable).
- c) leases of intangible assets (IFRS 16 is applicable).
- d) financial assets (IAS 32 or IFRS 10/IAS 27/IAS 28 is/are applicable)
- e) goodwill acquired in a business combination (IFRS 3 is applicable).
- f) assets arising from contracts with customers (IFRS 15 is applicable)

Rights held by a lessee under licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights are within the scope of IAS 38 and are excluded from the scope of IFRS 16.

1.2 Definition and concept of intangible asset [IAS 38: 8 & 10]

An intangible asset is an identifiable non-monetary asset without physical substance.

If an item does not meet the definition of intangible assets, it is charged as an expense when incurred.

1.2.1 Identifiable [IAS 38: 11 & 12]

An intangible asset must be identifiable to distinguish it from the goodwill. An asset is identifiable if it either:

- is separable (can be exchanged, rented, sold or transferred separately); or
- arises from contractual or other legal rights, regardless of whether those rights are transferable or separable.

The purchased goodwill is not an identifiable asset as it cannot be exchanged, rented, sold or transferred and it does not arise from contractual or legal rights. Therefore, IAS 38 is not applicable on acquired goodwill and IFRS 3 provides guidance on it and as per IFRS 3, Goodwill = FV of consideration – net asset acquired at FV.

► Example 01:

An entity incurred Rs. 4 million on a massive marketing campaign to promote a new product. The accountant wishes to capitalize these costs. The cost of the advertising campaign is not separable as it cannot be separated from the entity and sold, transferred, rented or exchanged etc. Furthermore, the advertising campaign does not arise from contractual or legal rights. Thus, the cost of the advertising campaign is not identifiable and must be expensed out.

1.2.2 Non-monetary [IAS 38: 8]

Monetary assets are money held and assets to be received in fixed or determinable amounts of money, for example, cash and trade receivable. Intangible asset must be a non-monetary asset.

1.2.3 Asset [IAS 38: 10, 13 & 17]

An intangible asset must meet the definition criteria of an asset i.e. identifiable (see 1.2.1), control over a resource and existence of future economic benefits.

An entity controls an asset if the entity has the power to obtain the future economic benefits flowing from the underlying resource and to restrict the access of others to those benefits.

The future economic benefits flowing from an intangible asset may include revenue from the sale of products or services, cost savings, or other benefits resulting from the use of the asset by the entity.

► *Example 02:*

Market and technical knowledge may give rise to future economic benefits. Control over such knowledge exists if it is protected by legal rights such as copyrights, a restraint of trade agreement (where permitted) or by a legal duty on employees to maintain confidentiality.

► *Example 03:*

The entity usually has insufficient control over the expected economic benefits from customer relationships and loyalty for such items (e.g. portfolio of customers, market shares) to meet the definition of intangible assets.

► *Example 04:*

The exchange transactions for the same or similar non-contractual customer relationships provide evidence that the company is able to control those benefits in the absence of such legal rights. Such exchange transactions also provide evidence that the customer relationship is separable so, thus meeting the intangible asset definition. This means that a purchased customer list would usually be capitalised.

► *Example 05:*

An entity may have a team of skilled staff and may be able to identify incremental staff skills leading to future economic benefits from training. The entity may also expect that the staff will continue to make their skills available to the entity. However, an entity usually has insufficient control over the expected future economic benefits (e.g. an employee might leave the entity taking with him the skills obtained from training) arising from a team of skilled staff and from training for these items to meet the definition of an intangible asset. Similarly, specific management or technical talent is unlikely to meet the definition of an intangible asset, unless it is protected by legal rights to use it.

1.2.4 Physical and non-physical elements [IAS 38: 4 & 5]

Some intangible assets may be contained in or on a physical substance such as a compact disc (in the case of computer software), legal documentation (in the case of a licence or patent) or film. Intangible assets may have secondary physical element. Therefore, although these activities may result in an asset with physical substance (e.g. a prototype), the physical element of the asset is secondary to its intangible component, i.e. the knowledge embodied in it.

► *Example 06:*

An entity acquired a fishing license. The directors insist that it is a physical asset since it is written on a piece of paper. Although the fishing license has a physical form (the related legal documentation), the license is right rather than the physical proof thereof. Such a right (whether documented or not) is always considered to be intangible.

In determining whether an asset that incorporates both intangible and tangible elements should be treated under IAS 16 Property, Plant and Equipment or as an intangible asset under IAS 38, an entity uses judgement to assess which element is more significant. For example, computer software for a computer-controlled machine tool that cannot operate without that specific software is an integral part of the related hardware and it is treated as property, plant and equipment. The same applies to the operating system of a computer. It is included in PPE.

► *Example 07:*

An air-conditioning unit has software installed to control and display the temperature including its connectivity with the remote. The software element of air-conditioning unit is insignificant and supportive only to its physical parts including compressor etc. which achieve its primary purpose i.e. air cooling. The air-conditioning unit shall be accounted for as PPE.

However, when the software is not an integral part of the related hardware, computer software is treated as an intangible asset.

► *Example 08:*

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

The IT division has begun a training course for all managers in a new programming language at a cost of Rs. 200,000. The consultants running the training course have quantified the present value of the training benefits over the next two years to be Rs. 400,000. The project cost has been included in the statement of financial position as a current asset. The accounting policy note identifies that the costs will be written off over the next two years to match the benefits.

Required:

Explain the correct accounting treatment for the above.

► *ANSWER:*

An entity may have a team of skilled staff and may be able to identify incremental staff skills leading to future economic benefits from training. The entity may also expect that the staff will continue to make their skills available to the entity.

However, an entity usually has insufficient control over the expected future economic benefits arising from a team of skilled staff and from training for these items to meet the definition of an intangible asset. Therefore, IAS 38 specifically states that training costs should not be capitalised. Hence the treatment adopted by Fazal is not correct and the training costs should be charged to P&L.

1.3 Other Key Definitions [IAS 38: 8]

Carrying amount is the amount at which an asset is recognised in the statement of financial position after deducting any accumulated amortisation and accumulated impairment losses thereon.

Cost is the amount of cash or cash equivalents paid or the fair value of other consideration given to acquire an asset at the time of its acquisition or construction, or, when applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other IFRSs, e.g. IFRS 2 Share-based Payment.

Depreciable amount is the cost of an asset, or other amount substituted for cost, less its residual value.

Entity-specific value is the present value of the cash flows an entity expects to arise from the continuing use of an asset and from its disposal at the end of its useful life or expects to incur when settling a liability.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (See IFRS 13 Fair Value Measurement.)

An **impairment loss** is the amount by which the carrying amount of an asset exceeds its recoverable amount.

Amortisation is the systematic allocation of the depreciable amount of an intangible asset over its useful life.

The **residual value** of an intangible asset is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.

Useful life is:

- 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 the asset by an entity.

2 RECOGNITION AND INITIAL MEASUREMENT

2.1 Recognition of intangible assets [IAS 38: 18, 21 & 22]

The recognition of an item as an intangible asset requires an entity to demonstrate that the item meets:

- a) the definition of an intangible asset; and
- b) the recognition criteria.

The above requirement applies to costs incurred initially to acquire or internally generate an intangible asset and those incurred subsequently to add to, replace part of, or service it.

An intangible asset shall be recognised if, and only if:

- a) it is probable that the expected future economic benefits that are attributable to the asset will flow to the entity; and
- b) the cost of the asset can be measured reliably.

An entity shall assess the probability of expected future economic benefits using reasonable and supportable assumptions that represent management's best estimate of the set of economic conditions that will exist over the useful life of the asset.

2.2 Recognition of subsequent expenditure [IAS 38: 20]

Subsequent expenditure is only capitalised if it can be measured and attributed to an asset and enhances the value of the asset.

This would rarely be the case because:

- The nature of intangible assets is such that, in many cases, there are no additions to such an asset or replacements of part of it.
- Most subsequent expenditure is likely to maintain the expected future economic benefits embodied in an existing intangible asset rather than meet the definition of an intangible asset and the recognition criteria.
- Also, it is often difficult to attribute subsequent expenditure directly to a particular intangible asset rather than to the business as a whole.

Maintenance expenditure is charged to profit or loss.

2.3 Initial measurement [IAS 38: 24]

An intangible asset shall be measured initially at cost. An intangible asset may be acquired in following ways:

- Acquired or Purchased separately
- Acquired in exchange of another asset
- Acquired by way of government grant
- Internally generated including Research & Development (covered later in this chapter)
- Acquired in business combination (covered later in this chapter)

2.3.1 Intangible assets acquired or purchased separately [IAS 38: 25 to 32]

Normally, the price an entity pays to acquire the intangible asset separately will reflect expectations about the probability that the expected future economic benefits embodied in the asset will flow to the entity. Therefore, the probability of economic benefits is always considered to be satisfied for separately acquired intangible assets.

In addition, the cost of a separately acquired intangible asset can usually be measured reliably. This is particularly so when the purchase consideration is in the form of cash or other monetary assets.

The cost of a separately acquired intangible asset comprises:

- a) its purchase price, including import duties and non-refundable purchase taxes (e.g. input sales tax paid by an unregistered person), after deducting trade discounts and rebates; and
- b) any directly attributable cost of preparing the asset for its intended use.

Examples of directly attributable costs are:

- costs of employee benefits arising directly from bringing the asset to its working condition;
- professional fees (e.g. legal or consulting fees) arising directly from bringing the asset to its working condition; and
- costs of testing whether the asset is functioning properly.

Examples of expenditures that are not part of the cost of an intangible asset are:

- costs of introducing a new product/service (including advertising/promotional activities);
- costs of conducting business in a new location or with a new class of customer (including costs of staff training); and
- administration and other general overhead costs.

The following are important considerations regarding initial measurement of acquired intangible assets:

- Recognition of costs in the carrying amount of an intangible asset ceases when the asset is in the condition necessary for it to be capable of operating in the manner intended by management. For example, initial operating losses or cost of redeploying the asset.
- Income and expenses relating to incidental operations (not directly attributable) are recognised immediately in profit or loss, and included in their respective classifications of income and expense.
- If payment for an intangible asset is deferred beyond normal credit terms, its cost is the cash price equivalent. The difference is interest expense unless capitalised as per IAS 23.

► **Example 09:**

Ateeq Limited acquires new technology that will significantly reduce its energy costs for manufacturing. Costs incurred include:

	Rupees
Cost of new technology	1,500,000
Trade discount provided	200,000
Training course for staff in new technology	70,000
Initial testing of new technology	20,000
Losses incurred while other parts of plant shutdown during testing and training	30,000

Required:

Calculate the cost that can be capitalised.

► **ANSWER:**

The cost that can be capitalised is:	Rs.
Cost of a new technology	1,500,000
Less discount	(200,000)
Plus initial testing	20,000
Total	1,320,000

► **Example 10:**

On 30 June 20X4, Habib Limited (HL) discovered that it had been manufacturing a product illegally since this product happened to be a patented product for which it did not have the necessary rights. HL immediately shut down its factory and hired a firm of lawyers to act on its behalf in the acquisition of the necessary rights to manufacture this patented product.

Legal fees of Rs.50,000 were incurred during July 20X4.

The legal process was finalized on 31 July 20X4, HL was then required to pay Rs.800,000 to purchase the rights, including Rs.80,000 as refundable taxes.

During the month of July 20X4, factory was shut-down:

- Overhead costs of Rs.40,000 were incurred;
- Significant market share was lost due to shut-down. HL's total sales over August and September was Rs.20,000 but its expenses were Rs.50,000, resulting in a loss of Rs.30,000.

To increase market share, HL spent an extra Rs.25,000 aggressively marketing its product. This marketing campaign was successful, resulting in sales returning to profitable levels in October.

Required:

Discuss which of the above costs relating to acquisition of patent can be capitalised.

► **ANSWER:**

Purchase price: The purchase price should be capitalised, but this must exclude refundable taxes. Rs. 720,000 (800,000 – 80,000).

Legal costs: This is a directly attributable cost. Directly attributable costs must be capitalised i.e. Rs. 50,000.

Overhead costs: This is not an incidental cost that is necessary to the acquisition of the rights (the shut-down was only necessary because HL had been operating illegally).

Operating loss: The operating loss incurred while demand for the product increased to its normal level is an example of a cost that was incurred after the rights were acquired. Costs incurred after the Intangible Asset is available for use will not be capitalised.

Advertising campaign: The extra advertising incurred in order to recover market share is an example of a cost that was incurred after the rights were acquired. Furthermore, advertising costs are listed in IAS 38 as one of the costs that should be expensed out.

2.3.2 Intangible asset acquired in exchange of another asset [IAS 38: 45 & 46]

In order to recognize an asset that was acquired in an asset exchange, it must meet both the definition and recognition criteria. However, the asset acquired will only be recognised and the asset given up will only be derecognised, if the transaction has commercial substance.

A transaction is said to have commercial substance if its future cash flows are expected to change as a result of the transaction.

In the case of the exchange of assets, the cost of the intangible asset acquired will be:

- fair value of the asset given up $\pm$ Cash paid (received);
- fair value of the acquired asset, if this is more clearly evident;
- the carrying amount of the asset given up $\pm$ Cash paid (received), if neither of the fair values are available or the transaction lacks commercial substance.

2.3.3 Intangible asset acquired by way of government grant [IAS 38: 44]

In some cases, an intangible asset may be acquired free of charge, or for nominal consideration, by way of a government grant. This may happen when a government transfers or allocates to an entity intangible assets such as airport landing rights, licences to operate radio or television stations, import licences or quotas or rights to access other restricted resources.

In accordance with IAS 20, an entity may choose to recognise both the intangible asset and the grant initially at fair value. Alternatively, the entity recognises the asset initially at a nominal amount plus any expenditure that is directly attributable to preparing the asset for its intended use.

There is detailed discussion of the topics of intangible asset arising from internally generated items and items acquired in business combination in next sections of this chapter.

3 INTERNALLY GENERATED ITEMS

3.1 Recognition issue [IAS 38: 51 to 53]

It can sometimes be difficult for a company to assess whether an internally-generated asset qualifies for recognition as an asset in the financial statements because:

- a) it is not identifiable; or
- b) its cost cannot be determined reliably.

To assess whether an internally generated intangible asset meets the criteria for recognition, an entity classifies the generation of the asset into:

- a) a research phase; and
- b) a development phase.

Although the terms 'research' and 'development' are defined, the terms 'research phase' and 'development phase' have a broader meaning for the purpose of IAS 38. If an entity cannot distinguish the research phase from the development phase of an internal project to create an intangible asset, the entity treats the expenditure on that project as if it were incurred in the research phase only.

3.2 Research [IAS 38: 54 to 56]

Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

Examples of research activities are:

- activities aimed at obtaining new knowledge;
- the search for, evaluation and final selection of, applications of research findings or other knowledge;
- the search for alternatives for materials, devices, products, processes, systems or services; and
- the formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services.

In the research phase of an internal project, an entity cannot demonstrate that an intangible asset exists that will generate probable future economic benefits. Therefore, this expenditure is recognised as an expense when it is incurred and no intangible asset arising from research (or from the research phase of an internal project) is recognised.

3.3 Development [IAS 38: 57 to 59]

Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use.

Examples of development activities are:

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

In the development phase of an internal project, an entity can, in some instances, identify an intangible asset and demonstrate that the asset will generate probable future economic benefits. This is because the development phase of a project is further advanced than the research phase. Therefore, this expenditure is capitalised if it meets certain criteria, otherwise this expenditure is recognised as an expense when it is incurred.

An intangible asset arising from development (or from the development phase of an internal project) shall be recognised if, and only if, an entity can demonstrate all of the following:

- a) the technical feasibility of completing the intangible asset so that it will be available for use or sale.
- b) its intention to complete the intangible asset and use or sell it.
- c) its ability to use or sell the intangible asset.
- d) how the intangible asset will generate probable future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.
- e) the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset.
- f) its ability to measure reliably the expenditure attributable to the intangible asset during its development.

► **Example 11:**

Company Q has undertaken the development of a new product. Total costs to date have been Rs. 800,000. All of the conditions for recognising the development costs as an intangible asset have now been met.

However, Rs. 200,000 of the Rs. 800,000 was spent before it became clear that the project was technically feasible, could be resourced and the developed product would be saleable and profitable.

The Rs. 200,000 incurred before all of the conditions for recognising the development costs as an intangible asset were met must be written off as a research costs (expense). The remaining Rs. 600,000 should be capitalised and recognised as an intangible asset (development costs).

3.4 Past expenses not to be recognised as an asset [IAS 38: 71]

Expenditure on an intangible item that was initially recognised as an expense shall not be recognised as part of the cost of an intangible asset at a later date.

► **Example 12:**

Sino Care Limited (SCL) started a R&D project for developing new product on 1st January 20X1. The following expenditure was incurred during 20X1. Year-end is 31 December 20X1.

- Research phase (1 January to 31 March): Rs. 1 million per month
- Development phase (1 April to 31 October): Rs. 1.5 million per month.

The project became technically feasible on 31 August 20X1 when initial patent was also submitted for registration.

Required:

Discuss the accounting treatment.

► **ANSWER:**

Expenditure incurred in research phase from 1 January to 31 March of Rs. 3 million (i.e. Rs. 1 million x 3 months) shall be charged to profit or loss.

Expenditure incurred in development phase from 1 April to 31 August of Rs. 7.5 million (i.e. Rs. 1.5 million x 5 months) shall be charged to profit or loss since in this period the capitalisation criteria was not met. Even after the criteria for capitalisation has been met subsequently, this expenditure shall not be reinstated as an asset.

Expenditure incurred in development phase after capitalisation criteria has been met from 1 September to 31 October of Rs. 3 million (i.e. Rs. 1.5 million x 2 months) shall be capitalised as intangible asset.

3.5 Cost of an internally generated intangible asset [IAS 38: 65 to 67]

The cost of an internally generated intangible asset is the sum of expenditure incurred from the date when the intangible asset first meets the recognition criteria.

The cost comprises all directly attributable costs:

- costs of materials and services used or consumed in generating the intangible asset;
- costs of employee benefits arising from the generation of the intangible asset;
- fees to register a legal right; and
- amortisation of patents and licences that are used to generate the intangible asset.

IAS 23 specifies criteria for the recognition of interest as an element of the cost of an internally generated intangible asset.

The following are not components of the cost of an internally generated intangible asset:

- selling, administrative and other general overhead expenditure unless this expenditure can be directly attributed to preparing the asset for use;
- identified inefficiencies and initial operating losses incurred before the asset achieves planned performance; and
- expenditure on training staff to operate the asset.

► **Example 13:**

Saqib Limited began researching and developing an intangible asset. The following is a summary of the costs that the R&D Department incurred each year:

20X1: Rs.180,000

20X2: Rs.100,000

20X3: Rs.80,000

Additional information:

- The costs listed above were incurred evenly throughout each year.
- Included in the costs incurred in 20X1 are administrative costs of Rs. 60,000 that are not considered to be directly attributed to the research and development process. The first two months of the year were dedicated to research. Then development began from 1 March 20X1 but it was unable to measure reliably the expenditure on development till 31 March 20X1.
- Included in the costs incurred in 20X2 are administrative costs of Rs. 20,000 that are considered to be directly attributed to the research and development process.
- Included in the costs incurred in 20X3 are training costs of Rs. 30,000 that are considered to be directly attributed to the research and development process as in preparation for the completion of the development process, certain employees were trained on how to operate the asset.

Required:

Prepare journal entries related to the costs incurred for each of the years ended 31 December 20X1 to 20X3 and briefly comment on accounting treatment.

► ANSWER:

	Debit	Credit
20X1	Rupees	
Administration expense (not directly attributable)	60,000	
Research Expense $(180,000 - 60,000) \times 2/12$	20,000	
Development Expense $(180,000 - 60,000) \times 1/12$	10,000	
Development cost (Asset) $(180,000 - 60,000) \times 9/12$	90,000	
Bank		180,000

	Debit	Credit
20X2	Rupees	
Development cost (Asset)	100,000	
Bank		100,000

	Debit	Credit
20X3	Rupees	
Training Expense	30,000	
Development cost (Asset)	50,000	
Bank		80,000

Comments

Administration costs are capitalised if they are considered directly attributable (see 20X2), otherwise they are expensed (see 20X1).

Training costs are always expensed even if they are considered to be directly attributable (see 20X3).

Research costs are always expensed.

Development costs that are expensed due to being incurred before the recognition criteria were met may not be subsequently capitalised, even if the recognition criteria are subsequently met. They remain expensed.

3.6 Recognition prohibition [IAS 38: 63 to 64, 48 to 50]

Internally generated brands, mastheads, publishing titles, customer lists and items similar in substance shall not be recognised as intangible assets.

Expenditure on above items cannot be distinguished from the cost of developing the business as a whole. Therefore, such items are not recognised as intangible assets.

Internally generated goodwill is not recognised as an asset because it is not an identifiable resource (i.e. it is not separable nor does it arise from contractual or other legal rights) controlled by the entity that can be measured reliably at cost.

Differences between the fair value of an entity and the carrying amount of its identifiable net assets at any time may capture a range of factors that affect the fair value of the entity. However, such differences do not represent the cost of intangible assets controlled by the entity.

► **Example 14:**

During 20X5 Henry has the following research and development projects in progress:

Project A was completed at the end of 20X4. Development expenditure brought forward at the beginning of 20X5 was Rs. 412,500 on this project. Savings in production costs arising from this project are first expected to arise in 20X5. In 20X5 savings are expected to be Rs. 100,000, followed by savings of Rs. 300,000 in 20X6 and Rs. 200,000 in 20X7.

Project B commenced on 1 April 20X5. Costs incurred during the year were Rs. 56,000. In addition to these costs a machine was purchased on 1 April 20X5 for Rs. 30,000 for use on the project. This machine has a useful life of five years. At the end of 20X5 there were still some uncertainties surrounding the completion of the project.

Project C had been started in 20X4. In 20X4 the costs relating to this project of Rs. 36,700 had been written off, as at the end of 20X4 there were still some uncertainties surrounding the completion of the project. Those uncertainties have now been resolved before a further Rs. 45,000 costs incurred during the year.

Required:

Show movement and balance of non-current assets of Henry for the year to 31 December 20X5.

► **ANSWER:**

	Property, plant & equipment	Research & Development
Cost	Rs.	Rs.
On 1 January 20X5	-	412,500
Additions	30,000	45,000
On 31 December 20X5	30,000	457,500
Accumulated depreciation/amortisation		
On 1 January 20X5	-	-
Charge for the year	4,500 W1	68,750 W2
On 31 December 20X5	4,500	68,750
Carrying amount		
On 31 December 20X5	25,500	388,750
On 31 December 20X4	-	412,500

Comments

The costs in respect of Project B cannot be capitalised as there are uncertainties surrounding the successful outcome of the project – but the machine bought may be capitalised in accordance with IAS 16. The 20X5 costs in respect of Project C can be capitalised as the uncertainties have now been resolved. However, the 20X4 costs cannot be reinstated.

W1 – Depreciation charge (machine)	Rs.
Rs. 30,000 / 5 years x 9/12	4,500
W2 – Amortisation charge (project A)	Rs.
100,000 / (100,000 + 300,000 + 200,000) x Rs. 412,500	68,750

4 ACQUIRED IN BUSINESS COMBINATION

A transaction or other event in which an acquirer obtains control of one or more businesses is called business combination, for example, when a company (the acquirer) buys a controlling interest (usually 50% or more voting power) in another company (the acquiree), it is also called business combination and consolidated financial statements are to be prepared by the acquirer.

4.1 Acquisition of intangible asset in a business combination [IAS 38: 33 & 34]

The cost of that intangible asset is its fair value at the acquisition date. The fair value of an intangible asset will reflect market participants' expectations at the acquisition date about the probability that the expected future economic benefits embodied in the asset will flow to the entity.

If an asset acquired in a business combination is separable or arises from contractual or other legal rights, sufficient information exists to measure reliably the fair value of the asset. Thus, the reliable measurement criterion is also satisfied.

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.

► Example 15:

Company X buys 100% of Company Y. Company Y owns a famous brand that it launched several years ago. The fair value of the brand has been estimated at Rs. 6 million at acquisition date.

Required:

Discuss the recognition of brand in financial statements.

► ANSWER:

The brand is not recognised in Company Y's financial statements (IAS 38 prohibits the recognition of internally generated brands).

From the Company X group viewpoint the brand is a purchased asset. Part of the consideration paid by Company X to buy Company Y was to buy the brand and it should be recognised in the consolidated financial statements at its fair value of Rs. 6 million.

4.2 Acquiree's in-process research and development project [IAS 38: 34]

This means that the acquirer recognises as an asset separately from goodwill an in-process R&D project of the acquiree if the project meets the definition of an intangible asset.

An acquiree's in-process R&D project meets the definition of an intangible asset when it:

- meets the definition of an asset; and
- is identifiable, i.e. is separable or arises from contractual or other legal rights.

► Example 16:

Company X buys 100% of Company Y. Company Y has spent Rs. 600,000 on a research and development project. This amount has all been expensed as the IAS 38 criteria for capitalising costs incurred in the development phase of a project have not been met. Company Y has knowhow as the result of the project.

Company X estimates the fair value of Company Y's knowhow which has arisen as a result of this project to be Rs. 500,000.

Required:

Discuss the accounting treatment.

► **ANSWER:**

The in-process research and development is not recognised in Company Y's financial statements (IAS 38 prohibits the recognition of internally generated assets).

From the Company X group viewpoint the in-process research and development is a purchased asset. Part of the consideration paid by Company X to buy Company Y was to buy the knowhow resulting from the project and it should be recognised in the consolidated financial statements at its fair value of Rs. 500,000.

4.3 Subsequent expenditure on acquired research and development [IAS 38: 42 & 43]

Research or development expenditure that relates to an in-process R&D project acquired separately or in a business combination and recognised as an intangible asset, and is incurred after the acquisition of that project shall be accounted for in accordance with IAS 38 rules on research and development as explained earlier in this chapter.

► **Example 17:**

Continuing the previous example, Company X owns 100% of Company Y and has recognised an intangible asset of Rs. 500,000 as a result of the acquisition of the company Y.

Company Y has spent a further Rs. 150,000 on the research and development project since the date of acquisition. This amount has all been expensed as the IAS 38 criteria for capitalising costs incurred in the development phase of a project have not been met.

Required:

Discuss the accounting treatment.

► **ANSWER:**

The Rs. 150,000 expenditure is not recognised in Company Y's financial statements (IAS 38 prohibits the recognition of internally generated brands).

From the Company X group viewpoint, further work on the in-process research and development project is research and the expenditure of Rs. 150,000 must be expensed.

► **Example 18:**

Zouq Inc. is a multinational company. As part of its vision to expand its business in South Asia, it purchased a 90% share of a locally incorporated company, Momin Limited. Following are the brief details of the acquisition:

Date of acquisition	January 1, 20X4
Total paid up capital of Momin Limited (Rs. 10 each)	Rs. 500,000,000
Purchase price per share	Rs. 30
Net assets of Momin Limited (as per 20X3 audited financial statements)	650,000,000
Fair value of net assets (other than intangible assets) of Momin Limited	1,100,000,000

Momin Limited has an established line of products under the brand name of "Badar". On behalf of Zouq Inc., a firm of specialists has valued the brand name at Rs. 100 million with an estimated useful life of 10 years at January 1, 20X4. It is expected that the benefits will be spread equally over the brand's useful life.

An impairment test of goodwill and brand was carried out on December 31, 20X4 which indicated an impairment of Rs. 50 million in the value of goodwill.

An impairment test carried out on December 31, 20X5 indicated a decrease of Rs. 13.5 million in the carrying value of the brand.

Required:

Prepare the ledger accounts for goodwill and the brand, showing initial recognition and all subsequent adjustments.

► ANSWER:

Goodwill					
		Rs. m			Rs. m
1 Jan X4	Acquisition (W1)	270	31 Dec X4	Impairment loss	50
			31 Dec X4	Balance c/d	220
		270			270
1 Jan X5	Balance b/d	220			
			31 Dec X5	Balance c/d	220
		220			220

Brand "Badar"					
		Rs. m			Rs. m
1 Jan X4	Acquisition (fair value)	100	31 Dec X4	Amortisation	10
			31 Dec X4	Balance c/d	90
		100			100
1 Jan X5	Balance b/d	90	31 Dec X5	Amortisation	10
			31 Dec X5	Impairment loss	13.5
			31 Dec X5	Balance c/d	66.5
		90			90

W1: Value of goodwill	Rs. m
Purchase price (50,000,000 x Rs. 30 x 90%)	1,350
Less: Fair value of net identifiable assets and liabilities (Rs. 1,100,000,000 x 90%)	(990)
Less: Value of brand (Rs. 100,000,000 x 90%)	(90)
Goodwill recognised	270

5 MEASUREMENT AFTER RECOGNITION

5.1 Choice of accounting policy [IAS 38: 72 to 75, 79 & 81]

An entity shall choose either:

- the cost model (i.e. cost less any accumulated amortisation and impairment); or
- the revaluation model (i.e. fair value less any subsequent accumulated amortisation and impairment) as its accounting policy.

For the purpose of revaluations under IAS 38, fair value shall be measured by reference to an active market and if an intangible asset is accounted for using the revaluation model, all the other assets in its class shall also be accounted for using the same model, unless there is no active market for those assets.

An active market is a market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis. [IFRS 13 Appendix A]

If an intangible asset in a class of revalued intangible assets cannot be revalued because there is no active market for this asset, the asset shall be carried at cost model.

The items within a class of intangible assets are revalued simultaneously to avoid selective revaluation of assets and the reporting of mixed amounts.

Revaluations shall be made with such regularity that at the end of the reporting period the carrying amount of the asset does not differ materially from its fair value. The frequency of revaluations depends on the volatility of the fair values of the intangible assets being revalued.

5.2 Measurement under revaluation model [IAS 38: 76, 77 & 79]

The revaluation model does not allow:

- a) the revaluation of intangible assets that have not previously been recognised as assets e.g. internally generated brand; or
- b) the initial recognition of intangible assets at amounts other than cost.

The revaluation model is applied after an asset has been initially recognised at cost. However, if only part of the cost of an intangible asset is recognised as an asset because the asset did not meet the criteria for recognition until part of the way through the process (e.g. development costs), the revaluation model may be applied to the whole of that asset.

Also, the revaluation model may be applied to an intangible asset that was received by way of a government grant and recognised at a nominal amount.

5.3 Active market valuation [IAS 38: 78, 82 to 84]

It is uncommon for an active market to exist for an intangible asset, although this may happen. An active market may exist for freely transferable taxi licences, fishing licences or production quotas. However, an active market cannot exist for brands, newspaper mastheads, music and film publishing rights, patents or trademarks, because each such asset is unique.

If the fair value of a revalued intangible asset can no longer be measured by reference to an active market, the carrying amount of the asset shall be its revalued amount at the date of the last revaluation by reference to the active market less any subsequent accumulated amortisation and any subsequent accumulated impairment losses.

The fact that an active market no longer exists for a revalued intangible asset may indicate that the asset may be impaired and that it needs to be tested in accordance with IAS 36.

If the fair value of the asset can be measured by reference to an active market at a subsequent measurement date, the revaluation model is applied from that date.

5.4 Summary of accounting treatment for revaluation [IAS 38: 80, 85 to 87]

The following accounting treatment of revaluation of intangible assets are same as those of property, plant and equipment under IAS 16:

- a) Adjustment to carrying amount on revaluation by either:
 - i. Proportionate restatement; or
 - ii. Elimination of accumulated amortisation.
- b) Recognition of gain or loss in either:
 - i. Other comprehensive income
 - ii. Profit or loss
- c) Transfer (realization) of revaluation surplus to retained earnings on:
 - i. Derecognition; and
 - ii. Over useful life (incremental amortisation)

5.5 Useful life of intangible assets [IAS 38: 88, 89, 91, 94, 107 to 110]

An entity shall assess whether the useful life of an intangible asset is;

- a) Finite; or
- b) Indefinite. The term 'indefinite' does not mean 'infinite'.

If useful life is assessed to be finite, the entity shall assess that useful life in terms of:

- a) the length of time period, or
- b) number of production or similar units.

An intangible asset shall be regarded by the entity as having an indefinite useful life when, based on an analysis of all of the relevant factors, there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity.

The accounting for an intangible asset is based on its useful life:

- An intangible asset with a finite useful life is amortised.
- An intangible asset with an indefinite useful life is not amortised (rather tested for impairment annually or when there is indication for impairment).
- The intangible assets with indefinite useful life shall be reviewed each period to determine whether useful life continues to be indefinite.
- The change in the useful life assessment from indefinite to finite shall be accounted for as a change in an accounting estimate in accordance with IAS 8.
- The change in the useful life assessment from indefinite to finite is an indicator that the asset may be impaired.

The contractual period and/or renewal options may also impact the assessment of useful life of intangible assets:

- a) The useful life of an intangible asset that arises from contractual or other legal rights shall not exceed the period of the contractual or other legal rights, but may be shorter depending on the period over which the entity expects to use the asset.
- b) If the contractual or other legal rights are conveyed for a limited term that can be renewed, the useful life of the intangible asset shall include the renewal period(s) only if there is evidence to support renewal by the entity without significant cost.

5.6 Amortisation [IAS 38: 97, 98, 98A & 100]

The depreciable amount of an intangible asset with a finite useful life shall be allocated on a systematic basis over its useful life.

Amortisation shall begin when the asset is available for use, i.e. when it is in the location and condition necessary for it to be capable of operating in the manner intended by management. Amortisation shall cease at the earlier of the date that the asset is classified as held for sale (IFRS 5) and the date that the asset is derecognised.

The amortisation method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity. If that pattern cannot be determined reliably, the straight-line method shall be used. There is a rebuttable presumption that an amortisation method that is based on the revenue generated by an activity that includes the use of an intangible asset is inappropriate.

A variety of amortisation methods can be used;

- i. Straight line method,
- ii. Diminishing balance method;
- iii. The units of production method.

The method used is selected on the basis of the expected pattern of consumption of the expected future economic benefits embodied in the asset and is applied consistently from period to period

The amortisation charge for each period shall be recognised in profit or loss unless IAS 38 or another Standard permits or requires it to be included in the carrying amount of another asset.

The residual value of an intangible asset with a finite useful life shall be assumed to be zero unless:

- a) there is a commitment by a third party to purchase the asset at the end of its useful life; or
- b) there is an active market for the asset and
 - residual value can be determined by reference to that market; and
 - it is probable that such a market will exist at the end of the asset's useful life.

The amortisation period and the amortisation method for an intangible asset with a finite useful life shall be reviewed at least at each financial year-end.

► Example 19:

During the year ended 31 December 20X7, following transactions were made by Zebra Limited (ZL):

On 1 April 20X7 ZL acquired a licence for operating a TV channel for Rs. 86.3 million out of which Rs. 50 million was paid immediately. The balance amount is payable on 1 April 20X9. A mega social media and print media campaign was launched to promote the channel at a cost of Rs. 10 million. The transmission of the channel started on 1 August 20X7.

The license is valid for 5 years but is renewable every five years at a cost of Rs. 35 million. Since the renewal cost is significant, the management intends to renew the license only once and sell it at the end of 8 years.

In the absence of any active market, the management has estimated that residual value of the license would be Rs. 15 million and Rs. 20 million at the end of 5 years and 8 years respectively.

Applicable discount rate is 10% p.a.

Required:

Discuss how these transactions should be recorded in ZL's books of accounts for the year ended 31 December 20X7.

► **ANSWER:**

These transactions should be recorded in ZL's books of accounts for the year ended 31 December 20X7 as follows:

Since a part of the payment for the license has been deferred beyond normal credit terms so the license will be initially recognised at cash price equivalent of Rs. 80 million i.e. Rs. 50 million plus Rs. 30 million (i.e. present value of Rs. 36.3 million discounted at 10% for 2 years.)

The advertisement cost of Rs. 10 million incurred on launching of the channel cannot be included in the cost of the license and will be charged to Profit and loss account.

Since the renewal cost is significant so the useful life of the license will be restricted to the original 5 years only.

The residual value of the license will be assumed to be zero since there is no active market for the license and there is no commitment by third party to purchase the license at the end of useful life.

The amortization for the year will be Rs. 12 million $[(80 - 0) \times 1/5 \times 9/12]$ calculated from 1 April 20X7 when the license was available for use:

Unwinding of interest expense of Rs. 2.25 million $(30 \times 10\% \times 9/12)$ shall be recorded with increasing the liability of payable for license with same amount.

5.7 Retirement and disposals [IAS 38: 112 to 115]

The disposal of an intangible asset may occur in a variety of ways (e.g. by sale, by entering into a finance lease, or by donation). The date of disposal of an intangible asset is the date that the recipient obtains control in accordance with IFRS 15.

An intangible asset shall be derecognised:

- on disposal; or
- when no future economic benefits are expected from its use or disposal.

Gain (or loss) is difference of 'net disposal proceeds' and 'carrying amount' of disposed intangible asset. Gain (loss) shall be recognised in profit or loss when the asset is derecognised and gains shall not be classified as revenue.

If a part of an intangible asset is being disposed of and replaced, then an entity:

- derecognises the carrying amount of the replaced part; and
- recognises the cost of the replacement part.

If it is not practicable for an entity to determine the carrying amount of the replaced part, it may use the cost of the replacement as an indication of what the cost of the replaced part was at the time it was acquired or internally generated.

► **Example 20:**

Raisin International (RI) is planning to expand its line of products. The related information for the year ended 31 December 20X5 is as follows:

- Research and development of a new product commenced on 1 January 20X5. On 1 October 20X5, the product development resources were complete and available for use. It is estimated that the product would have a useful life of 7 years. Details of expenditures incurred are as follows:

	Rs. m
Research work	4.50
Development work*	9.00
Training of production staff*	0.50
Cost of trial run*	0.80
Total costs	14.80

*incurred after all the criteria for capitalisation of development costs were met.

- ii. The right to manufacture a well-established product under a patent for a period of five years was purchased on 1 March 20X5 for Rs. 17 million. The patent has an expected remaining useful life of 10 years. RI has the option to renew the patent for a further period of five years for a sum of Rs. 12 million.
- iii. RI has acquired a brand at a cost of Rs. 2 million. The cost was incurred in the month of June 20X5. The life of the brand is expected to be 10 years. Currently, there is no active market for this brand. However, RI is planning to launch an aggressive marketing campaign in February 20X6.
- iv. In September 20X4, RI developed a new production process and capitalised it as an intangible asset at Rs. 7 million. The new process is expected to have an indefinite useful life. During 20X5, RI incurred further development expenditure of Rs. 3 million on the new process which meets the recognition criteria for capitalization of an intangible asset.

Required:

In the light of IFRSs, explain how each of the above transaction should be accounted for in the financial statements of Raisin International for the year ended 31 December 20X5.

► ANSWER:

- i. Since the product met all the criteria for the development of the product, it should be recognised as an intangible in the statement of financial position (SFP) of the company.

However, RI should capitalize only the development work (i.e. Rs.9.80 million) as intangible asset. IAS 38 does not allow capitalization of cost relating to the research work and training of staff.

Since the product has a useful life of 7 years, the amortization expense amounting to Rs.0.35 million $[(Rs. 9.8 \text{ million} \div 7 \text{ years} \times 3/12)]$ should be recorded in the statement of profit or loss.

- ii. This purchasing of right to manufacture should be recognised as an intangible in the SFP because:

- it is for an established product which would generate future economic benefits.
- cost of the patent can be measured reliably.

Since there is a finite life, the patent must be amortised over its useful life. The useful life will be shorter of its actual life (i.e. 10 years) and its legal life (i.e. 5 years). The amortization to be recorded in profit or loss is Rs. 2.83 million $(Rs. 17 \text{ million} \times 10/12 \div 5)$.

- iii. The acquired brand should be recognised as an intangible in the SFP because acquisition price is a reliable measure of its value. The amortization to be recorded in profit or loss is Rs. 0.12 million $(Rs. 2 \text{ million} \div 10 \text{ years} \times 7/12)$.
- iv. The carrying value of the intangible asset should be increased to Rs. 10 million in the SFP. Since there is an indefinite useful life of the intangible assets, it should not be amortised. Instead, RI should test the intangible asset for impairment by comparing its recoverable amount with its carrying amount.

6 DISCLOSURE

6.1 Classes of intangible assets [IAS 38: 119]

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

- a) brand names;
- b) mastheads and publishing titles;
- c) computer software;
- d) licences and franchises;
- e) copyrights, patents and other industrial property rights, service and operating rights;
- f) recipes, formulae, models, designs and prototypes; and
- g) intangible assets under development.

The classes mentioned above may be disaggregated (or aggregated) into smaller (or larger) classes if this results in more relevant information for the users of the financial statements.

6.2 General disclosure [IAS 38: 118]

An entity shall, for each class of intangible assets, distinguishing between internally generated intangible assets and other intangible assets, disclose the following:

- a) whether the useful lives are indefinite or finite and, if finite, the useful lives or the amortisation rates used;
- b) the amortisation methods used for intangible assets with finite useful lives;
- c) the gross carrying amount and any accumulated amortisation (aggregated with accumulated impairment losses) at the beginning and end of the period;
- d) the line item(s) of the statement of comprehensive income in which any amortisation of intangible assets is included.

6.3 Reconciliation [IAS 38: 118]

An entity shall, for each class of intangible assets, distinguishing between internally generated intangible assets and other intangible assets, disclose a reconciliation of the carrying amount at the beginning and end of the period showing:

- a) additions, indicating separately:
 - i. internal development,
 - ii. acquired separately, and
 - iii. acquired through business combinations);
- b) disposals;
- c) increases or decreases during the period resulting from revaluations from impairment losses recognised or reversed;
- d) any amortisation recognised during the period;
- e) net exchange differences (under IAS 21);
- f) other changes in the carrying amount during the period.

► **Example 21:**

The below is a note to the financial statement with disclosures about intangible assets:

Disclosure Note – Intangible assets	Internally generated	Acquired		Total
	Development cost	Software license	Goodwill	
	Rs. m	Rs. m	Rs. m	Rs. m
Cost				
At the start of the year	290	64	900	1,254
Additions	60	14	-	74
Business combination	-	-	20	20
Disposals	(30)	(4)	-	(34)
At the end of the year	320	74	920	1,314
Accumulated amortisation and impairment losses				
At the start of the year	140	31	120	291
Amortisation	25	10	-	35
Impairment losses	-	-	15	15
Disposals	(10)	(2)	-	(12)
At the end of the year	155	39	135	329
Net carrying amount				
At the end of the year	165	35	785	985
At the start of the year	150	33	780	963

► **Example 22:****Accounting Policy (Illustrative) – Intangible assets**

The intangible assets of the group comprise patents, licences and computer software.

The entity accounts for all intangible assets at historical cost less accumulated amortisation and accumulated impairment losses.

Computer software

Development costs that are directly attributable to the design and testing of identifiable and unique software products controlled by the group are recognised as intangible assets when the following criteria are met:

- it is technically feasible to complete the software product so that it will be available for use;
- management intends to complete the software product and use or sell it;
- there is an ability to use or sell the software product;
- it can be demonstrated how the software product will generate probable future economic benefits;
- adequate technical, financial and other resources to complete the development and to use or sell the software product are available; and
- The expenditure attributable to the software product during its development can be reliably measured.

Directly attributable costs that are capitalised as part of the software product include the software development employee costs and an appropriate portion of relevant overheads.

Development expenditures that do not meet these criteria are recognised as an expense as incurred. Costs associated with maintaining computer software programmes are recognised as an expense as incurred.

Useful lives

Amortisation is calculated using the straight-line method to allocate their cost or revalued amounts to their residual values over their estimated useful lives, as follows:

- Patents: 25 to 30 years
- Licenses 5 to 15 years
- Computer software 3 years

All intangible assets are estimated as having a zero residual value.

6.4 Disclosure under certain circumstances [IAS 38: 122]

An entity shall also disclose:

- a) for an intangible asset assessed as having an indefinite useful life, the carrying amount of that asset and the reasons supporting the assessment of an indefinite useful life. In giving these reasons, the entity shall describe the factor(s) that played a significant role in determining that the asset has an indefinite useful life.
- b) a description, the carrying amount and remaining amortisation period of any individual intangible asset that is material to the entity's financial statements.
- c) for intangible assets acquired by way of a government grant and initially recognised at fair value:
 - i. the fair value initially recognised for these assets;
 - ii. their carrying amount; and
 - iii. whether under the cost model or the revaluation model.
- d) the existence and carrying amounts of intangible assets whose title is restricted and the carrying amounts of intangible assets pledged as security for liabilities.
- e) the amount of contractual commitments for the acquisition of intangible assets.

6.5 Disclosure in case of revalued intangible assets [IAS 38: 124]

If intangible assets are accounted for at revalued amounts, an entity shall disclose the following:

- a) by class of intangible assets:
 - i. the effective date of the revaluation;
 - ii. the carrying amount of revalued intangible assets; and
 - iii. the carrying amount using the cost model; and
- b) the amount of the revaluation surplus that relates to intangible assets at the beginning and end of the period, indicating the changes during the period and any restrictions on the distribution of the balance to shareholders.

6.6 Disclosure of research and development expense [IAS 38: 126 & 127]

An entity shall disclose the aggregate amount of research and development expenditure recognised as an expense during the period. Research and development expenditure comprises all expenditure that is directly attributable to research or development activities.

6.7 Additional disclosure [IAS 38: 128]

An entity is encouraged, but not required, to disclose the following information:

- a description of any fully amortised intangible asset that is still in use; and
- a brief description of significant intangible assets controlled by the entity but not recognised as assets because they did not meet the recognition criteria.

► **Example 23:**

Toby entered into the following transactions during the year ended 31 December 2015. The directors of Toby wish to capitalise all assets wherever possible.

On 1 January Toby acquired the net assets of George for Rs. 105,000. The assets acquired had the following book and fair values.

	Book value	Fair value
	Rs.	Rs.
Goodwill	5,000	5,000
Patents	15,000	20,000
Non-current assets	40,000	50,000
Other sundry net assets	30,000	25,000
	90,000	100,000

- The patent expires at the end of 2022. The goodwill arising from the above had a recoverable value at the end of 2015 of Rs. 7,000.
- On 1 April Toby acquired a brand from a competitor for Rs. 50,000. The directors of Toby have assessed the useful life of the brand as five years.
- During the year Toby spent Rs. 40,000 on developing a new brand name. The development was completed on 30 June. The useful life of this brand has been assessed as eight years.
- The directors of Toby believe that there is total goodwill of Rs. 2 million within Toby and that this has an indefinite useful life.

Required:

Prepare the note to the financial statements for intangible assets as at 31 December 2015.

► **ANSWER:**

	Goodwill	Patents	Brands	Total
Intangible assets	Rs.	Rs.	Rs.	Rs.
Cost				
On 1 January 2015	-	-	-	-
Acquired in business combination	10,000 ^{w1}	20,000	-	50,000
Separately acquired	-	-	50,000	30,000
On 31 December 2015	10,000	20,000	50,000	80,000

	Goodwill	Patents	Brands	Total
	Rs.	Rs.	Rs.	Rs.
Acc. amortisation/impairment				
On 1 January 2015	-	-	-	-
Amortisation	-	2,500 ^{W3}	7,500 ^{W4}	10,000
Impairment	3,000 ^{W2}	-	-	3,000
On 31 December 2015	3,000	2,500	7,500	13,000
Carrying amount				
On 31 December 2015	7,000	17,500	42,500	67,000
On 31 December 2014	-	-	-	-

W1: Rs. 105,000 – 95,000 = Rs. 10,000

W2: Rs. 10,000 – 7,000 = Rs. 3,000

W3: Rs. 20,000 / 8 years = Rs. 2,500

W4: Rs. 50,000 / 5 years x 9/12 = Rs. 7,500

Tutorial note: IAS38 Intangible assets prohibits the recognition of internally generated brands (3) or internally-generated goodwill (4).

7 SIC 32: WEB SITE COSTS

7.1 The issue [SIC 32: 1 & 4]

An entity may incur expenditure on the development and operation of its own web site for internal or external access:

- a) A web site designed for external access may be used for various purposes such as to promote and advertise an entity's own products and services, provide electronic services, and sell products and services.
- b) A web site designed for internal access may be used to store company policies and customer details, and search relevant information.

The main issues are:

- a) whether the web site is an internally generated intangible asset that is subject to the requirements of IAS 38; and
- b) the appropriate accounting treatment of such expenditure.

7.2 Exclusion from scope [SIC 32: 5 & 6]

SIC 32 does not apply to expenditure on

- a) purchasing, developing, and operating hardware (e.g. web servers, staging servers, production servers and internet connections). IAS 16 applies.
- b) when an entity incurs expenditure on an Internet service provider hosting the entity's web site, the expenditure is recognised as an expense when services are received (conceptual framework and IAS 1.88)
- c) the development or operation of a web site for sale to another entity (IAS 2 and IFRS 15 applies).
- d) Leases of intangible assets accounted for under IFRS 16

7.3 General Consensus [SIC 32: 7 & 8]

An entity's own web site is an internally generated intangible asset that is subject to the requirements of IAS 38. It should be recognised as an intangible asset if it satisfies the IAS 38 recognition criteria.

If a web site is developed solely (or primarily) for promoting and advertising its own products and services, then an entity will not be able to demonstrate how it will generate probable future economic benefits. All expenditure on developing such a web site should be recognised as an expense when incurred.

The nature of each activity for which expenditure is incurred (e.g. training employees and maintaining the web site) and the web site's stage of development or post development should be evaluated to determine the appropriate accounting treatment

The best estimate of a web site's useful life should be short.

7.4 Consensus: Planning Stage [SIC 32: 2 & 9]

The planning stage of web site development includes:

- a) Feasibility studies
- b) Defining hardware and software specifications
- c) Evaluating alternative products and suppliers
- d) Selecting preferences.

This stage is similar in nature to the research phase and expenditure incurred in this stage shall be recognised as an expense when it is incurred.

7.5 Consensus: Development Stage [SIC 32: 2 & 9]

The development stage may include:

- a) Application and Infrastructure Development:
 - i. Obtaining a domain name
 - ii. Developing operating software (e.g. operating system and server software)
 - iii. Developing code for the application
 - iv. Installing developed applications on the web server
 - v. Stress testing
- b) Graphical Design Development i.e. designing the appearance of web pages.
- c) Content Development i.e. creating, purchasing, preparing and uploading information on the web site before the completion of the web site's development.

This stage is similar in nature to the development phase. The accounting treatment is as follows:

- a) Charge as an expense if sole/primary purpose is to advertise or promote an entity's own products and services.
- b) Capitalise to the extent that content is developed for purposes other than to advertise or promote entity's own products and services.
- c) Past expense shall not be reinstated as asset.

7.6 Consensus: Operating Stage [SIC 32: 3 & 9]

The operating stage of web site includes:

- a) Updating graphics and revising content
- b) Adding new functions, features and content
- c) Registering the web site with search engines
- d) Backing up data
- e) Reviewing security access
- f) Analysing usage of the web site

The operating stage begins once development of a web site has been completed. During this stage, an entity maintains and enhances the applications, infrastructure, graphical design and content of the web site. Expenditure incurred in this stage shall be recognised as an expense when it is incurred unless it meets the recognition criteria in IAS 38.

7.7 Other web site related costs

The following costs should be charged as expense when incurred:

- a) Selling, administrative and other general overhead expenditure unless it can be directly attributed to preparing the web site for use
- b) Inefficiencies and initial operating losses incurred
- c) Training employees to operate the web site

► **Example 24:**

Ajwa Limited (AL) is engaged in the business of manufacturing and trading of consumer goods. On 1 July 2021, AL launched its own website for online sale of its products. The website was developed internally which met the criteria for recognition as an intangible asset on 1 May 2021. Directly attributable costs incurred for the website are as follows:

	*Incurred in 2021	Rs. in million
Defining hardware and software specifications	January to March	0.5
Salaries and general overheads	January to June	6.0
Development of the content	May to June	7.0
Registering website with search engines	June	1.0
Annual fees for website hosting	June	0.6
Employees training costs	June to July	1.5
Discount offers for logging on the website	July to August	2.0

***All costs were incurred evenly throughout the mentioned period.**

Required:

Compute the cost of the website for initial measurement. Also discuss the reason(s) for not inclusion of any of the above costs in the computation.

► **ANSWER:**

Cost of website:		Rs. in million
Salaries and general overheads	Rs. 6m x 2/6 months	2.0
Development of the content		7.0
Registering website with search engines		1.0
		10.0

Items not included:

Defining hardware and software specifications	This activity relates to research phase (planning stage as per SIC 32) so should be expensed out.
Salaries and general overheads	Since salaries and general overheads of Rs. 4 million from January 2021 to April 2021 were incurred before meeting of recognition criteria, it should be expensed out.
Annual fees for hosting website	This is operating expense (operating stage as per SIC 32) which is of recurring nature so it should be expensed out.
Employees training costs	This is not eligible cost for capitalization (due to lack of control and reliable measurement) so it should be expensed out.
Discount offers for logging on the website	This is promotional activity (operating stage as per SIC 32) related to post development so it should be expensed out.

► **Example 25:**

Zinc Limited (ZL), a broadcasting company, uses revaluation model for subsequent measurement of its intangible assets, wherever possible. Following information pertains to ZL's intangible assets:

- i. On 1 January 2018, ZL bought an incomplete research and development project from Bee Tech at its fair value of Rs. 90 million. The purchase price was analysed as follows:

	Rs. in million
Research	30
Development	60

Subsequent expenditures incurred on this project are as follows:

	Rs. in million
Further research to identify possible markets	10
Development	48

Recognition criteria for capitalization of development was met on 1 March 2018. All costs are incurred evenly from 1 January 2018 till project completion date i.e. 31 August 2018. It is expected that newly developed technology will provide economic benefits to ZL for the next 10 years.

On 31 December 2018, ZL received an offer of Rs. 170 million for its developed technology.

- ii. On 31 December 2018, ZL launched its new website for online streaming of TV shows, movies and web series. The website's content is also used to advertise and promote ZL's products. The website was developed internally and met the criteria for recognition as an intangible asset. Directly attributable costs incurred for the website are as follows:

	Rs. in million
Undertaking feasibility studies	3
Evaluating alternative products	1
Acquisition of web servers	16
Acquisition cost of operating system of web servers	7
Registration of domain names	2
Stress testing to ensure that website operates in intended manner	3
Designing the appearance of web pages	5
Development cost of new content related to:	
online streaming	11
advertising and promoting ZL's products	8
Advertising of the website	6

- iii. During 2018, the licensing authority intimated that broadcasting license of one of ZL's channels will not be further renewed.

ZL had obtained this license for indefinite period on 1 January 2012 by paying Rs. 150 million, subject to renewal fee of Rs. 0.3 million at every five years. Upto last year, this license was expected to contribute to ZL's cash inflows for indefinite period.

As on 31 December 2018, the recoverable amount of this license was assessed as Rs. 105 million.

Required:

In accordance with the requirements of IFRSs, prepare a note on intangible assets, for inclusion in ZL's financial statements for the year ended 31 December 2018 in respect of the above intangible assets. ('Total' column is not required)

► ANSWER:

Zinc Limited**Notes to the financial statements****For the year ended 31 December 2018**

	Research & Development	Website	License
INTANGIBLE ASSETS	----- Rs. in million -----		
<u>Cost</u>			
As at 1 Jan			150
Separate acquisition	90		
Development	36 ^{W1}	21 ^{W3}	
As at 31 Dec	126	21	150
Accumulated Amortisation & Impairment			
As at 1 Jan			
Amortisation	4.2 ^{W2}		37.5 ^{W4}
Impairment loss			7.5 ^{W5}
As at 31 Dec	4.2	0	45
Carrying amount 2018	121.8	21	105
Carrying amount 2017	0	0	150
Useful life	10	N/A	4
Amortisation method	Straight line	N/A	Straight line

W1: Rs. 48m x 6/8 months = Rs. 36m

W2: Rs. 126m / 10 years x 4/12 = Rs. 4.2m

W3: Domain Rs. 2m + Stress testing 3m + Designing 5m + Streaming content 11m = Rs. 21m

W4: Rs. 150m / 4 years = Rs. 37.5m

W5: Rs. 105m – (150m – 37.5m) = Rs. 7.5m

8 COMPREHENSIVE EXAMPLES

► Example 26:

Dove Limited (DL) commenced development of a new product on 1 January 2020. In this regard, following expenditures have been incurred:

Description	Incurred in	Rs. in million
Evaluation of possible alternatives	January 2020	2
Pre-production prototypes	February and March 2020	17
Pilot plant	April to July 2020	40
Fee to register legal rights	August 2020	15
Cost of manufacturing samples	August to October 2020	*32
Brand building cost	October to December 2020	16

***NRV of Rs. 20 million**

DL has also incurred directly attributable salaries and overheads of Rs. 5 million and Rs. 1.5 million respectively in each month over the development period of new product.

The recognition criteria for capitalization of internally generated intangible asset was met on 1 April 2020 and commercial production of the product was commenced from 1 November 2020.

Required:

Compute the cost of the new product for initial measurement. Also discuss the reason(s) for ignoring any of the above expenditures in the computation.

► ANSWER:

Cost of product:		Rs. in million
Pilot plant		40.0
Fee to register patent		15.0
Cost of manufacturing the samples	32-20	12.0
Salaries and administrative overheads	$[(5+1.5) \times 7]$	45.5
		112.5

Reasons for ignoring cost:

Description	Rs. in million	Reasons
Evaluation of possible alternatives	2	This is part of research and therefore should not be capitalised.
Pre-production prototypes	17	Since this cost was incurred before meeting of recognition criteria, this should be charged to P & L.
Brand building	16	This is selling cost and therefore should not be capitalised.
Salaries and overheads	19.5 $[(5+1.5) \times 3]$	Since salaries and overheads from January 2020 to March 2020 were incurred before meeting of recognition criteria, this should be charged to P & L.

► **Example 27:**

On 1 July 2016, Sunshine Limited (SL) acquired four licenses namely A, B, C and D for a period of ten years. The following information is available in respect of these licenses:

	A	B	C	D
Cost of license (Rs. in million)	200	230	90	60
Expected period of cash generation from acquisition date	12 years	indefinite	6 years	12 years
Active market value at 30 June 2017 (Rs. in million)	170	300	65	No active market
Renewal cost (Rs. in million)	65	85	2	1

The renewal would allow SL to use the licenses for another five years.

SL uses the revaluation model for subsequent measurement of its intangible assets.

An independent valuer has estimated the value of license 'D' at Rs. 130 million.

Required:

Determine the amounts that should be recognised in respect of the licenses in the statement of financial position and statement of profit or loss for the year ended 30 June 2017.

► **ANSWER:****Sunshine Limited**

For the year ended 30 June 2017	Rs. in million
Amount to be recognised in SOFP	
Intangibles – Licenses (170+300+65+55)	590
Revaluation surplus	(W-1) 93
Amount to be recognised in SOPL	
Amortization	(W-1) 63
Impairment	(W-1) 20

	A	B	C	D	Total
W-1:	-----Rs. in million-----				
Cost of licenses	200	230	90	60	580
Amortization for the year	(20)	(23)	(15)	(5)	(63)
	(200÷10)	(230÷10)	(90÷6)	(60÷12)	
Cost less amortization	180	207	75	55	517
Active market value	170	300	65	N/A	
Impairment	(10)	-	(10)		(20)
Revaluation surplus	-	93	-	-	93

► **Example 28:**

Opal Limited (OL) commenced research work on a new product on 1 July 2013 and entered the development phase on 1 July 2014. In this respect, the following expenses were incurred and debited to capital work in progress.

	For the year ended	
	30 Jun 2015	30 Jun 2014
	----- Rs. in million -----	
Research and development cost	12.00	8.00
Training of technical staff	0.90	-
Cost of laboratory equipment *	-	4.00
Cost of trial run	0.60	-
	13.50	12.00

* **Purchased on 1 January 2014, having estimated useful life of five years.**

Criteria for recognition of the internally generated intangible asset have been met. The commercial production was started from 1 January 2015. It is estimated that the related product would have a shelf life of 10 years.

Required:

Explain accounting treatment of the above in the financial statements for the year ended 30 June 2015 in the light of International Financial Reporting Standards.

► **ANSWER:****Opal Limited - Accounting treatment for research and development expenses****Development cost recognition as intangible asset:**

Since the new product met all the criteria for the development of a product, an intangible asset should be recognised at Rs. 13 million (12+0.4+0.6) as detailed under:

- Cost of Rs. 12 million incurred during the development phase that is 1 July 2014 to 31 December 2014.
- Depreciation of Rs. 0.4 million ($4.0 \div 5 \times 0.5$) on laboratory equipment for the development phase of six months from 1 July 2014 to 31 December 2014.
- Cost of trial run amounted to Rs. 0.6 million

Amortization of intangible asset:

Since the product has a shelf life of 10 years, the amortization expense amounting to Rs. 0.65 million ($13 \div 10 \times 6/12$) should be charged to profit and loss account for the period of six months i.e. 1 January to 30 June 2015.

Laboratory equipment cost recognition as tangible asset:

Laboratory equipment cost should be capitalised as a tangible asset as it is having useful life of more than one year and to be depreciated over its useful life of five years.

Research and other costs:

- IAS-38 does not allow capitalization of costs pertaining to research work. Therefore, these costs should be charged to profit and loss account in the period in which they incurred. However, research cost of Rs. 8 million. and depreciation for the research phase of Rs. 0.4 million ($4 \div 5 \times 0.5$) pertained to last year, therefore, comparative figures for the year ended 30 June 2014 should be restated and retained earnings be adjusted for these amounts.
- Cost for training of staff is also not allowed for capitalization and should be charged to profit and loss account for the year ended 30 June 2015.
- Depreciation of Rs. 0.4 million on laboratory equipment for the period from the commencement of the commercial production i.e. 1 January to 30 June 2015 should be charged to profit and loss account for the year ended 30 June 2015.

► **Example 29:**

Draft financial statements of Tulip Limited (TL) for the year ended 31 December 2017 show the following amounts:

	Rs. in million
Total assets	2,700
Total liabilities	1,620
Net profit for the year	398

While reviewing the draft financial statements, following matters have been noted:

TL commenced development of a new product on 1 January 2017. Following directly attributable costs have been incurred upto the launching date of 1 October 2017 and have been capitalised as intangible asset:

	Rs. in million
Staff salary	30
Equipment (having useful life of 5 years)	360
Consumables	90
Consultant fee	212
Total	692

The recognition criteria for capitalization of internally generated intangible assets was met on 1 March 2017. All costs have been incurred evenly during the period except equipment which was purchased specifically for this product on 1 January 2017.

TL estimated that useful life of this new product will be 10 years. However, TL had not charged any amortization in 2017.

Required:

Determine the revised amounts of total assets, total liabilities and net profit, after incorporating the impact of above adjustment(s), if any.

► ANSWER:

Tulip Limited

	Profit	Total assets	Total liabilities
Description	----- Rs. in million -----		
As per question	398	2,700	1,620
<i>Costs incurred before capitalisation criteria:</i>			
Depreciation (Rs. 360/5 years x 2/12)	(12)	(12)	
Other costs (Rs. 332 x 2/9 months)	(74)	(74)	
<i>Expenses after asset is in use:</i>			
Depreciation (Rs. 360 /5 years x 3/12)	(18)	(18)	
Amortisation (Rs. 300* /10 years x 3/12)	(7.5)	(7.5)	
Revised amounts	286.5	2,588.5	1,620

*Development asset capitalised at Rs. 42m + 258m = Rs. 300m calculated as given below:

Depreciation Capitalised Rs. 360m/5 years x 7/12 = Rs. 42m

Other costs Capitalised Rs. 332m x 7/9 months = Rs. 258m

Costs other than equipment = Rs. 692m – 360m = Rs. 332m

► Example 30:

Following information pertains to International Associates Limited (IAL):

i. Intangible assets as at 30 June 2015 were as follows:

	Brands	Software	License
Useful life (years)	10	5	Indefinite
	----- Rs. in million -----		
Cost	200	80	15
Accumulated amortization / impairment	40	48	-

ii. Details of expenses incurred on a project to improve IAL's existing production process are as under:

Period	Rs. in million
Up to June 2015	20
July 2015 – March 2016	45

Expenses were incurred evenly during the above period. On 30 September 2015, it was established that the project is commercially viable. The new process became operational with effect from 1 April 2016 and it is anticipated that it will generate cost savings of Rs. 10 million per annum for a period of 10 years.

- iii. On 1 August 2015, IAL entered into an agreement to acquire an ERP software which would replace its existing accounting software. The new software became operational on 1 April 2016. IAL incurred following expenditure in respect of the ERP software:

Description	Rs. in million
Purchase price (including 15% sales tax)	115
Training of staff	2
Consultancy charges for implementation of ERP	5

ERP software has an estimated useful life of 15 years. However, IAL expects to use it for a period of 10 years. The existing accounting software has become redundant and is of no use for the company.

- iv. During the year ended 30 June 2016, IAL spent Rs. 10 million on development of a new brand. Useful life of the brand is estimated as ten years.
- v. The license appearing in IAL's books was issued by the government for an indefinite period. However, on 1 January 2016 the Government introduced a legislation under which the existing license would have to be renewed after ten years.
- vi. IAL uses cost model to value its intangible assets and amortises them on straight-line basis.

Required:

Prepare a note on "intangible assets" for inclusion in IAL's financial statements for the year ended 30 June 2016 in accordance with International Financial Reporting Standards.

► ANSWER:

International Associates Limited

Notes to the financial statements

For the year ended 30 June 2016

Note: Intangible assets	Brands	Software	License	Development	Total
	 Rs. In million				
Cost					
1 July 2015	200	80	15		295
Additions		120 ^{W3}		30 ^{W1}	150
Derecognition		(80)			
30 June 2016	200	120	15	30	365
Accumulated Amortisation					
1 July 2015	40	48			88
Amortisation	20 ^{W5}	15 ^{W4}	0.75 ^{W6}	0.75 ^{W2}	36.5
Derecognition		(60)			(60)
30 June 2016	60	3	0.75	0.75	64.5
Carrying amount 2016	140	117	14.25	29.25	300.5
Carrying amount 2015	160	32	15	0	207

W1: Rs. 45m x 6/9 months = Rs. 30m

W2: Rs. 30m / 10 years x 3/12 = Rs. 0.75m

W3: Rs. 115m + 0 + 5m = Rs. 120m

W4: Rs. 120m / 10 years x 3/12 + Rs. 80m / 5 years x 9/12 = Rs. 15m

W5: Rs. 200m / 10 years = Rs. 20m

W6: Rs. 15m / 10 years x 6/12 = Rs. 0.75m

► **Example 31:**

Qabil Limited (QL) is in process of finalizing its financial statements for the year ended 31 December 2019. Following information pertains to QL's intangible assets:

- i. Intangible assets as at 31 December 2018 were as follows:

	Product design	ERP software
	---- Rs. in million ----	
Cost	750	200
Accumulated amortization / impairment	75	80
	----- Years -----	
Useful life	10	8

- ii. Cost incurred on development of product design was capitalised in 2018. The competition for the product is increasing. QL has estimated the following net cash inflows from the product:

Year	2020	2021	2022	2023	2024	2025 & onwards
Net cash inflows (Rs. in million)	190	170	140	100	80	Nil

Pre-tax and post-tax discount rates are 12% and 10% respectively.

- iii. On 1 January 2019, QL entered into an agreement to replace existing ERP software with a new ERP software at a cost of Rs. 360 million. According to the agreement, 40% payment was made on signing of the contract while the remaining amount was paid evenly over customization and installation period which completed on 31 October 2019.

The entire cost of project was financed through a running finance from Honehaar Bank at mark- up of 15% per annum. The software became operational on 1 November 2019. QL expects to use it for a period of 9 years.

The existing ERP software will be continued till 31 December 2020.

- iv. On 1 January 2019, QL acquired a licence for Rs. 600 million for a period of 5 years. QL made an initial payment of Rs. 100 million and the remaining amount will be paid in two equal instalments on 1 January 2020 and 2021. Cash price equivalent of the license is Rs. 520 million.

On expiry of 5 years, the license is renewable for further five years at an insignificant cost of Rs. 15 million. QL intends to renew the license and sell it at the end of 8th year.

In the absence of any active market, QL has estimated that residual value of the license would be Rs. 80 million and Rs. 60 million at the end of 8th year and 10th year respectively.

Required:

Prepare a note on 'Intangible assets' for inclusion in QL's financial statements for the year ended 31 December 2019 in accordance with the requirements of IFRSs.

► ANSWER:

Qabil Limited**Notes to the financial statements for the year ended 31 December 2019**

INTANGIBLE ASSETS	Product design	ERP software	License
	----- Rs. in million -----		
Cost			
As at 1 January	750	200	
Separate acquisition			520
Development		391.5 ^{W1}	
As at 31 December	750	591.5	520
Accumulated amortisation and impairment			
As at 1 January	75	80	
Amortisation	112.5 ^{W3}	67.25 ^{W5}	65 ^{W6}
Impairment loss	48.7 ^{W4}		
As at 31 December	236.2	147.25	65
Carrying amount			
Year 2019	513.8 ^{W2}	444.25	455
Year 2018	675	120	0
Measurement basis	Cost model	Cost model	Cost model
Useful life (years)	6	2 & 9	8
Amortisation method	Straight line	Straight line	Straight line
W1: Cost of software			Rs. in million
Purchase price			360.00
Borrowing cost: On advance $(360 \times 40\% \times 15\%) \times (10 \div 12)$			18.00
On remaining payments $[(360 \times 60\% \times 15\%) \times 10 \div 12] \div 2$			13.50
			391.50

W2: Value in use

Years	Cash flow	Discount factor @ 12%	Amount
	Rs. in million		Rs. in million
2020	190	0.8929	169.6
2021	170	0.7972	135.5
2022	140	0.7118	99.6
2023	100	0.6355	63.6
2024	80	0.5674	45.4
			513.8

W3: $(\text{Rs. } 750\text{m} - 75\text{m}) / 6 \text{ years} = \text{Rs. } 112.5\text{m}$

W4: $\text{Rs. } 513.8\text{m} - 75\text{m} - 112.5\text{m} = \text{Rs. } 48.7\text{m}$

W5: $(\text{Rs. } 200\text{m} - 80\text{m}) / 2 \text{ years} + \text{Rs. } 391.5\text{m} / 9 \text{ years} \times 2/12 = \text{Rs. } 67.25\text{m}$

W6: $\text{Rs. } 520\text{m} / 8 \text{ years} = \text{Rs. } 65\text{m}$

► **Example 32:**

Apple Limited (AL) is in the process of finalizing its consolidated financial statements for the year ended 30 June 2018. Following information pertains to the Group's intangible assets:

- As on 30 June 2017, revalued amount of AL's license and related revaluation surplus were Rs. 450 million and Rs. 30 million respectively.
- On 1 July 2017 AL acquired entire shareholding of Mango Limited (ML) for Rs. 1,950 million. Fair values of net assets appearing in ML's books on acquisition date are given below:

	Rs. in million
Software (Rs. 100 million each)	200
Other net assets	1,545

In respect of acquisition of ML, following information is also available:

- Till acquisition date, ML had incurred research & development cost of Rs. 80 million on product 'ABC'. ML had not recognised this as an asset because criteria for recognition of the internally generated intangible asset was met on 1 July 2017. On this date, AL estimated that the fair value of research and development work on ABC was Rs. 95 million.
 - On acquisition date, fair value of ML's customer list was assessed at Rs. 20 million.
- ML incurred following expenditures on this project from 1 July 2017 till ABC's launching date i.e. 1 May 2018.

	Rs. in million
Market research	5
Product design	12
Cost of pilot plant (not for commercial production)	48
Refinement of product before commercial production	6
Training of production staff	8
Testing of pre-production	4
Production and launching of product	105
	188

- As on 1 July 2017, the fair value of AL's own customer list was assessed at Rs. 35 million.
- As on 1 July 2017, remaining useful life of all intangible assets except goodwill was 10 years.
- On 31 March 2018, ML sold one of its software for Rs. 110 million.
- Group follows the revaluation model for license whereas cost model is used for other intangible assets.
- As on 30 June 2018:
 - fair value of licence was assessed at Rs. 350 million.
 - goodwill of ML has been impaired by 20%.

Required:

Prepare a note on intangible assets, for inclusion in AL's consolidated financial statements for the year ended 30 June 2018 in accordance with the requirements of IFRSs. (**Total' column is not required**)

► **ANSWER:****Apple Limited****Notes to the consolidated financial statements****For the year ended 30 June 2018**

	License	Software	Goodwill	R&D	Customer lists
Intangible assets	Rs. in million				
As at 1 July 2017	450				
Business acquisitions		200	90 ^{W1}	95	20
Development				70 ^{W2}	
Revaluation adjustment	(45)				
Revaluation (loss)	(55) ^{W7}				
Disposal		(100)			
As at 30 June 2018	350	100	90	165	20

Accumulated amortisation and impairment					
As at 1 July 2017	0				
Amortisation	45 ^{W3}	17.5 ^{W4}		2.75 ^{W5}	2 ^{W6}
Impairment			18 ^{W8}		
Revaluation adjustment	(45)				
Disposal		(7.5)			
As at 30 June 2018	0	10	18	2.75	2
<i>Carrying amount 2018</i>	<i>350</i>	<i>90</i>	<i>72</i>	<i>162.25</i>	<i>18</i>
<i>Carrying amount 2017</i>	<i>450</i>	<i>0</i>	<i>0</i>	<i>0</i>	<i>0</i>

W1: Rs. 1,950m – (200m + 1,545m + 95m + 20m) = Rs. 90m

W2: Rs. 12m product design + 48m pilot plant + 6m refinement + 4m testing = Rs. 70m

W3: Rs. 450m / 10 years = Rs. 45m

W4: Rs. 100m / 10 years + Rs. 100m / 10 years × 9/12 = Rs. 17.5m

W5: Rs. 165m / 10 years × 2/12 = Rs. 2.75m

W6: Rs. 20m / 10 years = Rs. 2m

W7: Rs. 350m – (450m – 45m) = Rs. 55m loss

W8: Rs. 90m × 20% = Rs. 18m

► **Example 33:**

The following transactions pertain to Amused Limited (AL):

- In 2020, AL started development of a new product. The recognition criteria for capitalization of internally generated intangible asset was met on 1 January 2021. On this date, AL started development of a plant which completed in 3 months. It is pilot plant for testing the new product and is not of a scale economically feasible for commercial production. AL incurred cost of Rs. 3 million and Rs. 7 million on design and construction of plant respectively. AL expects to operate the plant for two years till end of development phase. During 2021, AL incurred Rs. 5 million in operating the pilot plant.

- ii. On 1 March 2021, AL acquired a patent with indefinite life in exchange of its old equipment and cash consideration of Rs. 25 million. The fair values of the patent and equipment were assessed at Rs. 57 million and Rs. 35 million respectively. On the date of exchange, the equipment had a carrying value of Rs. 30 million. AL believes that its future cash flows will change as a result of this exchange. AL incurred cost of Rs. 2 million for transferring the title of the patent to its name.
- iii. On 1 June 2021, the government granted a license to AL free of cost to import raw material upto 10 tons from international market for its intended use. The license is non-transferable. There are no further conditions attached by the government. The fair value of the license is Rs. 50 million.

Required:

Explain how each of the above transactions should be accounted for in the financial statements of AL for the year ended 31 December 2021, in accordance with the requirements of IFRSs.

► **Answer:****Part (i)**

Cost incurred on pilot plant should be recorded as intangible as it falls under development activities. As criteria for capitalizing development cost has been met, all cost (i.e. designing, constructing and operating) incurred on pilot plant should be capitalised as an intangible. Amortization will begin once development activity ends and commercial production starts over the life of product.

Part (ii)

This exchange has a commercial substance and future cash flows are expected to change as a result of this exchange. Therefore, the exchange should be recognised at fair value. As fair value of both assets exchanged is given, the exchange should be recorded at the fair value of equipment given. So, the patent should be recorded at Rs. 60 million i.e. sum of fair value of equipment given up (Rs. 35 million) and cash consideration (Rs. 25 million). Further, cost of transferring title of Rs. 2 million should be added to cost of patent. No amortization will be charged on patent due to indefinite life. However, the patent will be tested for impairment annually.

Part (iii)

Grant of license by government should be treated as government grant. The license can be recorded as intangible asset at its fair value of Rs. 50 million. Government grant so recognised should be amortized to P&L over the life of license. Alternatively, intangible asset can be recorded at a nominal amount. AL should select an accounting policy in this regard and apply it consistently.

► **Example 34:**

The following transactions pertain to Sphere Limited (SL) for the year ended 30 June 2022:

Transaction (i)

On 1 July 2021, SL acquired a license against cash consideration of Rs. 50 million. SL incurred cost of Rs. 3 million which includes refundable taxes of Rs. 1 million for transferring the title to its name.

The license is valid for five years but is renewable every five years at a significant cost of Rs. 40 million. SL intends to renew the license only once and then sell the license at the end of ten years.

SL estimates that residual value of the license would be Rs. 12 million and Rs. 9 million at the end of five years and ten years respectively.

Transaction (ii)

On 1 July 2021, SL decided to develop a website for advertising and promotion of its products. SL believes that website would enhance the brand value of the products and would also be used for providing general information about SL to the public.

On 1 September 2021, SL internally initiated development of the website which was completed on 31 January 2022. Directly attributable costs incurred by SL for developing website were as follows:

- Rs. 2 million for planning the website in September 2021.
- Rs. 7 million for acquisition of the web servers in October 2021.
- Rs. 3 million for content development equally in November and December 2021.
- Rs. 1 million for annual website hosting fees (valid till 31 January 2023) paid in January 2022.

Required:

Discuss how the above transactions should be dealt with in the SL's books for the year ended 30 June 2022, in accordance with the IFRSs.

► **Answer:**

Transaction (i)

The license should be recognised as intangible asset at initial cost of Rs. 52 million (50+2). The transfer fee being directly attributable cost should be included while refundable tax of Rs. 1 million should not be included in cost.

The useful life of license will be restricted to the original five years as the renewal cost of Rs. 40 million is significant which should be considered separate intangible at the time of renewal. The residual value of license at the end of five years as zero because there is no commitment by 3rd party to purchase the license and there is no active market for the license. The amortization for the year should be Rs. 10.4 million (52/5).

Transaction (ii)

As per IAS 38, Rs. 5 million (2+3) for planning and content development should be expensed out. Website is developed primarily for promoting and advertising SL's products and services. So, SL will not be able to demonstrate how it will generate probable future economic benefits.

Rs. 7 million incurred for acquisition of the web servers should be capitalised under property, plant and equipment and depreciated over useful life.

Since webhosting fees is paid for one year, Rs. 0.42 (1/12×5) million will be expensed out while Rs. 0.58 million will be recorded as prepayment.

► **Example 35:**

The following information pertains to the intangible assets of Irresistible Limited (IL):

Information (i)

IL started a research and development project for a new product Alpha, on 1 February 2023. Up till the launch date of 1 December 2023, the following directly attributable costs were incurred on Alpha:

	Date(s) of incurrence	Rs. in million
Staff salary	February to November 2023	60
Equipment (useful life of five years)	1 April 2023	120
Consumables	February to November 2023	70
Consultant fee	May to November 2023	28
Total		278

Though the development activities started on 1 May 2023, the recognition criteria for the capitalization of internally generated intangible assets were met on 1 June 2023. All costs have been incurred evenly during the period mentioned against each cost. The useful life of Alpha is estimated to be six years.

Information (ii)

On 1 July 2023, IL launched its new web site for online sale of its products. The web site was developed internally and met the criteria for recognition as an intangible asset. Directly attributable costs incurred for the web site are as follows:

	Rs. in million
Acquiring of web servers and its operating system	22
Capturing digital photographs of the products	6
Conducting feasibility studies and selecting preferences	2
Creating and uploading new content on the web site	13
Developing code and installing developed applications on the web server	8
Providing additional discount to customers for ordering through web site	9
Registering of domain names	3

It is estimated that the web site would be technologically obsolete in 4 years; however, IL plans to incur additional expenditures on the web site to incorporate new technologies, which will enable IL to use the web site for 8 years.

Required:

Prepare a note on 'Intangible assets' for inclusion in IL's financial statements for the year ended 31 December 2023, in accordance with the requirements of IFRSs. ('Total' column is not required).

► **Answer:****Irresistible Limited****Notes to the financial statements for the year ended 31 December 2023**

	Product development	Web site
Note: Intangible assets	Rs. m	Rs. M
Cost		
1 January	0	0
Addition through development	114	24
31 December	114	24
Accumulated amortisation		
1 January	0	0
For the year	(1.6)	(3)
31 December	(1.6)	(3)
Carrying amount	112.4	21
Basis of measurement	Cost	Cost
Useful life (in years)	6	4
Amortisation method	Straight line	Straight line

W1: Product development		Rs. in million
Staff salary	Rs. 60m x 6/10 months	36.0
Depreciation on equipment	Rs. 120m / 5 years x 6/12	12.0
Consumables	Rs. 70m x 6/10 months	42.0
Consultant fee	Rs. 28m x 6/7 months	24.0
		114.0
Amortisation	Rs. 114m / 6 years x 1/12	(1.6)
		112.4

W2: Web site cost		Rs. in million
Creating and uploading new content on the web site		13.0
Developing code and installing developed applications on the webserver		8.0
Registration of domain names		3.0
		24.0
Amortisation Rs. 24m / 4 years x 6/12		(3.0)
		21.0

► **Example 36:**

Average Limited (AL) is preparing its consolidated financial statements for the year ended 30 June 2024. The following information is available:

- i. On 1 October 2023, AL acquired the entire shareholding of Xlookup Limited (XL) for Rs. 4,140 million. The carrying amount of net assets appearing in XL's books on the acquisition date are provided below:

	Rs. in million
Software	400
Product NEO	210
Other net assets	2,880
	3,490

Additional details in respect of the acquisition of XL are as follows:

- Up to the acquisition date, XL had incurred Rs. 150 million and Rs. 350 million respectively on research and development for the Product NEO. XL had only recognised cost incurred after the recognition criteria for capitalization of the internally generated intangible asset was met i.e. 1 July 2022.
 - On the acquisition date, the fair value of the research and development work on NEO was estimated at Rs. 600 million. This fair value can be attributed to research component and development component in the ratio of 3:7.
- ii. XL incurred further directly attributable cost of Rs. 90 million on Product NEO after the acquisition until the launching date i.e. 31 December 2023. This comprises of materials for testing, staff salaries and training costs amounting to Rs. 32 million, Rs. 24 million and Rs. 34 million respectively. The commercial life of Product NEO was estimated to be 8 years.
- iii. On 1 October 2023, the remaining useful life of the software was 10 years.

- iv. On 1 April 2024, XL acquired a patent in respect of Product NEO at a cost of Rs. 48 million, with a useful life of 6 years.
- v. An impairment test carried out at year-end indicated that goodwill of XL has been impaired by 10% due to temporary adverse economic conditions.

Required:

Prepare the relevant extracts from AL's consolidated statement of profit or loss for the year ended 30 June 2024 and consolidated statement of financial position as at that date. (Comparative figures and notes to the financial statements are not required).

► *Answer:*

Average Limited**Consolidated statement of profit or loss for the year ended 30 June 2024**

		Rs. in million
Amortisation:		
– Software	$400 \div 10 \times 9 \div 12$	30
– Product NEO	$656 \div 8 \times 6 \div 12$	41
– Patent	$48 \div 6 \times 3 \div 12$	2
Impairment of goodwill	$260(\text{W-1}) \times 10\%$	26
Training costs on NEO		34

Consolidated statement of financial position as at 30 June 2024

		Rs. in million
Non-current assets:		
Goodwill	$260(\text{W-1}) - 26$	234
Software	$400 - 30$	370
Product NEO	$600 + 32 + 24 - 41$	615
Patent	$48 - 2$	46

W-1: Goodwill	Rs. in million
Consideration	4,140
Fair value of net assets acquired	
Software	400
Product NEO at fair value	600
Other net assets	2,880
	(3,880)
	260

9 OBJECTIVE BASED Q&A

1. Power Limited has spent Rs. 200,000 researching new cleaning chemicals in the year ended 31 December 2020. They have also spent Rs. 400,000 developing a new cleaning product which will not go into commercial production until next year. The development project meets the criteria laid down in IAS 38 Intangible Assets.

How should these costs be treated in the financial statements of Power Limited for the year ended 31 December 2020?

- Rs. 600,000 should be capitalised as an intangible asset on the statement of financial position.
 - Rs. 400,000 should be capitalised as an intangible asset and should be amortised; Rs.200,000 should be written off to the statement of profit or loss.
 - Rs. 400,000 should be capitalised as an intangible asset and should not be amortised; Rs. 200,000 should be written off to the statement of profit or loss.
 - Rs. 600,000 should be written off to the statement of profit or loss
2. Which TWO of the following items below could potentially be classified as intangible assets?
- purchased brand name
 - training of staff
 - internally generated brand
 - licences and quotas

3. Star Limited has provided the following information as at 31 December 2016:
- Project A – Rs. 500,000 has been spent on the research phase of this project during the year.
 - Project B – Rs. 800,000 had been spent on this project in the previous year and Rs. 200,000 this year. The project was capitalised in the previous year however, it has been decided to abandon this project at the end of the year.
 - Project C – Rs. 1,000,000 was spent on this project this year. The project meets the criteria of IAS 38 and is to be capitalised.

Which of the following adjustments will be made in the financial statements as at 31 December 2016?

- Charge to profit or loss Rs. 700,000 and net increase in non-current assets by Rs. 1,000,000
 - Charge to profit or loss Rs. 1,500,000 and net increase in non-current assets by Rs. 200,000
 - Charge to profit or loss Rs. 1,300,000 and net increase in non-current assets by Rs. 1,800,000
 - Charge to profit or loss Rs. 1,300,000 and net increase in non-current assets by Rs. 2,000,000
4. Which of the following statements concerning the accounting treatment of research and development expenditure are true, according to IAS 38 Intangible Assets?
- Research is original and planned investigation undertaken with the prospect of gaining new knowledge and understanding.
 - Development is the application of research findings.
 - Depreciation of plant used specifically on developing a new product can be capitalised as part of development costs.
 - Expenditure once treated as an expense cannot be reinstated as an asset.
- i, ii and iii
 - i, ii and iv
 - ii, iii and iv
 - All of the above

5. Which of the following should be included in a company's statement of financial position as an intangible asset under IAS 38 Intangible Assets?
 - a) Internally developed brands
 - b) Internally generated goodwill
 - c) Expenditure on completed research
 - d) Payments made on the successful registration of a patent.
6. Which TWO of the following criteria must be met before development expenditure is capitalised according to IAS 38 Intangible Assets?
 - a) the technical feasibility of completing the intangible asset
 - b) future revenue is expected
 - c) the intention to complete and use or sell the intangible asset
 - d) there is no need for reliable measurement of expenditure
7. Which of the following shall be capitalised as intangible asset in financial statements?
 - a) Rs. 400,000 developing a new process which will bring in no revenue but is expected to bring significant cost savings
 - b) Rs. 400,000 developing a new product. During development a competitor launched a rival product and now the entity is hesitant to commit further funds to the process
 - c) Rs. 400,000 spent on marketing a new product which has led to increased sales of Rs. 800,000
 - d) Rs. 400,000 spent on designing a new corporate logo for the business
8. Which of the following CANNOT be recognised as an intangible non-current asset in Ghalib Limited (GL)'s consolidated statement of financial position at 30 September 2021?
 - a) GL spent Rs. 132 million developing a new type of product. In June 2021 management worried that it would be too expensive to fund. The finances to complete the project came from a cash injection from a benefactor received in November 2021
 - b) GL purchased a subsidiary during the year. During the fair value exercise, it was found that the subsidiary had a brand name with an estimated value of Rs. 50 million but had not been recognised by the subsidiary as it was internally generated
 - c) GL purchased a brand name from a competitor on 1 November 2020, for Rs. 65 million
 - d) GL spent Rs. 21 million during the year on the development of a new product, after management concluded it would be viable in November 2020. The product is being launched on the market on 1 December 2021 and is expected to be profitable
9. Which of the following could be classified as development expenditure in Mars Limited's statement of financial position as at 31 March 2020 according to IAS 38 Intangible Assets?
 - a) Rs. 120,000 spent on developing a prototype and testing a new type of propulsion system. The project needs further work on it as the system is currently not viable
 - b) A payment of Rs. 50,000 to a local university's engineering faculty to research new environmentally friendly building techniques
 - c) Rs. 35,000 developing an electric bicycle. This is near completion and the product will be launched soon. As this project is first of its kind it is expected to make a loss
 - d) Rs. 65,000 developing a special type of new packaging for a new energy-efficient light bulb. The packaging is expected to reduce Mars Limited distribution costs by Rs. 35,000 a year

10. Which TWO of the following factors are reasons why key staff cannot be capitalised as an intangible asset by an entity?
- They do not provide expected future economic benefits
 - They cannot be controlled by an entity
 - Their value cannot be measured reliably
 - They are not separable from the business as a whole
11. Which of the following items should be recognised as intangible assets?
- Patent for new drug
 - Licence for new vaccine
 - Specialist training courses
- i and ii
 - ii and iii
 - i and iii
 - i only
12. Which TWO of the following can be recognised as intangible assets in an entity's financial statements in accordance with IAS 38 and SIC 32?
- Internally generated goodwill
 - Separately acquired in-process research and development project
 - In-house developed website to promote and advertise entity's products
 - A license, having useful life of seven years, received by way of government grant
13. IAS 38 gives examples of activities that would be regarded as research and therefore not eligible for recognition as an intangible asset.
- Which one of the following would be an example of research costs?
- The design and construction of chosen alternative products or processes
 - The design of pre-production prototypes and models
 - The design of possible new or improved product or process alternatives
 - The design, construction and operation of a pilot plant
14. Which of the following statements relating to intangible assets is true?
- All intangible assets must be carried at amortised cost or at an impaired amount, they cannot be revalued upwards
 - The development of a new process which is not expected to increase sales revenues may still be recognised as an intangible asset
 - Expenditure on the prototype of a new engine cannot be classified as an intangible asset because the prototype has physical substance
 - Impairment losses for a cash generating unit are first applied to goodwill and then to other intangible assets before being applied to tangible assets
15. Hali Limited is developing a new product and expects to be able to capitalise the costs. Which one of the following would preclude capitalisation of the costs?
- Development of the product is not yet complete
 - No patent has yet been registered in respect of the product
 - No sales contracts have yet been signed in relation to the product
 - It has not been possible to reliably allocate costs to development of the product

16. During the year to 31 December 2018 Faiz Limited (FL) incurred Rs. 200,000 of development costs for a new product. In addition, FL spent Rs. 60,000 on 1 January 2018 on machinery specifically used to help develop the new product and Rs. 40,000 on building the brand identity.

Commercial production is expected to start during 2019.

The machinery is expected to last 4 years with no residual value.

What value should be included within Intangible Assets in respect of the above in FL's Statement of Financial Position as at 31 December 2018?

- a) Rs. 200,000
- b) Rs. 300,000
- c) Rs. 260,000
- d) Rs. 215,000

17. A company had Rs. 20 million of capitalised development expenditure at cost brought forward at 1 October 2017 in respect of products currently in production and a new project began on the same date.

The research stage of the new project lasted until 31 December 2017 and incurred Rs. 1.4 million of costs. From that date the project incurred development costs of Rs. 800,000 per month.

On 1 April 2018 the directors became confident that the project would be successful and yield a profit well in excess of costs. The project was still in development at 30 September 2018. Capitalised development expenditure is amortised at 20% per annum using the straight-line method.

What amount will be charged to profit or loss for the year ended 30 September 2018 in respect of research and development costs?

- a) Rs. 1,400,000
- b) Rs. 3,800,000
- c) Rs. 7,800,000
- d) Rs. 8,600,000

18. At 30 September 2019 Shakir Limited (SL)'s trial balance showed a brand at cost of Rs. 30 million, less accumulated amortisation brought forward at 1 October 2018 of Rs. 9 million. Amortisation is based on a ten-year useful life.

An impairment review on 1 April 2019 concluded that the brand had a value in use of Rs. 12 million and a remaining useful life of three years. However, on the same date SL received an offer to purchase the brand for Rs. 15 million.

What should be the carrying amount of the brand in the statement of financial position of SL as at 30 September 2019?

- a) Rs. 12,500,000
- b) Rs. 39,000,000
- c) Rs. 15,000,000
- d) Rs. 12,000,000

19. Down Limited (DL) owns a pharmaceutical business with a year-end of 30 September 2014. DL commenced the development stage of a new drug on 1 January 2014.

Rs. 40,000 per month was incurred until the project was completed on 30 June 2014, when the drug went into immediate production. The directors became confident of the project's success on 1 March 2014. The drug has an estimated life span of five years and time apportionment is used by DL where applicable.

What amount will DL charge to profit or loss for development costs, including any amortisation, for the year ended 30 September 2014?

- a) Rs. 40,000
- b) Rs. 80,000
- c) Rs. 88,000
- d) Rs. 160,000

20. Apollo Limited (AL) carries out research and development. In the year ended 30 June 2015 AL incurred total costs in relation to project M of Rs. 750,000, spending the same amount each month up to 30 April 2015, when the project was completed. The product produced by the project went on sale from 31 May 2015.

The project had been confirmed as feasible on 1 January 2015, and the product produced by the project was expected to have a useful life of five years.

What is the carrying amount of the development expenditure asset as at 30 June 2015?

- a) Rs. 225,000
 - b) Rs. 290,000
 - c) Rs. 295,000
 - d) Rs. 300,000
21. An entity purchased patent for its product A in 2014 for 20 years. In 2019, the entity purchased patent of a competing product for 20 years to eliminate competition for product A. However, the entity does not intend to manufacture the competing product. The cost of purchasing second patent for competing product should be:
- a) expensed out in 2019
 - b) capitalised and amortized over 20 years
 - c) capitalised and amortized over 15 years
 - d) capitalised and only assessed for impairment at year end
22. Computer hardware and related operating system, which is an integral part of the computer hardware, are treated under:
- a) IAS 16 as a combined asset
 - b) IAS 38 as a combined asset
 - c) IAS 16 for computer hardware and IAS 38 for operating system
 - d) IAS 16 or IAS 38 at the option of the entity
23. An entity acquired a patent for a period of ten years at cost of Rs. 90 million. The patent can be further renewed for another five years at renewal cost of Rs. 1 million. The entity estimated that expected period of cash inflows is twelve years from acquisition date. The useful life of patent in years is:
- a) Five
 - b) Ten
 - c) Twelve
 - d) Fifteen
24. A company exchanged an intangible asset having fair value and carrying value of Rs. 15 million and Rs. 13.6 million respectively with a new intangible asset having a fair value of Rs. 18 million. An amount of Rs. 3.2 million was also paid in cash. If this transaction lacks commercial substance, the cost of intangible asset acquired would be measured at:
- a) Rs. 15.0 million
 - b) Rs. 16.8 million
 - c) Rs. 18.0 million
 - d) Rs. 18.2 million
25. Which TWO of the following costs related to development of a website may be capitalised?
- a) Defining hardware and software specifications
 - b) Stress testing
 - c) Evaluating alternative products and suppliers
 - d) Graphical design development

26. If an asset incorporates both intangible and tangible elements, it should be treated under:
- a) either IAS 16 or IAS 38 but once opted should be applied to all such assets consistently
 - b) IAS 38
 - c) IAS 16 and IAS 38 by segregating the cost of each element
 - d) either IAS 16 or IAS 38 depending on which element is significant

ANSWERS

01.	(c)	Rs. 200,000 is research and should be written off as incurred. Rs. 400,000 should be capitalised as a development asset but is not amortised until commercial production begins.
02.	(a) & (d)	Training cannot be capitalised as a firm cannot control the future economic benefits by limiting the access of others to the staff. Internally generated brands cannot be capitalised
03.	(b)	Charge to profit or loss: Project A Rs. 500,000 and Project B Rs. 1,000,000 (i.e. Rs. 800,000 + 200,000) Net increase in non-current assets: Project C Rs. 1,000,000 – Project B Rs. 800,000
04.	(d)	All the statements are true.
05.	(d)	Internally generated intangible assets cannot be recognised, and research costs are written off as incurred.
06.	(a) & (c)	There is no need for revenue, there needs to be probable economic benefits which may come in the form of cost savings as well as revenue.
07.	(a)	Cost savings are inflow of economic benefits as well.
08.	(a)	The finance was only available after the year end. Therefore, the criteria of recognising an asset were not met, as the resources were not available to complete the project. Even though the brand is internally generated in the subsidiary's accounts, it can be recognised at fair value for the group. Item (b) can be recognised as a purchased intangible and item (d) meets the criteria for being capitalised as development costs.
09.	(d)	Item (a) cannot be capitalised because it does not meet all the criteria as it is not viable. Item (b) is research and cannot be capitalised. Item (c) cannot be capitalised because it does not meet all the criteria as it is making a loss.
10.	(b) & (c)	Key staff cannot be capitalised as firstly they are not controlled by an entity. Secondly, the value that one member of key staff contributes to an entity cannot be measured reliably.
11.	(a)	The training courses should be charged to profit or loss.
12.	(b) & (d)	In-house developed website to promote and advertise entity's products. A license, having useful life of seven years, received by way of government grant.
13.	(c)	This activity is still at the research stage.
14.	(b)	A new process may produce benefits (and therefore be recognised as an asset) other than increased revenues, e.g. it may reduce costs.
15.	(d)	In order for capitalisation to be allowed it is not necessary for development to be completed, patents to be registered or sales contracts signed. However, an intangible asset can only be recognised if its cost can be reliably measured.
16.	(d)	The development costs of Rs. 200,000 can be capitalised, as can the depreciation on the asset while the project is being developed. The asset is used for a year on the project, so the depreciation for the first year (Rs. 60,000/4 years = Rs. 15,000) can be added to intangible assets. The Rs. 40,000 is an internally generated brand and cannot be capitalised.

17.	(c)		
			Rs.
		Research costs	1,400,000
		Expensed development Jan-Mar ($800,000 \times 3$)	2,400,000
		Depreciation on capitalised amount b/f ($20m \times 20\%$)	4,000,000
			7,800,000
		Note that no depreciation is charged on the new project as it is still in development.	
18.	(a)		Rs.
		Recoverable amount (fair value - costs of disposal)	15,000,000
		Less depreciation 1.04.2019 – 30.09.2019 ($15m / 3 \times 6/12$)	(2,500,000)
			12,500,000
19.	(c)		Rs.
		Write off to 1 Jan 2014 to 28 Feb 2014 ($2 \times 40,000$)	80,000
		Amortisation $160,000/5$ years $\times 3/12$ (July to Sep)	8,000
			88,000
		Capitalise March to June = $4 \times 40,000 = 160,000$	
20.	(b)	The costs of Rs. 750,000 relate to ten months of the year (up to April 2015). Therefore, the costs per month were Rs. 75,000. As the project was confirmed as feasible on 1 January 2015, the costs can be capitalised from this date. So, four months of these costs can be capitalised = $\text{Rs. } 75,000 \times 4 = \text{Rs. } 300,000$. The asset should be amortised from when the project is complete and available for use, so two month's amortisation should be charged to 30 June 2015. Amortisation is $(\text{Rs. } 300,000/5) \times 2/12 = \text{Rs. } 10,000$. The carrying amount of the asset at 30 June 2015 is $\text{Rs. } 300,000 - \text{Rs. } 10,000 = \text{Rs. } 290,000$.	
21.	(c)	capitalised and amortized over 15 years	
22.	(a)	IAS 16 as a combined asset	
23.	(c)	The renewal shall be taken into account as the cost of renewal are insignificant. However, the useful life shall not exceed the period of use intended by management.	
24.	(b)	Carrying amount of asset given up 13.6m + Cash paid 3.2m = Rs. 16.8 million	
25.	(b) and (d)	Stress testing Graphical design development	
26.	(d)	Either IAS 16 or IAS 38 depending on which element is significant	

STICKY NOTES

Intangible assets

Intangible asset is an identifiable non-monetary asset without physical substance.

- | | |
|----|---|
| 1. | Identifiable means either separable or arising from legal/contractual right. |
| 2. | The entity must have control and expect economic benefits to recognise an intangible asset. |
| 3. | Intangible assets may have secondary physical element. |

Recognition and initial measurement

- | | |
|----|---|
| 1. | Intangible asset is recognised if it meets the definition, there is probably of expected economic benefits and cost can be measured reliably. |
| 2. | Recognition of subsequent expenditure is rare and is allowed only if it can be measured/attributed and enhanced the value of asset. |
| 3. | Initial measurement is at cost. |
| 4. | Intangible assets acquired or purchased separately are measured at purchase price and directly attributable costs. |
| 5. | Intangible asset acquired in exchange of another asset are measured at cost (same as IAS 16). |
| 6. | Intangible asset acquired by way of government grant is recognised at fair value, or alternatively at nominal amount. |

Internally generated items

- | | |
|----|---|
| 1. | Recognition issue |
| 2. | Research is charged as expense. |
| 3. | Development is capitalised only if certain criteria are met. |
| 4. | Past development expenses not to be recognised as an asset. |
| 5. | Cost of an internally generated intangible asset comprises all directly attributable costs. Borrowing costs may also be included in accordance with IAS 23. |
| 6. | Internally generated goodwill, brand, publishing titles, customer lists and similar items are not recognised as expenditure on these items cannot be distinguished from the cost of developing the business as a whole. |

Acquired in business combination

- | | |
|----|--|
| 1. | If an asset acquired in business combination is identifiable and its fair value can be measured reliably, it is recognised separately from goodwill, even if the acquiree (or subsidiary) has not recognised that assets in its financial statements. |
| 2. | Similarly, acquired in-process research and development project may be recognised in consolidated financial statements. However, subsequent expenditure on such project is capitalised or expensed in accordance with the rules of IAS 38 on research and development. |

Measurement after recognition

- | | |
|----|--|
| 1. | Choice of accounting policy i.e. cost model or revaluation model |
| 2. | Revaluation model is only allowed if fair value is determined from active market. |
| 3. | Intangible assets with definite useful life are amortised based on residual value of zero except in certain circumstances. |
| 4. | Intangible assets with indefinite useful life are not amortised but tested for impairment annually. |
| 5. | Gain or loss on derecognition is recognised in profit or loss (not classified as revenue) |

Disclosure can be classified into following categories:

- | | |
|----|--|
| 1. | General disclosure |
| 2. | Reconciliation |
| 3. | Disclosure under certain circumstances |
| 4. | Disclosure in case of revalued intangible assets |
| 5. | Disclosure of research and development expense |
| 6. | Additional disclosure |

SIC 32: Web site costs

- | | |
|---|--|
| 1. | Planning Stage is similar in nature to research phase and expenditure is charged as expense. |
| 2. | Development Stage expenditure is capitalised only if capitalisation criteria is met. |
| 3. | Operating Stage expenditure is charged as expense unless capitalisation criteria is met. |
| If sole or primary purpose of website is advertisement/promotion of entity's products and services, all expenditure is charged to profit or loss. | |

IAS 41 AGRICULTURE

IN THIS CHAPTER:

AT A GLANCE

SPOTLIGHT

1. Introduction
2. Recognition and measurement
3. Disclosure
4. Comprehensive Examples
5. Objective Based Q&A

STICKY NOTES

AT A GLANCE

The objective of IAS 41 is to prescribe the accounting treatment and disclosures related to agricultural activity.

The key definitions are agricultural activity, biological asset and agricultural produce. Agricultural activity is the management by an entity of the biological transformation of biological assets for sale, into agricultural produce, or into additional biological assets. A biological asset is a living animal or plant. Agricultural produce is the harvested product of the entity's biological assets. IAS 41 prescribes, among other things, the accounting treatment for biological assets during the period of growth, degeneration, production, and procreation, and for the initial measurement of agricultural produce **at the point of harvest**. It requires measurement at fair value less costs to sell from initial recognition of biological assets up to the point of harvest, other than when fair value cannot be measured reliably on initial recognition.

IAS 41 is applied to agricultural produce, which is the harvested product of the entity's biological assets, only at the point of harvest. Thereafter, IAS 2 Inventories or another applicable Standard is applied.

IAS 41 requires that a change in fair value less costs to sell of a biological asset be included in profit or loss for the period in which it arises.

IAS 41 requires that an unconditional government grant related to a biological asset measured at its fair value less cost to sell be recognised as income when, and only when, the government grant becomes receivable. If a government grant is conditional, an entity should recognise the government grant as income when, and only when, the conditions attaching to the government grant are met.

1 INTRODUCTION

1.1 Scope [IAS 41: 1 to 4]

IAS 41 Agriculture covers the following agricultural activities:

- biological assets, except for bearer plants;
- agricultural produce at the point of harvest; and
- government grants for agriculture (in certain situations).

IAS 41 does not apply to:

- the harvested agricultural product (IAS 2 Inventory or another applicable Standard applies);
- land relating to the agricultural activity (IAS 16 or IAS 40 applies);
- bearer plants related to agricultural activity (however, IAS 41 does apply to the produce on those bearer plants).
- intangible assets related to agricultural activity (IAS 38 Intangible assets applies).

The table below provides examples of biological assets, agricultural produce, and products that are the result of processing after harvest:

Biological assets	Agricultural produce	Products that result from processing after harvest
Sheep	Wool	Yarn, carpet etc.
Trees in a timber plantation	Felled trees	Logs, lumber
Dairy cattle	Milk	Cheese
Cotton plants	Harvested cotton	Thread, clothing etc.
Sugarcane	Harvested cane	Sugar
Tobacco plants	Picked leaves	Cured tobacco
Tea bushes	Picked leaves	Tea
Fruit trees	Picked fruit	Processed fruit
Oil palm	Picked fruit	Palm oil
Pigs	Carcass	Sausages
Grape vines	Picked grapes	Wine
Rubber trees	Harvested latex	Rubber products

► Example 01:

A farmer has a field of lambs ('biological assets').

As the lambs grow they go through biological transformation.

As sheep they are able to procreate and lambs will be born (additional biological assets) and the wool from the sheep provides a source of revenue for the farmer ('agricultural produce').

Once the wool has been sheared from the sheep ('harvested'), IAS 2 requires that it be accounted for as regular inventory.

► **Example 02:**

Fatima Limited has a forest asset. The total value of the group's forest assets is Rs.3,400 million comprising:

	Rs. in million
Freestanding trees	2,500
Land under trees	500
Roads in forests	400
	3,400

Required:

Show how the forests would be presented in the financial statements.

► **ANSWER:****Fatima Limited****Extracts of Statement of Financial Position as at 31 December 20X8**

	Rs. in million
Non-current assets	
Property, plant and equipment: Land under trees	500
Forest roads	400
Biological assets: Freestanding trees	2,500
	3,400

1.2 Definitions [IAS 41: 5]

“Biological asset” is a living animal or plant. Examples include sheep, cows, plant and trees, etc.

A **“group of biological assets”** is an aggregation of similar living animals or plants. Examples include herd of cows, orchard of fruit trees, etc.

“Harvest” is the detachment of produce from a biological asset or the cessation of a biological asset's life processes. Examples include milking the cows, slaughtering the cows, picking fruit from trees and cutting trees for wood logs.

“Agricultural produce” is the harvested produce of the entity's biological assets. Example include milk and/or meat obtained from cows and fruit and/or wood logs obtained from trees.

“Costs to sell” are the incremental costs directly attributable to the disposal of an asset, excluding finance costs and income taxes. Examples include commission to brokers, non-refundable transfer taxes and duties.

1.3 Biological transformation [IAS 41: 5 & 7]

Biological transformation comprises the processes of:

- Growth (an increase in quantity or improvement in quality of an animal or plant e.g. lambs grow into sheep, trees grow);
- Degeneration (a decrease in the quantity or deterioration in quality of an animal or plant e.g. death, old age, cut down);
- Production (getting agricultural produce such as latex, tea leaf, wool, and milk); and
- Procreation (creation of additional living animals or plants e.g. birth of new animals) that cause qualitative or quantitative changes in a biological asset.

1.4 Agricultural activity [IAS 41: 5 & 6]

Agricultural activity is the management by an entity of the biological transformation and harvest of biological assets

- for sale; or
- for conversion into agricultural produce; or
- into additional biological assets.

► **Example 03:**

Discuss whether IAS 41 shall be applied in each of the following circumstances:

- i. A zoo has bought two lions and one tiger for exhibition in zoo cages for earning ticket revenue.
- ii. Peacock kept by a restaurant in their open dining area to attract more customers.
- iii. Mules kept for transportation of luggage of tourists by a company which provides camping and hiking services to foreign tourists.
- iv. A small business using horses in horse-wagons for tourists to travel around historical places.
- v. Parrots kept for breeding by a bird shop so that their offspring can be sold.
- vi. Horses kept in stable for breeding and to be trained and sold later.

► **ANSWER:**

Although all circumstances indicate the existence of biological assets i.e. living animals, the item (i) to (iv) do not fall under the scope of IAS 41 as those biological assets are not for agricultural activity.

IAS 41 shall be applied on item (v) and (vi) since these biological assets relate to agricultural activity (i.e. for sale or for having additional biological assets by breeding).

Agricultural activity covers a diverse range of activities; for example, raising livestock, forestry, annual or perennial cropping, cultivating orchards and plantations, floriculture and aquaculture (including fish farming).

Certain common features exist within this diversity

- a) **Capability to change.** Living animals & plants are capable of biological transformation;
- b) **Management of change.** Management facilitates biological transformation by enhancing, or at least stabilising, conditions necessary for the process to take place (for example, nutrient levels, moisture, temperature, fertility, and light). Such management distinguishes agricultural activity from other activities. For example, harvesting from unmanaged sources (such as ocean fishing and deforestation) is not agricultural activity; and
- c) **Measurement of change.** The change in quality (for example, genetic merit, density, ripeness, fat cover, protein content, and fibre strength) or quantity (for example, progeny, weight, cubic metres, fibre length or diameter, and number of buds) brought about by biological transformation or harvest is measured and monitored as a routine management function.

1.5 Bearer plants [IAS 41: 5 to 5C]

IAS 16 applies to the bearer plants. A bearer plant is a living plant that:

- a) is used in the production or supply of agricultural produce;
- b) is expected to bear produce for more than one period; and
- c) has a remote likelihood of being sold as agricultural produce, except for incidental scrap sales.

When bearer plants are no longer used to bear produce, they might be cut down and sold as scrap, for example, for use as firewood.

Produce growing on bearer plants is a biological asset. IAS 41 is applied on such produce.

The following are not bearer plants (IAS 41 is applied):

- a) plants cultivated to be harvested as agricultural produce (e.g. trees grown for use as lumber);
- b) plants cultivated to produce agricultural produce and more than a remote likelihood that the entity will also harvest and sell the plant as agricultural produce, other than as incidental scrap sales (e.g., trees that are cultivated both for their fruit and their lumber);
- c) annual crops (e.g., maize and wheat).

Note that there is no animal-equivalent of bearer plant. Thus, cows kept for milk only are within the scope of IAS 41.

2 RECOGNITION AND MEASUREMENT

2.1 Recognition [IAS 41: 10 & 11]

An entity shall recognise a biological asset or agricultural produce when, and only when:

- the entity controls the asset as a result of past events;
- it is probable that future economic benefits associated with the asset will flow to the entity; and
- the fair value or cost of the asset can be measured reliably.

In agricultural activity, control may be evidenced by, for example, legal ownership of cattle and the branding or otherwise marking of the cattle on acquisition, birth, or weaning.

The future benefits are normally assessed by measuring the significant physical attributes.

► **Example 04:**

XYZ Limited owns a large area of farmland nearby a wild forest. Employees of XYZ Limited have noticed that a herd (or a parade) of wild elephants is living permanently on the farmland of XYZ Limited. If sold in international market, the whole herd can fetch a fair value less costs to sell of Rs. 58 million.

Required:

How should XYZ Limited recognise the herd of elephants in its financial statements?

► **ANSWER:**

It is unlikely that XYZ Limited controls these wild animals and/or able to sell them and obtain the future economic benefits. Therefore, XYZ Limited should not recognise the herd of elephants in its financial statements.

2.2 Measurement [IAS 41: 12 to 25]

2.2.1 Biological asset

A biological asset shall be measured on initial recognition and at the end of each reporting period at its fair value less costs to sell, except where the fair value cannot be measured reliably.

► **Example 05:**

Adeel Limited (AL) operates a goat breeding farm. AL sells goats to local meat businesses and goats-milk to cosmetics companies. They also use goat milk for making premium cheese for sale. On 1 March 20Y2, AL bought 10 goats for Rs. 25,000 each (i.e. fair value) from a nearby market. The market broker charges 2% commission from buyer and 3% from seller on each transaction.

On 15 June 20Y2, two kids were born having fair value of Rs. 7,000 each.

On 30 June 20Y2, the year-end of AL, each goat has a fair value of Rs. 33,000 and each kid has a fair value of Rs. 9,000.

Required:

Calculate the cost of purchase and the amount at which the above biological assets should be measured at initial recognition and on 30th June 20Y2.

► **ANSWER:**

The cost of 10 goats purchased:

$$[10 \text{ goats} \times \text{Rs. } 25,000 \times 102\%] = \text{Rs. } 255,000$$

Measurement at initial recognition (at fair value less costs to sell):

$$[10 \text{ goats} \times \text{Rs. } 25,000 \times 97\%] = \text{Rs. } 242,500$$

$$[2 \text{ goat kids} \times \text{Rs. } 7,000 \times 97\%] = \text{Rs. } 13,580$$

Measurement at year-end (at fair value less costs to sell):

[10 goats x Rs. 33,000 x 97%] = Rs. 320,100

[2 goat kids x Rs. 9,000 x 97%] = Rs. 17,460

2.2.2 Agricultural produce

Agricultural produce harvested from an entity's biological assets shall be measured at its fair value less costs to sell at the point of harvest. Such measurement is the cost at that date when applying IAS 2 Inventories or another applicable Standard.

► Example 06:

Kashif Limited (KL) operates a goat breeding farm. KL sells goats to local meat businesses and goats-milk to cosmetics companies. They also use goat milk for making premium cheese for sale.

During the year ended 30 June 20Y2, KL could get 980 litre of milk which had fair value less costs to sell of Rs. 170 per litre on the day goats were milked.

The 900 litre of milk was sold to cosmetics companies for Rs. 160,000 and remaining 80 litre was converted into making cheese which was later sold for Rs. 24,000. KL had to incur a cost of Rs. 5,000 to convert the milk into cheese.

Required:

Briefly discuss the accounting treatment of milk obtained from goats.

► ANSWER:

The harvested milk shall be recognised at Rs. 166,600 (980 litres x Rs. 170 per litre) at the point of harvest. This amount will be deemed cost of inventory of milk subsequently. The excess of sale price over this cost of inventory shall result in profit in the statement of comprehensive income of KL.

2.2.3 Biological assets attached to land

Biological assets are often physically attached to land (for example, trees in a plantation forest).

There may be no separate market for biological assets that are attached to the land, but an active market may exist for the combined assets, that is, the biological assets, raw land, and land improvements, as a package. An entity may use information regarding the combined assets to measure the fair value of the biological assets. The fair value of raw land and land improvements may be deducted from the fair value of the combined assets to arrive at the fair value of biological assets.

► Example 07:

ABC Limited has a fruit orchard over fifteen acres area of land. The separate value of orchard from the land could not be determined, however, combined value of land and orchard has been determined to be Rs. 336 million. The similar agricultural land (but without any crop or orchard) in the area is valued at Rs. 10 million per acre.

Required:

Advise ABC Limited as to how they may value their fruit orchard.

► ANSWER:

Use the combined fair value of the land and orchard, less the estimated fair value of land. So the orchard's fair value might be determined at Rs. 186 million (i.e. Rs. 336 million – Rs. 10 million x 15 acres).

2.2.4 Grouping of assets

The fair value measurement may be facilitated by grouping biological assets or agricultural produce according to significant attributes; for example, by age or quality as used in the market as a basis for pricing.

2.2.5 Future contract prices

Future contract prices are not necessarily relevant in measuring fair value because fair value reflects the current market conditions in which market participant buyers and sellers would enter into a transaction. The fair value is not adjusted because of existence of such contract. IAS 37 is applied if such contract is onerous.

2.2.6 Using cost as fair value

Cost may sometimes approximate fair value, particularly when:

- little biological transformation has taken place since initial cost incurrence (for example, for seedlings planted immediately prior to the end of a reporting period or newly acquired livestock); or
- the impact of the biological transformation on price is not expected to be material (for example, for the initial growth in a 30-year pine plantation production cycle).

2.3 Gains and losses [IAS 41: 26 to 29]

2.3.1 Biological assets

A gain or loss arising on initial recognition of a biological asset at fair value less costs to sell and from a change in fair value less costs to sell of a biological asset shall be included in profit or loss for the period in which it arises.

A loss may arise on initial recognition of a biological asset, because costs to sell are deducted in determining fair value less costs to sell of a biological asset. A gain may arise on initial recognition of a biological asset, such as when a calf is born.

► Example 08:

Adeel Limited (AL) operates a goat breeding farm. AL sells goats to local meat businesses and goats-milk to cosmetics companies. They also use goat milk for making premium cheese for sale. On 1 March 20Y2, AL bought 10 goats for Rs. 25,000 each (i.e. fair value) from a nearby market. The market broker charges 2% commission from buyer and 3% from seller on each transaction.

On 15 June 20Y2, two goat kids were born having fair value of Rs. 7,000 each.

On 30 June 20Y2, the year-end of AL, each mature goat has now fair value of Rs. 33,000 and each goat kid has fair value of Rs. 9,000.

Required:

Journal entries.

► ANSWER:

Date	Particulars	Debit Rs.	Credit Rs.
1 Mar 20Y2	Biological assets [10 goats x Rs. 25,000 x 97%]	242,500	
	Loss on initial recognition (PL)	12,500	
	Bank [10 goats x Rs. 25,000 x 102%]		255,000
15 Jun 20Y2	Biological assets [2 goat kids x Rs. 7,000 x 97%]	13,580	
	Gain on initial recognition (PL)		13,580
30 Jun 20Y2	Biological assets W1	81,480	
	Gain on re-measurement (PL)		81,480

W1: Gain on re-measurement of Biological assets	Rs.
At year end	
[10 goats × Rs. 33,000 × 97%]	320,100
[2 goat kids × Rs. 9,000 × 97%]	17,460
	337,560
Already measured at [Rs. 242,500 + 13,580]	(256,080)
	81,480

2.3.2 Agricultural Produce

A gain or loss arising on initial recognition of agricultural produce at fair value less costs to sell shall be included in profit or loss for the period in which it arises.

A gain or loss may arise on initial recognition of agricultural produce as a result of harvesting.

► **Example 09:**

Kashif Limited (KL) operates a goat breeding farm. KL sells goats to local meat businesses and goats-milk to cosmetics companies. They also use goat milk for making premium cheese for sale.

During the year ended 30 June 20Y2, KL could get 980 litre of milk which had fair value less costs to sell of Rs. 170 per litre on the day goats were milked.

The 900 litre of milk was sold to cosmetics companies for Rs. 160,000 and remaining 80 litre was converted into making cheese which was later sold for Rs. 24,000. KL had to incur a cost of Rs. 5,000 to convert the milk into cheese.

Required:

Journal entries (perpetual inventory system).

► **ANSWER:**

Sr. #	Particulars	Debit Rs.	Credit Rs.
(i)	Milk (agricultural produce) [980 litres x Rs. 170]	166,600	
	Gain on harvest (PL)		166,600
(ii)	Milk inventory	166,600	
	Milk (agricultural produce)		166,600
(iii)	Cash/Receivables	160,000	
	Revenue: Milk		160,000
	Cost of sales	153,000	
	Milk inventory [900 litres x Rs. 170]		153,000
(iv)	Cheese inventory	18,600	
	Cash/Bank (conversion cost)		5,000
	Milk inventory [80 litres x Rs. 170]		13,600
(v)	Cash/Receivables	24,000	
	Revenue: cheese		24,000
	Cost of sales	18,600	
	Cheese inventory		18,600

2.4 Inability to measure fair value reliably [IAS 41: 30 to 33]

There is a presumption that fair value can be measured reliably for a biological asset. The presumption can be rebutted only on initial recognition for a biological asset for which quoted market prices are not available and for which alternative fair value measurements are determined to be clearly unreliable.

In such a case, that biological asset shall be measured at its cost less any accumulated depreciation and any accumulated impairment losses. The entity should consider application of IAS 2, IAS 16 and/or IAS 36.

Once the fair value of such a biological asset becomes reliably measurable, an entity shall measure it at its fair value less costs to sell.

The presumption can be rebutted only on initial recognition. An entity that has previously measured a biological asset at its fair value less costs to sell continues to measure the biological asset at its fair value less costs to sell until disposal.

In all cases, an entity measures agricultural produce at the point of harvest at its fair value less costs to sell. IAS 41 reflects the view that the fair value of agricultural produce at the point of harvest can always be measured reliably.

2.5 Government grants related to biological asset [IAS 41: 34 to 38]

Biological assets measured at fair value less cost to sell (IAS 41 is applicable)	Unconditional grant It shall be recognised in profit or loss when, and only when, the government grant becomes receivable.
	Conditional grant Such grant (including when a government grant requires an entity not to engage in specified agricultural activity) shall be recognised in profit or loss when, and only when, the conditions attaching to the government grant are met.
	Partial recognition for conditional grants Terms and conditions of government grants vary. For example, a grant may require an entity to farm in a particular location for five years and require the entity to return all of the grant if it farms for a period shorter than five years. In this case, the grant is not recognised in profit or loss until the five years have passed. However, if the terms of the grant allow part of it to be retained according to the time that has elapsed, the entity recognises that part in profit or loss as time passes.
Biological assets measured at cost or bearer plants	The grant shall be recognised in accordance with IAS 20.

► Example 10:

Multan Limited (ML) operates a large cow and buffalo dairy farm. On 1 January 20Y2, ML received a government grant of Rs. 15 million on the condition that ML adopts organic cattle feed system and continues to do so for five years. If ML discontinues organic cattle feed system any time during five years, it will have to repay the whole amount of grant.

ML has already implemented organic feed system and it is reasonably certain that ML will meet the conditions of grant. ML year end is 31 December. ML measures all its biological assets at fair value less costs to sell.

Required:

Briefly discuss the recognition of government grant in the financial statements of ML.

► ANSWER:

ML shall recognise the grant of Rs. 15 million in profit or loss on 31st December 2026 only when the conditions attaching to the government grant are met.

► *Example 11:*

Peshawar Limited (PL) operates a large cow and buffalo dairy farm. On 1 April 20Y2, PL received a government grant of Rs. 15 million on the condition that PL adopts organic cattle feed system and continues to do so for next five years. If PL discontinues organic cattle feed system any time during five years, it will have to repay the proportionate amount of grant.

PL has already implemented organic feed system and it is reasonably certain that PL will meet the conditions of grant. PL year end is 31 December. PL measures all its biological assets at fair value less costs to sell.

Required:

Briefly discuss the recognition of government grant in the financial statements of PL.

► *ANSWER:*

PL shall recognise the grant of Rs. 3 million (i.e. Rs. 15 million / 5 years) in profit or loss each year on 31st December from 20Y2 to 20Y7 as the time passes provided that PL is complying the conditions of the government grant.

3 DISCLOSURE

3.1 General [IAS 41: 40 to 45]

An entity shall disclose the aggregate gain or loss arising during the current period on initial recognition of biological assets and agricultural produce and from the change in fair value less costs to sell of biological assets.

An entity shall provide a description (narrative or quantified) of each group of biological assets. An entity is encouraged to provide a quantified description of each group of biological assets, distinguishing between consumable and bearer biological assets or between mature and immature biological assets, as appropriate.

An entity discloses the basis for making any such distinctions.

Group Type	Explanation
Consumable biological assets	Consumable biological assets are those that are to be harvested as agricultural produce or sold as biological assets. Examples include livestock intended for the production of meat, livestock held for sale, fish in farms, crops such as maize and wheat, produce on a bearer plant and trees being grown for lumber.
Bearer biological assets	Bearer biological assets are those other than consumable biological assets; for example, livestock from which milk is produced and fruit trees from which fruit is harvested.
Mature biological assets	Mature biological assets are those that have attained harvestable specifications (for consumable biological assets) or are able to sustain regular harvests (for bearer biological assets).

3.2 Reconciliation [IAS 41: 50 to 52]

An entity is required to present a reconciliation of changes in the carrying amount of biological assets between the beginning and the end of the current period.

The reconciliation shall include:

- the gain or loss arising from changes in fair value less costs to sell (Separate disclosure of physical change and price change is encouraged but not required);
- increases due to purchases;
- decreases attributable to sales and classification as held for sale;
- decreases due to harvest;
- increases resulting from business combinations;
- net exchange differences; and
- other changes.

► **Example 12:**

Nawabpur Farming Limited (NFL) owned a dairy herd. On 1st January 20Y2, the herd had 100 animals that were two years old and 50 newly born calves. On 31 December 20Y2 (year-end), a further 03 calves were born. None of the herd died during the period. NFL incurred total farm maintenance cost of Rs. 1.2 million.

Relevant fair value less costs to sell (per animal) were:

	1 st January 20Y2	31 December 20Y2
	Rupees	
Newly born calves	30,000	50,000
One year old animals	45,000	60,000
Two year old animals	65,000	75,000
Three year old animals	75,000	80,000

Required:

Prepare reconciliation of change in fair value (price change and physical change) and extracts of financial statements for the year ended 31st December 20Y2.

► **ANSWER:****Reconciliation**

	Rs. 000	Rs. 000
On 1st January 20Y2		
2 year old [100 x Rs. 65]	6,500	
Newly born [50 x Rs. 30]	1,500	
		8,000
Increase due to price change*		
2 year old [100 x (Rs. 75 - 65)]	1,000	
Newly born [50 x (Rs. 50 - 30)]	1,000	
		2,000
Increase due to physical change**		
2 year old to 3 year old [100 x (Rs. 80 - 75)]	500	
Newly born to 1 year old [50 x (Rs. 60 - 50)]	500	
Newly born [3 x Rs. 50]	150	
		1,150
On 31 December 20Y2		
3 year old [100 x Rs. 80]	8,000	
1 year old [50 x Rs. 60]	3,000	
Newly born [3 x Rs. 50]	150	
		11,150

*age at beginning of period or on initial recognition

** prices at year-end

Statement of financial position (extracts) as at 31 December 20Y2

	Rs. 000
Non-current assets	
Biological assets	11,150

Statement of profit or loss (extracts) for the year ended 31 December 20Y2

	Rs. 000
Income	
Gain on measurement of biological assets [2,000 + 1,150]	3,150
Expenses:	
Maintenance cost of herd	(1,200)

3.3 Other information [IAS 41: 46, 49 & 53]

If not disclosed elsewhere in information published with the financial statements, an entity shall describe:

- a) the nature of its activities involving each group of biological assets; and
- b) non-financial measures or estimates of the physical quantities of:
 - i. each group of the entity's biological assets at the end of the period; and
 - ii. output of agricultural produce during the period.

An entity shall disclose:

- a) the existence and carrying amounts of biological assets whose title is restricted, and the carrying amounts of biological assets pledged as security for liabilities;
- b) the amount of commitments for the development or acquisition of biological assets; and
- c) financial risk management strategies related to agricultural activity.

Agricultural activity is often exposed to climatic, disease and other natural risks. Examples of such an event include an outbreak of a virulent disease, a flood, a severe drought or frost, and a plague of insects. If an event occurs that gives rise to a material item of income or expense, the nature and amount of that item are disclosed in accordance with IAS 1.

3.4 Additional disclosure when fair value cannot be measured reliably [IAS 41: 54 to 56]

If an entity measures biological assets at cost model, the following are disclosed:

- a) a description of the biological assets;
- b) an explanation of why fair value cannot be measured reliably;
- c) if possible, the range of estimates within which fair value is highly likely to lie;
- d) the depreciation method used;
- e) the useful lives or the depreciation rates used; and
- f) the gross carrying amount and the accumulated depreciation (and impairment losses) at the beginning and end of the period.
- g) Any gain or loss recognised on disposal (related assets to be disclosed separately in reconciliation).

In addition, the reconciliation shall include the following amounts:

- a) impairment losses;
- b) reversals of impairment losses; and
- c) depreciation.

If the fair value becomes reliably measurable during the current period, an entity shall disclose for those biological assets:

- a) a description of the biological assets;
- b) an explanation of why fair value has become reliably measurable; and
- c) the effect of the change.

3.5 Government grant [IAS 41: 57]

An entity shall disclose the following related to agricultural activity covered by IAS 41:

- a) the nature and extent of government grants recognised in the financial statements;
- b) unfulfilled conditions and other contingencies attaching to government grants; and
- c) significant decreases expected in the level of government grants.

4 COMPREHENSIVE EXAMPLES

► Example 13:

Smooth Road Limited (SRL) had a stock of 2,000 cows on 1 January 20X9.

On 1 May 20X9, SRL 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 20X9, SRL imported cattle feed of Rs. 24.6 million against 70% payment. SRL also paid 5% non-refundable taxes. 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-X9	1-May-X9	31-Dec-X9	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.

Required:

Prepare journal entries in SRL's books to record the above information for the year ended 31 December 20X9.

► ANSWER:

Date	Description	Debit	Credit
		Rs. in '000	
1-May-X9	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-X9	Carriage expense	2,000	
	Cash / Bank		2,000
1-Aug-X9	Cattle feed expense [Rs. 24.6m × 105%]	25,830	
	Payable [24.6m × 30%]		7,380
	Cash/Bank (Bal.)		18,450
31-Dec-X9	Biological Assets (W1)	24,205	
	P & L / Gain on re-measurement		24,205
31-Dec-X9	Cattle feed inventory [Rs. 25.83 x 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-20X9			39,480
			(133,480)
			24,205

► **Example 14:**

The Dairy Company (TDC) owns three farms and has a stock of 3,200 cows. During the year ended 30 June 20X5, 300 animals were born, all of which survived and were still owned by TDC at year-end.

Of those, 225 are infants whereas 75 are nine month old having market values of Rs. 26,000 and Rs. 53,000 per animal respectively. The incidental costs are 2% of the transaction price.

Required:

Discuss how the gain in respect of the new born cows should be recognised in TDC's financial statements for the year ended 30 June 20X5. (Show all necessary computations)

► **ANSWER:**

The new born cows are biological assets and should be measured at fair value less costs to sell both on initial recognition and at each reporting date.

The gains on initial recognition and the gains from change in this value should be recognised in profit or loss for the period in which it arises. The total gains to be recognised in the year ended 30 June 20X5 is as follows:

	Rupees
New born $[26,000 \times 225 \times (100\% - 2\%)]$	5,733,000
9 month old $[53,000 \times 75 \times (100\% - 2\%)]$	3,895,500
	<u>9,628,500</u>

► **Example 15:**

Maria Limited has provided following information from its financial records:

	Rs. million
Initial recognition of biological assets (on acquisition at start of 20X8)	600
Fair value of biological assets as at 31 December 20X8	700
Increase in fair value of biological assets due to physical growth during 20X9	100
Increase in fair value of biological assets due to price fluctuations during 20X9	80
Decrease in fair value of biological assets due to harvest of agriculture produce (The fair value of harvested agriculture produce at point of harvest was Rs. 60 million)	56

The costs to sell are negligible. No agriculture produce was harvested in 20X8 and the agriculture produce harvested during 20X9 has not been sold yet.

Required:

Show how these values would be incorporated into the statement of financial position and statement of comprehensive income at December 31, 20X9 (including comparative).

► **ANSWER:****Maria Limited**

Statement of financial position (Extracts)	20X9	20X8
As at 31 December 20X9	Rs. in million	
Non-current asset: Biological assets $[700 + 100 + 80 - 56]$	824	700
Current assets: Inventory	60	
For the year ended 31 December 20X9		
Fair value gain on biological assets $[824 - 700]$ and $[700 - 600]$	124	100
Fair value gain on initial recognition of agricultural produce	60	-

► **Example 16:**

With reference to IAS 41, identify whether each of the following statements is TRUE or FALSE:

- Both fish farming and ocean fishing are agricultural activities.
- IAS 41 does not apply on bearer plant; however, it applies on produce growing on bearer plant.
- A biological asset should initially be measured at cost of purchase.
- A biological asset should subsequently be measured at fair value.
- The gain or loss on subsequent re-measurement of a biological asset should be taken to profit and loss account.
- Commission to brokers as well as advertising cost would be classified as cost to sell when valuing agricultural produce upon harvest.
- All government grants related to biological assets are accounted for under IAS 41.
- Once wool is extracted from the sheep, subsequent processing of wool into carpets is accounted for under IAS 2.

► **ANSWER:**

(i)	False	(ii)	True
(iii)	False	(iv)	False
(v)	True	(vi)	False
(vii)	False	(viii)	True

► **Example 17:**

Mishal Limited, a public limited company, operates a large dairy farm. At December 31, 20X8, the herds are:

- 150,000 cows (3 years old), all purchased on or before January 1, 20X8
- 10,000 heifers, average age 2 years, purchased on January 1, 20X8
- 75,000 heifers, average age 1.5 years, purchased on July 1, 20X8

No animals were born or sold in the year.

The unit fair value less cost to sell were	Rs.
1-year-old animal at December 31, 20X8:	32,000
2-year-old animal at December 31, 20X8:	45,000
1.5-year-old animal at December 31, 20X8:	36,000
3-year-old animal at December 31, 20X8:	50,000
1-year-old animal at January 1, 20X8:	30,000
1-year-old animal at July 1, 20X8:	30,000
2-year-old animal at January 1, 20X8:	40,000

Required:

Prepare the reconciliation of biological assets from 1 January 20X8 to 31 December 20X8, separately indicating the price change and physical change.

► ANSWER:

Reconciliation of biological assets: 01 January 20X8 to 31 December 20X8

	Rs. million
Fair value less cost to sell at January 1, 20X8	
Cows $150,000 \times 40,000$	6,000
Purchased	
Heifers 1 Jan $10,000 \times 30,000$	300
Heifers 1 July $75,000 \times 30,000$	2,250
	2,550
Increase due to price change	
$150,000 \times (45,000 - 40,000)$	750
$10,000 \times (32,000 - 30,000)$	20
$75,000 \times (32,000 - 30,000)$	150
	920
Increase due to physical change	
$150,000 \times (50,000 - 45,000)$	750
$10,000 \times (45,000 - 32,000)$	130
$75,000 \times (36,000 - 32,000)$	300
	1,180
Fair value less cost to sell 31 December 20X8	
$150,000 \times 50,000$	7,500
$10,000 \times 45,000$	450
$75,000 \times 36,000$	2,700
	10,650

5 OBJECTIVE BASED Q&A

1. To which of the following items does IAS 41 Agriculture apply?
 - i. A change in fair value of a herd of animals relating to the unit price of the animals.
 - ii. Logs held in a wood yard.
 - iii. Farm land which is used for growing vegetables.
 - iv. The cost of developing a new type of crop seed which is resistant to tropical diseases.
 - a) All four
 - b) (i) only
 - c) (i) and (ii) only
 - d) (ii) and (iii) only
2. IAS 41 should be applied to account for the following when they relate to agricultural activity:
 - i. Biological assets.
 - ii. Agricultural produce at the point of harvest.
 - iii. Certain government grants.
 - iv. Land related to agricultural activity.
 - v. Intangible assets related to agricultural activity.
 - a) (i)
 - b) (i) & (ii)
 - c) (i), (ii) & (iii)
 - d) (i), (ii), (iii) & (iv)
3. Agricultural activity is the management of biological transformation of biological assets:
 - i. for sale
 - ii. into agricultural produce.
 - iii. into additional biological assets.
 - a) (i)
 - b) (i) & (ii)
 - c) (i), (ii) & (iii)
 - d) (ii) & (iii)
4. Identify whether the following items would be accounted for under IAS 41 Agriculture or not.

Dairy cattle
Milk (at the point of harvest)
Cheese made from the (above) milk

 - a) All three
 - b) Dairy cattle and Milk only
 - c) Milk and Cheese only
 - d) Dairy cattle and Cheese only
5. Agricultural activity covers a diverse range of activities; for example:
 - i. Raising livestock
 - ii. Forestry
 - iii. Annual or perennial cropping
 - iv. Cultivating orchards and plantations
 - v. Food processing

- a) (i)
- b) (i), (ii) & (v)
- c) (i), (ii), (iii) & (v)
- d) (i), (ii), (iii) & (iv)

6. Fazal Limited owns a herd of cows recorded at Rs. 36 million on 1 January 20X9. At 31 December 20X9, these cows have a fair value of Rs. 50 million. A commission of 4% would be payable upon sale.

What is the correct accounting treatment for the cows at 31 December 20X9 according to IAS 41?

- a) Hold at Rs. 36 million
- b) Re-measure to Rs. 50 million, taking gain of Rs. 14 million to the profit or loss
- c) Re-measure to Rs. 48 million, taking gain of Rs. 12 million to other comprehensive income
- d) Re-measure to Rs. 48 million, taking gain of Rs. 12 million to the profit or loss

7. An entity should record a biological asset, or agricultural produce, only when:

- i. The entity controls the asset, as a result of past events.
- ii. Future benefits, associated with the asset, will flow to the entity.
- iii. The fair value, or cost, of the asset can be measured reliably.

- a) (i)
- b) (i), (ii)
- c) (i), (ii), & (iii)
- d) None of the above

8. IAS 41 applies to:

- a) change in fair value of a herd of livestock
- b) logs held for sale in a wood yard
- c) cost of developing a new type of crop seed
- d) cost of making irrigation system having life of more than 1 year

9. Pluto Limited owned a one-year old herd of cattle on 1 January, recognised in the financial statements at Rs. 140 million. At 31 December, the fair value of a two-year-old herd of cattle is Rs. 170 million. Costs to sell are still estimated to be Rs. 5 million for the whole herd.

What is the correct accounting treatment for the cattle at 31 December according to IAS 41 Agriculture?

- a) Revalue to Rs. 165 million, taking gain of Rs. 25 million to other comprehensive income
- b) Revalue to Rs. 165 million, taking gain of Rs. 25 million to the statement of profit or loss
- c) Revalue to Rs. 170 million, taking gain of Rs. 30 million to other comprehensive income
- d) Revalue to Rs. 170 million, taking gain of Rs. 30 million to the statement of profit or loss

10. Which two of the following treatments for recognition of government grant related to biological asset measured at its fair value less cost to sell are correct?

- a) An unconditional grant is recognised in profit or loss when, and only when the grant becomes receivables
- b) An unconditional grant is recognised in profit or loss only when, and only when the grant is received
- c) A conditional grant is recognised in profit or loss when, and only when the conditions attaching to the grant are met
- d) A conditional grant is recognised in profit or loss when, and only when the grant is received

11. A grant related to a biological asset measured at cost because 'fair value less cost to sell' could not be measured reliably, should be recorded as income:
- In accordance with IAS 41
 - In accordance with IAS 20
 - When the grant becomes receivable
 - When the conditions of grant are met
12. A gain (or loss) may arise on initial recognition of a biological asset:
- Because estimated cost to sell are deducted in determining 'fair value less cost to sell' of a biological asset
 - When a calf is born
 - As a result of harvesting
- (i)
 - (i) & (ii)
 - (i), (ii) & (iii)
 - None of these
13. An unconditional grant related to a biological asset measured at its 'fair value less cost to sell' should be recorded as income:
- Only when cash is received
 - Only when the grant becomes receivable
 - Only when the goods are sold
 - Only when it is expected that grant may be received
14. Wool Limited (WL) started its business on 1 April 20X5.
- On 1 April 20X5, WL purchased a flock of sheep for Rs. 100 million. At 31 March 2016, the flock was valued at Rs. 120 million. Every time animals are sold there is a 5% commission fee payable to the district municipal corporation.
- No further sheep was purchased or sold during the year.
- During the year, the wool sheared by WL had "fair value less cost to sell" of Rs. 8 million.
- At which amount the flock of sheep should be presented in financial statement of WL as at 31 March 2016?
- Rs. 100 million
 - Rs. 95 million
 - Rs. 120 million
 - Rs. 114 million
15. Wool Limited (WL) started its business on 1 April 20X5.
- On 1 April 20X5, WL had a flock of sheep carried at Rs. 100 million. At 31 March 20X6, the flock was valued at Rs. 120 million. Every time animals are sold there is a 5% commission fee payable to the district municipal corporation.
- No further sheep was purchased or sold during the year.
- During the year, the wool sheared by WL had "fair value less cost to sell" of Rs. 8 million.
- Calculate the total income of WL in respect of its agriculture activity for the year ended 31 March 20X6.
- Rs. 8 million
 - Rs. 14 million
 - Rs. 22 million
 - Rs. 36 million

16. Maria Limited (ML) bought oil palm garden for Rs. 150 million (includes Rs. 120 million for land) on 1 January 20X9. The garden is expected to give agriculture produce for next three years before re-plantation process.

On 31 December 20X9, the year end, the fair value of garden is Rs. 22 million (excluding land). Estimated cost to sell are Rs. 2 million.

Land has fair value of Rs. 130 million on 31 December 20X9.

ML uses cost model for items under scope of IAS 16 and 'fair value less cost to sell' for items under scope of IAS 41.

What is the total amount of non-current assets to be presented in statement of financial position of ML as at 31 December 20X9?

- a) Rs. 150 million
- b) Rs. 140 million
- c) Rs. 120 million
- d) Rs. 20 million

17. Cow Limited (CL) owned cattle recorded in the financial statements at Rs. 10.5 million on 1 January 20X4.

At 31 December 20X4 the cattle have a fair value of Rs. 13 million. If CL sold the cattle, commission of 2% would be payable.

What is the gain to be recognised in profit or loss for the period ended at 31 December 20X4 according to IAS 41 Agriculture?

- a) Rs. 10.5 million
- b) Rs. 13 million
- c) Rs. 2.5 million
- d) Rs. 2.24 million

18. A herd of fifty 3-year old animals was held on 1 January 20X3. On 1 July 20X3 ten 3.5-year-old animal were purchased for Rs. 40,000 each.

The fair values less estimated cost to sell were:

- 3-year-old animal at 1 January 20X3 Rs. 32,000
- 3.5-year-old animal at 1 July 20X3 Rs. 40,000
- 4-year-old animal at 31 December 20X3 Rs. 43,000

Calculate the amount that will be taken to the statement of profit or loss for the year ended 31 December 20X3.

- a) Rs. 400,000
- b) Rs. 580,000
- c) Rs. 980,000
- d) Rs. 2,000,000

19. IAS 41 is applied to agricultural produce:

- a) before the harvest
- b) at the point of harvest
- c) after the harvest
- d) before, during and after the harvest

20. A conditional grant related to a biological asset measured at its 'fair value less estimated cost to sell' should be recorded as income:

- a) over the period in which conditions would be fulfilled
- b) only when the grant becomes receivable
- c) only when the conditions are met
- d) over the life of related biological asset

21. Government grants related to 'Bearer plants' are accounted for under:
- IAS 41
 - IAS 20
 - IAS 16
 - IAS 41 and IAS 20
22. Which of the following statements is/are correct?
- Ocean fishing is an agricultural activity.
 - Biological assets are never depreciated.
- Only (I) is correct
 - Only (II) is correct
 - Both are correct
 - None is correct
23. Which of the following is NOT required to be measured at fair value less costs to sell even if fair value is measurable?
- Biological assets at initial recognition
 - Biological assets at the end of each reporting period
 - Agricultural produce at the point of harvest
 - Agricultural produce at the end of each reporting period
24. On 1 January 2021, a herd of 20 animals of 1-year old was recorded at Rs. 800,000. On 1 July 2021, 10 animals of 1.5 years old were purchased for Rs. 50,000 each. On 31 December 2021, the fair value less costs to sell of 1-year and 2-year animals were Rs. 60,000 and Rs. 70,000 respectively. Calculate the amount that will be taken to profit or loss for the year ended 31 December 2021.
- Rs. 500,000
 - Rs. 1,000,000
 - Rs. 1,300,000
 - Rs. 800,000
25. Government grant related to a biological asset measured at its cost less any accumulated depreciation is accounted for under:
- IAS 20
 - IAS 16
 - IAS 41
 - IAS 41 and IAS 20
26. Which TWO of the following assets require the application of IAS 41?
- Animals kept by zoo for earning ticket revenue
 - Parrots kept by a restaurant to attract more customers
 - Birds kept for sale by a pet shop
 - Hens kept by a poultry farm

27. Beautiful Limited (BL) operates a large dairy farm. In 2022, BL received a government grant of Rs. 30 million on the condition that BL adopts an organic cattle feed system and continues to do so for the next five years. If BL discontinues the organic cattle feed system at any time during five years, BL will have to repay the entire amount of the grant immediately. In 2024, the entire grant becomes repayable due to non-compliance by BL.

The amount taken to BL's statement of profit or loss for the year ending 31 December 2024 upon repayment of government grant would be:

- a) Rs. 18 million
 - b) Rs. 12 million
 - c) Rs. 30 million
 - d) Nil
28. Alpha Livestock Limited (ALL) operates a goat-breeding farm. ALL sells goats to local meat businesses and goats-milk to cosmetics companies. On 1 March 2024, ALL bought 40 goats for Rs. 51,000 each (i.e., at fair value of Rs. 50,000 and 2% commission) from a nearby market. The market broker also charges 3% commission from the seller on each transaction.

The amount to be charged to profit or loss upon initial recognition would be:

- a) Nil
 - b) Rs. 100,000
 - c) Rs. 40,000
 - d) Rs. 60,000
29. Which of the following statements is/are correct?
- i. Bearer biological assets are those that are harvested as agricultural produce or sold as biological assets.
 - ii. Consumable biological assets include fruit trees from which fruit is harvested.
- a) Only (I) is correct
 - b) Only (II) is correct
 - c) Both (I) and (II) are correct
 - d) None is correct

ANSWERS

01.	(b)	The logs will be classed as inventory. The land will be classed as property, plant and equipment. The development costs will be treated as an intangible asset.												
02.	(c)	Land is not biological asset and IAS 38 applies to intangible assets relating to agricultural activity, for example, license for a dairy business.												
03.	(c)	All three are part of agriculture activity.												
04.	(b)	The cheese will be a product which is the result of processing after harvest, so will be outside the scope of IAS 41 Agriculture.												
05.	(d)	Food processing is outside scope of agriculture activity.												
06.	(d)	Re-measure to Rs. 48 million, taking gain of Rs. 12 million to the profit or loss												
07.	(c)	All three are required recognition criteria.												
08.	(a)	Change in fair value of a herd of livestock												
09.	(b)	Agriculture should be revalued to fair value less costs to sell, with the gain or loss being shown in the statement of profit or loss.												
10.	(a) and (c)	An unconditional grant is recognised in profit or loss when, and only when the government grant becomes receivables A conditional grant is recognised in profit or loss when, and only when the conditions attaching to the grant are met												
11.	(b)	IAS 20 applies in this case.												
12.	(b)	The gain (or loss) at the time of harvesting arises on initial recognition of agricultural produce (as opposed to initial recognition of biological assets).												
13.	(b)	Unconditional grant is recognised when it becomes receivable under IAS 41												
14.	(d)	Biological assets = 120 x 95% = Rs. 114 million												
15.	(c)	Gain on biological assets = (120 x 95%) – 100 = Rs. 14 million Agriculture produce at point of harvest = Rs. 8 million Total Rs. 22 million												
16.	(b)	Land Rs. 120 million (cost) Oil palms Rs. 30 million – Rs. 10 million depreciation = Rs. 20 million Total Rs. 140 million Oil palms are bearer plants and therefore, IAS 16 is applicable.												
17.	(d)	(Rs. 13 million x 98%) – 10.5 = Rs. 2.24 million												
18.	(b)	<table><tr><th></th><th>Rs.</th></tr><tr><td>As at 1 January 50 animals x Rs. 32,000</td><td>1,600,000</td></tr><tr><td>Purchased 10 animal x Rs. 40,000</td><td>400,000</td></tr><tr><td></td><td>2,000,000</td></tr><tr><td>Gain (balancing figure)</td><td>580,000</td></tr><tr><td>As at 31 December 60 animals x Rs. 43,000</td><td>2,580,000</td></tr></table>		Rs.	As at 1 January 50 animals x Rs. 32,000	1,600,000	Purchased 10 animal x Rs. 40,000	400,000		2,000,000	Gain (balancing figure)	580,000	As at 31 December 60 animals x Rs. 43,000	2,580,000
	Rs.													
As at 1 January 50 animals x Rs. 32,000	1,600,000													
Purchased 10 animal x Rs. 40,000	400,000													
	2,000,000													
Gain (balancing figure)	580,000													
As at 31 December 60 animals x Rs. 43,000	2,580,000													

19.	(b)	At the point of harvest															
20.	(c)	Only when conditions are met															
21.	(b)	IAS 20															
22.	(d)	None is correct															
23.	(d)	Agricultural produce at the end of each reporting period															
24.	(d)	Working: <table border="1"> <thead> <tr> <th></th><th></th><th>Rs.</th></tr> </thead> <tbody> <tr> <td>1 Jan 2021</td><td>20 One-year old</td><td>800,000</td></tr> <tr> <td>1 Jul 2021</td><td>10 One-and-half-years old x 50,000</td><td>500,000</td></tr> <tr> <td></td><td>Gain in profit or loss (balancing)</td><td>800,000</td></tr> <tr> <td>31 Dec 2021</td><td>30 two-year old x 70,000</td><td>2,100,000</td></tr> </tbody> </table>			Rs.	1 Jan 2021	20 One-year old	800,000	1 Jul 2021	10 One-and-half-years old x 50,000	500,000		Gain in profit or loss (balancing)	800,000	31 Dec 2021	30 two-year old x 70,000	2,100,000
		Rs.															
1 Jan 2021	20 One-year old	800,000															
1 Jul 2021	10 One-and-half-years old x 50,000	500,000															
	Gain in profit or loss (balancing)	800,000															
31 Dec 2021	30 two-year old x 70,000	2,100,000															
25.	(a)	IAS 20															
26.	(c) and (d)	Birds kept for sale by a pet shop Hens kept by a poultry farm															
27.	(d)	Nil															
28.	(b)	Cost of purchase Rs. 51,000 x 40 goats = Rs. 2,040,000 Initial recognition Rs. 50,000 x 97% x 40 goats = Rs. 1,940,000 Loss on initial recognition = Rs. 100,000															
29.	(d)	None is correct															

STICKY NOTES

Key definitions

1.	Agricultural activity is the management by an entity of the biological transformation and harvest of biological assets for sale or for conversion into agricultural produce or into additional biological assets.
2.	Biological transformation comprises the processes of growth, degeneration, production, and procreation that cause qualitative or quantitative changes in a biological asset.
3.	A biological asset is a living animal or plant.
4.	Agricultural produce is the harvested produce of the entity's biological assets.
5.	Harvest is the detachment of produce from a biological asset or the cessation of a biological asset's life processes.
6.	A bearer plant is a living plant that: (a) is used in the production or supply of agricultural produce; (b) is expected to bear produce for more than one period; and (c) has a remote likelihood of being sold as agricultural produce, except for incidental scrap sales.

Recognition and measurement

Recognition	An entity shall recognise a biological asset or agricultural produce when, and only when: (a) the entity controls the asset as a result of past events; (b) it is probable that future economic benefits associated with the asset will flow to the entity; and (c) the fair value or cost of the asset can be measured reliably.
Measurement	The following are required to be measured at fair value less costs to sell: • Biological assets at initial recognition • Biological assets at the end of each reporting period • Agricultural produce at the point of harvest. Gain and losses on measurement and re-measurement are recognised in profit or loss.
Government grant	For biological assets measured at fair value less costs to sell: • Unconditional grant is recognised in PL. • Conditional grant is recognised in PL when conditions are met. For other biological asset • IAS 20 applies for government grants

AT A GLANCE

SPOTLIGHT

STICKY NOTES

STATEMENT OF CHANGES IN EQUITY

IN THIS CHAPTER:

AT A GLANCE

SPOTLIGHT

1. Equity
2. Equity transactions
3. Statement of changes in equity
4. Comprehensive Examples
5. Objective Based Q&A

STICKY NOTES

AT A GLANCE

The statement of changes in equity is a financial statement that summarises the transactions affecting the shareholders' equity during a specific reporting period. This statement reconciles the opening and closing equity balances by reporting changes in retained earnings, other reserves and share capital of the entity.

Except for changes resulting from transactions with owners in their capacity as owners (such as issue of shares, payment of dividends) and transaction costs directly related to such transactions, the overall change in equity during a period represents the total amount of income and expense, including gains and losses, generated by the entity's activities during that period.

Therefore, statement of changes in equity enables shareholders and investors to make informed decisions regarding their investments by providing:

- information which is not provided elsewhere in the financial statements;
- a connection between statement of comprehensive income and statement of financial position.

The following items are usually presented in the statement of changes in equity:

- Right issue of shares
- Bonus issue of shares or interim and final bonus dividend declared
- Interim and final cash dividend declared
- Profit or loss for the period
- Other comprehensive income items
- Transfers between reserves
- Effect of retrospective application or retrospective restatement (IAS 8)

1 EQUITY

1.1 Components of equity

Equity is defined as the residual interest in the assets of the entity after deducting all its liabilities. Equity is presented in statement of financial position and consists of:

- a) Share capital
 - Ordinary share capital
 - Preference share capital (irredeemable)
- b) Capital (non-distributable) reserves
 - Share premium
 - Revaluation surplus
- c) Revenue (distributable) reserves
 - Retained earnings
 - General reserves
 - Other specific reserves created out of retained earnings (Dividend equalization reserves)

1.2 Dividend

A dividend is the distribution of a company's earnings (realised profits) to its shareholders and is determined by the company's board of directors and approved by either board of directors or shareholders.

1.3 Share capital

The term "share capital" refers to the amount of money the owners of a company have invested in the business as represented by ordinary and irredeemable preference shares.

1.3.1 Ordinary share capital

Owning ordinary shares entitles an investor to own a part of ownership in the company. The shareholders are given voting rights, rights to attend the annual general meetings, dividends, and bonus shares from the company. Most companies issue only this type of share capital.

1.3.2 Preference share capital

The preference shareholders are given preference over ordinary shareholders while paying dividends and repaying the amount of capital at the time of liquidation of the company.

Dividend payments for preference shareholders are often fixed and due to this preference shares are often seen as a less risky investment, although payments are likely to be lesser than ordinary dividend when company is performing well.

Preference shares are of two types: redeemable and irredeemable. Only irredeemable preference shares are treated as equity share capital since redeemable preference shares are often classified as liability as entity has obligation to settle the amount after a certain time.

1.4 Capital reserves

Capital reserves are reserves that are not regarded free for distribution by way of dividend. Two most common capital reserves are share premium and revaluation surplus.

1.4.1 Share premium

The excess of issue price (i.e. the total amount a company received for shares) over par value of a company's shares is called "share premium". For example, if a share having par value of Rs. 10 is issued for Rs. 12 then Rs. 2 is the share premium.

The Companies Act, 2017 (Section 81) prescribes that the share premium account may be used:

- To write-off the preliminary expenses;
- To write-off the expenses (commission, discount) of issue of shares;
- In providing for the premium payable on the redemption of any redeemable preference shares
- For issue of bonus shares

1.4.2 Revaluation surplus

The result of an upward revaluation of a non-current asset is a 'revaluation surplus'. The amount accumulated in revaluation surplus is non-distributable, as it represents unrealised profits on the revalued assets. The revaluation surplus may diminish if an asset which had previously been revalued upwards is devalued later. Revaluation surplus is transferred to retained earnings in case of disposal of asset and/or incremental depreciation.

1.5 Revenue reserves

Revenue reserve means reserve that is normally regarded as available for distribution including:

- retained earnings (also called un appropriated or accumulated profits);
- general reserves; and
- other specific reserves created out of profit (Dividend equalization reserves).

1.5.1 Retained earnings

Retained earnings comprise the earnings (profits and gains less expenses and losses) that the company retains within the business, i.e. part of profits that has not been paid out as dividends or transferred to any other reserve. A debit balance on the retained earnings account indicates that the company has accumulated losses.

1.5.2 General reserves

General reserve is the amount kept aside from the company's profit during its normal operation to meet future needs. i.e., contingencies, strengthening the company's financial position, increasing working capital, paying dividends to the shareholders, offsetting specific future losses, etc. Usually, a transfer to general reserves from retained earnings is made with approval of board of directors.

1.5.3 Dividend equalization reserve

Dividend equalization reserve is a specific reserve created out of retained earnings to ensure dividends remain stable irrespective of changes in earnings.

2 EQUITY TRANSACTIONS

2.1 Issue of shares for consideration / right issue

Each share has a nominal value that is stated on it and it is called par value (or face value or stated value). Market value of shares (i.e. the price at which shares are traded at stock exchange or otherwise) is usually higher than par value.

It is common to issue shares to existing shareholders in proportion to their existing shareholdings and such share issue is called right issue. Shares are often issued above par value but at discount on market price.

Share issue	Journal entry
At par value	Debit Bank Credit Share capital
Above par value (at premium)	Debit Bank Credit Share capital Credit Share premium
Below par value (at discount)	Debit Bank Debit Share premium / Retained earnings (Note) Credit Share capital
Transaction costs on share issue	Debit Share premium / Retained earnings (Note) Credit Bank/accrual

Note: Transaction costs and discount on share issue are never directly charged to profit or loss. Usually, the share premium account is debited, and the retained earnings are debited only if there is no balance or not enough balance in share premium account.

► Example 01:

Adeel Limited (AL) had following equity balances as on 1st January 2023:

	Rs. m
Ordinary share capital (Rs. 100 each)	600
Retained earnings	15

On 16 April 2023, AL made a 20% right issue at par value. Issue costs of Rs. 1 million were also incurred.

Required:

Journal entries.

► Answer:

Journal entries

Date	Particulars	Debit Rs. m	Credit Rs. m
16 Apr 2023	Bank [600 x 20%]	120	
	Share capital		120
16 Apr 2023	Retained earnings	1	
	Bank / accrual		1

► **Example 02:**

Aqeel Limited (AL) had following equity balances as on 1st January 2023:

	Rs. m
Ordinary share capital (Rs. 100 each)	600
Share premium	120
Retained earnings	85

On 16 August 2023, AL made a right issue of 1 for 4 shares already held at Rs. 150 per share. Issue costs of Rs. 5 million were also incurred.

Required:

Journal entries.

► **Answer:****Journal entries**

Date	Particulars	Debit Rs. m	Credit Rs. m
16 Aug 2023	Bank	225	
	Share capital [600 x ¼]		150
	Share premium [150 / 100 x 50]		75
16 Aug 2023	Share premium	5	
	Bank / accrual		5

► **Example 03:**

Arma Limited (AL) had following equity balances as on 1st January 2023:

	Rs. m
Ordinary share capital (Rs. 100 each)	600
Share premium	60
Retained earnings	(30)

On 11 December 2023, AL issued 300,000 shares at Rs. 90 each after obtaining necessary approvals from regulatory authorities. Issue costs of Rs. 2 million were also incurred.

Required:

Journal entries.

► **Answer:****Journal entries**

Date	Particulars	Debit Rs. m	Credit Rs. m
11 Dec 2023	Bank [300,000 x Rs. 90]	27	
	Share premium [300,000 x 10]	3	
	Share capital		30
11 Dec 2023	Share premium	2	
	Bank / accrual		2

2.2 Issue of shares for no consideration / bonus issue

A bonus issue, also known as a scrip issue or a capitalization issue, is an offer of free additional shares to existing shareholders in proportion to their existing shareholding. For example, a company may give one bonus share for every five shares held.

Bonus issue is always at par value and it does not involve any cash inflows. A company may decide to distribute bonus shares as an alternative to paying cash dividends and thus avoiding the cash outflow.

The company converts some of its reserves (share premium or retained earnings or both) into extra share capital. The journal entry is:

Debit Share premium / Retained earnings (Note)
Credit Share capital

Note: In case bonus issue is made as dividend, retained earnings are debited. However, for bonus issue other than as dividend, it is common to utilise the balance of share premium account first.

► Example 04:

Jazib Limited (JL) had following equity balances as on 1st January 2023:

	Rs. m
Ordinary share capital (Rs. 100 each)	600
Share premium	300
Retained earnings	285

On 5 February 2023, JL made a bonus issue of 1 for 5 shares already held.

Required:

Journal entries.

► Answer:

Journal entries

Date	Particulars	Debit Rs. m	Credit Rs. m
5 Feb 2023	Share premium	120	
	Share capital [600 x 1/5]		120

► Example 05:

Ghalib Limited (GL) had following equity balances as on 1st January 2023:

	Rs. m
Ordinary share capital (Rs. 100 each)	600
Share premium	300
Retained earnings	285

On 24 October 2023, GL declared a bonus dividend of 20%.

Required:

Journal entries.

► *Answer:*

Journal entries

Date	Particulars	Debit Rs. m	Credit Rs. m
24 Oct 2023	Retained earnings	120	
	Share capital [600 x 20%]		120

2.3 Dividend

Dividend is the distribution of profits to shareholders. Dividend must be recognised only when it is declared (i.e. approved by relevant authority). The dividend is usually paid within few days of its declaration.

Many companies pay dividends in two stages during the course of their accounting year:

Interim dividend	This dividend is declared during the year by board of directors and it is recognised immediately in the same year as no further approval is needed. It is common to declare interim dividend with half-yearly accounts.
Final dividend	This is dividend calculated after the end of a financial year based on the company's annual profits. It is proposed by directors but must be declared (approved) by shareholders in their meeting in the following year. Therefore, final dividend of year 2022 shall be declared and recognised in year 2023. Shareholders may accept, reject or reduce the amount of dividend as proposed by directors but cannot increase it.

The journal entries for recognising dividends are:

Cash dividend	Debit Retained earnings Credit Dividend payable / Bank
Bonus dividend	Debit Retained earnings Credit Share capital

The dividend on preference shares may be cumulative or non-cumulative. Any unpaid cumulative dividends passes to future years and have to be paid out before dividends for ordinary shareholders.

Preference dividend	Treatment
Cumulative	Such dividend for the period need to be taken into account irrespective of whether declared or not.
Non-cumulative	Such dividend for the period need to be taken into account only for the amount of dividend declared for the period.

► *Example 06:*

Maria Limited (ML) had following equity balances as on 1st January 2023:

	Rs. m
Ordinary share capital (Rs. 100 each)	600
Share premium	300
Retained earnings	285

The following detail of dividends declared is available:

For the year ended	*Interim cash dividend	**Final bonus dividend
31 December 2022	10%	20%
31 December 2023	12%	15%

*Declared with half yearly accounts by directors on 17th August each year.

**Declared by shareholders on 25th April of following year.

Required:

Journal entries for recognising dividend for the year ended 31 December 2023.

► *Answer:*

Journal entries

Date	Particulars	Debit Rs. m	Credit Rs. m
25 Apr 2023	Retained earnings [600 x 20%]	120	
	Share capital		120
17 Aug 2023	Retained earnings [(600+120) x 12%]	86.4	
	Dividend payable / Bank		86.4

► *Example 07:*

Zahra Limited (ZL) had following equity balances as on 1st January 2023:

	Rs. m
Ordinary share capital (Rs. 100 each)	600
Irredeemable preference shares (Rs. 1000 each)	400
Share premium	300
Retained earnings	285

The preference shareholders are entitled to 12% cumulative dividend in arrears. However, no dividend was declared or paid during the year.

Required:

Journal entries for recognising dividend for the year ended 31 December 2023.

► *Answer:*

Journal entries

Date	Particulars	Debit Rs. m	Credit Rs. m
31 Dec 2023	Retained earnings [400 x 12%]	48	
	Dividend payable		48

2.4 Transfers between reserves

A transfer from one reserve to another may also be made. The following transfers are common:

Event	Journal entry
Incremental depreciation on revalued asset	Debit Revaluation surplus Credit Retained earnings
Disposal of revalued asset	Debit Revaluation surplus Credit Retained earnings
Transfer to general reserve	Debit Retained earnings Credit General reserve

► **Example 08:**

The following information relate to Multan Limited (ML):

- ML disposed of a land on 3rd January 2023. This land had a carrying amount of Rs. 85 million (using revaluation model) and was purchased at a cost of Rs. 36 million few years ago.
- ML revalued its motor vehicles on 1st January 2023 and a revaluation surplus of Rs. 50 million was recognised at this date. The motor vehicles had remaining useful life of 5 years on this date and are being depreciated using straight line method.
- ML has determined its profit for the year ended 31 December 2023 at Rs. 75 million after all the necessary adjustments. The board of directors have approved a transfer 20% of profit to general reserves.

Required:

Journal entries involving transfers between reserves. Journal entries for disposal or gain (loss) on revaluation are not required.

► **Answer:**

Journal entries

Date	Particulars	Debit Rs. m	Credit Rs. m
3 Jan 2023	Revaluation surplus [85 – 36]	49	
	Retained earnings		49
31 Dec 2023	Revaluation surplus [50/5 years]	10	
	Retained earnings		10
31 Dec 2023	Retained earnings [75 x 20%]	15	
	General reserves		15

3 STATEMENT OF CHANGES IN EQUITY

3.1 Complete set of financial statements [IAS 1: 10]

A complete set of financial statements comprises:

- a) a statement of financial position as at the end of the period;
- b) a statement of profit or loss and other comprehensive income for the period;
- c) a statement of changes in equity for the period;
- d) a statement of cash flows for the period;
- e) notes, comprising significant accounting policies and other explanatory information;
- f) comparative information in respect of the preceding period; and
- g) a statement of financial position as at the beginning of the preceding period when an entity applies an accounting policy retrospectively or makes a retrospective restatement (covered in a later chapter on IAS 8).

You have prepared statement of financial position and statement of comprehensive income in your earlier studies. This chapter focuses on the preparation of statement of changes in equity.

3.2 Purpose and importance

The statement of changes in equity actually tells the users about the status of owner's equity at the beginning of the financial period, how it has changed during the year and the status of equity at the end of the period. Thus, the statement of changes in equity helps users of financial statement to identify the factors that cause a change in the owners' equity over the accounting periods.

Therefore, through statement of changes in equity, users, especially shareholders can get great insights about the effects of business operations and related factors on the wealth of the owners invested in the business.

The following items are usually presented in the statement of changes in equity:

- Right issue of shares
- Bonus issue of shares or interim and final bonus dividend declared
- Interim and final cash dividend declared
- Profit or loss for the period
- Other comprehensive income
- Transfers between reserves

3.3 Information to be presented [IAS 1: 106]

The statement of changes in equity includes the following information:

- a) total comprehensive income for the period
- b) for each component of equity, the effects of retrospective application or retrospective restatement recognised (covered later in a chapter on IAS 8); and
- c) for each component of equity, a reconciliation between the carrying amount at the beginning and the end of the period, separately (as a minimum) disclosing changes resulting from:
 - profit or loss;
 - other comprehensive income; and
 - transactions with owners in their capacity as owners, showing separately contributions by and distributions to owners.

3.4 Information to be presented either in the statement or in the notes [IAS 1: 106A & 107]

An entity shall present, either in the statement of changes in equity or in the notes:

- an analysis of other comprehensive income by item.
- the amount of dividends recognised as distributions to owners during the period, and the related amount of dividends per share.

3.5 Specimen

ABC Limited

Statement of changes in equity

For the year ended 30 June 2023

	Ordinary Share capital	Preference share capital	Share premium	Retained earnings	Revaluation surplus	Total
	Rs. m	Rs. m	Rs. m	Rs. m	Rs. m	Rs. m
Balance on 30 June 2021	200	60	30	50	40	380
Effect of change in accounting policy				(5)		(5)
Effect of correction of error				(2)		(2)
Balance on 30 June 2021 – restated	200	60	30	43	40	373
Right issue of shares	40		22			62
Transaction costs on issue			(3)			(3)
Bonus dividend (Interim 2022)	12			(12)		-
Total comprehensive income						
Profit for the year				40		40
Other comprehensive income					20	20
Transfer (incremental dep)				6	(6)	-
Preference dividend 10%				(3)		(3)
Balance on 1 July 2022	252	60	49	74	54	489
Cash dividend (Final 2022)				(15)		(15)
Cash dividend (Interim 2023)				(18)		(18)
Total comprehensive income						
Profit for the year				48		48
Other comprehensive income					(10)	(10)
Transfer (incremental dep)				5	(5)	-
Preference dividend 10%				(3)		(3)
Balance on 30 June 2023	252	60	49	91	39	491

Note: The following items will be covered later in chapter on IAS 8:

- Effect of change in accounting policy due to retrospective application; and
- Effect of correction of prior period error due to retrospective restatement.

► *Example 09:*

The equity of SMS Limited as on December 31, 2019 is as follows:

	Rs. in million
Total equity at the beginning of the year:	
Share Capital (@ Rs. 10 fully paid ordinary shares)	3,000
Share premium	1,900
Retained earnings	4,500
	9,400
Profit for the year	400
Cash dividends declared and paid	(300)
Total equity at the end of the year	9,500

The company also made a bonus issue of 2 shares for 1 already held, during the year.

Required:

Prepare statement of changes in equity of SMS Limited for the year ended on December 31, 2019.

► *Answer:***SMS Limited****Statement of changes in equity for the year ended 31 December 2019**

	Share capital	Share premium	Retained earnings	Total
	Rs. m	Rs. m	Rs. m	Rs. m
Balance as on 1 January 2019	3,000	1,900	4,500	9,400
Profit for the year			400	400
Cash dividend			(300)	(300)
Bonus issue [3,000 x 2/1]	6,000	(1,900)	(4,100)	-
Balance as on 31 December 2019	9,000	-	500	9,500

► *Example 10:*

M&K Limited (MKL) is in the business of manufacturing and sale of yarn products. MKL's year-ends on 31 December.

Below is the relevant information given:

Opening balances as at January 01, 2018	Rs. 000
Share capital (at par value of Rs. 10 per share)	25,000
Share premium	7,500
General reserves	750
Retained earnings	18,250
Revaluation surplus	1,500

MKL revalued non-current assets on December 31, 2017 resulting in revaluation surplus of Rs. 1.5 million. Remaining useful life of the assets is 10 years and MKL has a straight line method for depreciation.

The board of directors of MKL has implemented policy of transferring 5% of annual profits to general reserves each year.

Following events have taken place in year 2018 and 2019:

- On March 31, 2018, MKL issued right shares (one right share against five ordinary shares held) for Rs. 20 per share.
- The board of directors of MKL approved interim dividend of Rs. 2.25 per share for the half year ended June 30, 2018.
- Profit for the year ended December 31, 2018 is Rs. 10.25 million
- The board of directors recommended final dividend for the year 2018 of Rs. 4.25 per share on February 15, 2019, which was duly approved by the shareholders on March 21, 2019.
- The board of directors approved bonus shares of 20% of the outstanding shares on June 30, 2019 which were duly credited in shareholders account on August 31, 2019.
- The board of directors approved interim cash dividend of Rs. 1.25 per share for the third quarter ended September 30, 2019.
- Profit for the year ended December 31, 2019 is Rs. 12.5 million.
- The board of directors recommended final dividend for the year 2019 of Rs. 5 per share on February 15, 2020, which was duly approved by the shareholders on March 21, 2020.

Required:

Prepare statement of changes in equity for the year ended December 31, 2019 (including comparatives). **The column for total is not required.**

► **Answer:**

M&K Limited

Statement of changes in equity for the year ended 31 December 2019

	Share capital	Share premium	General reserve	Retained earnings	Revaluation surplus
	Rs. 000	Rs. 000	Rs. 000	Rs. 000	Rs. 000
Balance as on 1 January 2018	25,000	7,500	750	18,250	1,500
Right issue [25,000 x 1/5]	5,000	5,000			
Interim dividend (Rs. 2.25)				(6,750)	
Profit for the year				10,250	
Transfer 10.25 x 5%			512.5	(512.5)	
Transfer 1.5 / 10 years				150	(150)
Balance as on 31 Dec 2018	30,000	12,500	1,262.5	21,387.5	1,350
Final dividend (Rs. 4.25)				(12,750)	
Bonus issue (20%)	6,000	(6,000)			
Interim dividend (Rs. 1.25)				(4,500)	
Profit for the year				12,500	
Transfer 12.5 x 5%			625	(625)	
Transfer 1.5 / 10 years				150	(150)
Balance as on 31 Dec 2019	36,000	6,500	1,887.5	16,162.5	1,200

► **Example 11:**

ABC Industries Limited is in the business of manufacturing and sale of Cars. The company's year-ends on 31 December.

Below is the relevant information given:

Opening balances as at January 01, 2018:	Rs. 000
Share capital (at par value of Rs. 10 per share)	100,000
Share premium	50,000
General reserves	5,000
Retained earnings	55,000

The board of directors of ABC Industries Limited has implemented policy of transferring 5% of annual profits to general reserves each year.

Following events have taken place in year 2018 and 2019:

- i. The board of directors recommended final dividend for the year ended December 31, 2017 of Rs. 5 per share on February 15, 2018, whereas shareholders only approved Rs. 4 per share on March 31, 2018.
- ii. On 30 April 2018, the company issued 5 million shares for Rs. 25 each.
- iii. The board of directors approved interim dividend of Rs. 1 per share for the third quarter ended September 30, 2018.
- iv. Profit for the year ended December 31, 2018 is Rs. 130.25 million.
- v. The board of Directors recommended final dividend for the year ended December 31, 2018 of Rs. 4.25 per share on February 15, 2019, shareholders have approved it and have asked to increase it to Rs. 6 per share in their meeting held on March 31, 2019.
- vi. The board of directors approved bonus shares of 10% of the outstanding shares on June 30, 2019.
- vii. The board of directors approved interim dividend of Rs. 1.5 per share for the third quarter ended September 30, 2019.
- viii. Profit for the year ended December 31, 2019 is Rs. 175 million.
- ix. The board of directors of the company recommended final dividend for the year ended December 31, 2019 of Rs. 5.5 per share on February 15, 2020, which was duly approved by the shareholders on March 31, 2020.

Required:

Prepare statement of changes in equity for the year ended December 31, 2019 (including comparatives). **The column for total is not required.**

► Answer:

ABC Industries Limited**Statement of changes in equity for the year ended 31 December 2019**

	Share capital	Share premium	General reserve	Retained earnings
	Rs. 000	Rs. 000	Rs. 000	Rs. 000
Balance as on 1 January 2018	100,000	50,000	5,000	55,000
Final dividend 2017: Rs. 4 per share				(40,000)
Share issue for cash	50,000	75,000		
Interim dividend 2018: Re. 1 per share				(15,000)
Profit for the year				130,250
Transfer 5%			6,512.5	(6,512.5)
Balance as on 31 December 2018	150,000	125,000	11,512.5	123,737.5
Final dividend 2018: Rs. 4.25 per share				(63,750)
Bonus issue of shares (10%)	15,000	(15,000)		
Interim dividend 2019: Rs. 1.5 per share				(24,750)
Profit for the year				175,000
Transfer 5%			8,750	(8,750)
Balance as on 31 December 2019	165,000	110,000	20,262.5	201,487.5

4 COMPREHENSIVE EXAMPLES

► Example 12:

The following information pertains to draft financial statements of Pak Ocean Limited (POL) for the year ended 31 December 2018.

Shareholders' equity as at 1 January 2018 was as follows:	Rs in million
Share capital (Rs. 100 each)	200
Retained earnings	45

Cash dividend @ 18% for the year ending 2017 was declared in March 2018.

Bonus issue declared during the year ended 31 December 2018:

- Interim (declared with half yearly accounts) 10%
- Final 25%

On 30 November 2018, POL issued 25% right shares to its ordinary shareholders at Rs. 120 per share.

	Rs. in million
Profit after tax	78
Other comprehensive income (gain on revaluation)	12
Incremental depreciation due to revaluation	1.5

Required:

Prepare the statement of changes in equity for the year ended December 31, 2018 for Pak Ocean Limited.

► Answer:

Pak Ocean Limited

Statement of changes in equity for the year ended 31 December 2018

	Share capital	Share premium	Retained earnings	Revaluation surplus	Total
	Rs. m	Rs. m	Rs. m	Rs. m	Rs. m
Balance on 1 January 2018	200	-	45		245
Final cash dividend			(36)		(36)
Interim bonus dividend	20		(20)		-
Right issue 25%	55	11			66
Total comprehensive income					
Profit for the year			78		78
Other comprehensive income				12	12
Transfer (incremental dep.)			1.5	(1.5)	
Balance as at 31 Dec 2018	275	11	68.5	10.5	365

► **Example 13:**

For the purpose of preparation of statement of changes in equity for the year ended 31 December 2017, Daffodil Limited (DL) has extracted the following information:

	2017	2016	2015
	Draft	Audited	Audited
	----- Rs. in million -----		
Net profit	650	318	214
Transfer to general reserves	112	-	141
Transfer of incremental depreciation	-	49	55
Final cash dividend	-	-	7.5%

The asset which was revalued upward in previous years has been sold on 15 October 2017.

Details of share issues:

- 25% right shares were issued on 1 May 2016 at 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.
- A bonus issue of 15% was made on 1 September 2017 as interim dividend.

Share capital and reserves as at 31 December:

	2015	2014
	----- Rs. in million -----	
Ordinary share capital (Rs. 10 each)	1,600	1,600
General reserves	1,850	1,709
Retained earnings	1,430	1,302
Revaluation surplus	75	-

Required:

Prepare DL's statement of changes in equity for the year ended 31 December 2017 along with comparative figures. The column for total is not required.

► **Answer:****Daffodil Limited****Statement of changes in equity for the year ended 31 December 2017**

	Share capital	Share premium	General reserve	Retained earnings	Revaluation surplus
	Rs. m	Rs. m	Rs. m	Rs. m	Rs. m
Balance as on 1 January 2016	1,600	-	1,850	1,430	75
Final cash dividend 7.5%				(120)	
Right issue 25%	400	320			
Profit for the year				318	
Transfer (Inc. dep.)				49	(49)
Balance as on 31 Dec 2016	2,000	320	1,850	1,677	26

	Share capital	Share premium	General reserve	Retained earnings	Revaluation surplus
	Rs. m	Rs. m	Rs. m	Rs. m	Rs. m
Final bonus dividend 10%	200			(200)	
Right issue 50m shares	500	250			
Interim bonus dividend 15%	405			(405)	
Profit for the year				650	
Transfer to general reserve			112	(112)	
Transfer on disposal				26	(26)
Balance as on 31 Dec 2017	3,105	570	1,962	1,636	0

► **Example 14:**

The following information pertains to Wednesday Limited (WL) for the year ended 30 June 2019:

- i. Shareholders' equity as at 1 July 2018:

	Rs. in million
Share capital (Rs. 100 each)	200
Share premium	85
Retained earnings	124
Revaluation surplus	65

- ii. On 30 November 2018, WL issued 30% right shares at a premium of Rs. 120 per share.
 iii. Cash dividend and bonus shares for the last two years:

For the year ended	Final dividend		*Interim dividend	
	Cash	Bonus	Cash	Bonus
30 June 2018	18%	-	20%	-
30 June 2019	-	25%	-	10%

*Declared with half yearly accounts

- iv. Profit for the year amounted to Rs. 95 million.
 v. Revaluation surplus arising during the year amounted to Rs. 35 million whereas transfer of incremental depreciation for the year was Rs. 9 million.

Required:

Prepare WL's Statement of changes in equity for the year ended 30 June 2019. (Column for total and comparative figures are not required)

► *Answer:***Wednesday Limited****Statement of changes in equity for the year ended 30 June 2019**

	Share capital	Share premium	Retained earnings	Revaluation surplus
	Rs. m	Rs. m	Rs. m	Rs. m
Balance as on 1 July 2018	200	85	124	65
Final cash dividend [200 x 18%]			(36)	
Right issue @ 30%	60	72		
Interim bonus dividend [260 x 10%]	26		(26)	
Total compressive income				
Profit for the year			95	
Other comprehensive income				35
Transfer of incremental depreciation			9	(9)
Balance as at 30 June 2019	286	157	166	91

► *Example 15:*

Following information pertains to Astrazenca Limited (AL):

- i. Shareholders' equity as on 1 January 2020:

	Rs. in million
Share capital (Rs. 100 each)	250
Share premium	138
Retained earnings	142
Revaluation surplus:	
Land	25
Buildings	20

- ii. Profit and transfer of incremental depreciation as per the draft financial statements for the year ended 31 December 2020 amounted to Rs. 45 million and Rs. 5 million respectively.
- iii. Dividends for the last two years:

For the year ended	*Interim cash dividend	Final bonus dividend
31 December 2019	10%	20%
31 December 2020	12%	15%

*Declared with half yearly accounts

- iv. AL uses revaluation model for subsequent measurement of its land and buildings only. The revalued amounts of land and buildings have been assessed at 31 December 2020 but not incorporated in draft financial statements. The relevant details are as under:

	Land	Buildings
	--- Rs. in million ---	
Balances as on 31 December 2020 before revaluation:		
Cost	75	240
Accumulated depreciation	-	60
Revalued amounts assessed at 31 December 2020	65	158

Required:

Prepare AL's statement of changes in equity for the year ended 31 December 2020. (Column for total and comparative figures are not required)

► **Answer:**

Astrazenca Limited

Statement of changes in equity for the year ended 31 December 2020

	Share capital	Share premium	Retained earnings	Revaluation surplus
	Rs. m	Rs. m	Rs. m	Rs. m
Balance as on 1 January 2020	250	138	142	45
Final bonus dividend 2019 [250 x 20%]	50		(50)	
Interim cash dividend [(250+50) x 12%]			(36)	
Total comprehensive income:				
Profit for the year [45 - 7]			38	
Other comprehensive income [10 + 15]				(25)
Transfer of incremental depreciation			5	(5)
Balance as on 31 December 2020	300	138	99	15

Working: Revaluation		Land Rs. m		Building Rs. m
Revalued amount		65		158
Carrying amount		75	[240 - 60]	180
Revaluation loss		(10)		(22)
Charge to OCI	[Available 25]	10	Available [20 - 5]	15
Charge to profit or loss		0		7

► **Example 16:**

Kashif Construction Limited (KCL), a public listed company, is in the process of finalizing its accounts for the year ended 31 December 2023. The following information is available:

- i. Share capital and reserves as at 1 January 2022 were as follows:

	Rs. m
Ordinary share capital (Rs. 10 each)	900
Irredeemable preference share capital (Rs. 100 each)	360
Share premium	200
General reserve	150
Retained earnings	600

The preference shareholders are entitled to the cumulative preference dividend of 10% which becomes due on 31 December each year.

- ii. The details share issued for cash consideration are as follows:

- A right issue of 20% at Rs. 18 per share on 30 May 2022. Transaction costs of Rs. 3 million were also incurred.
- A right issue of 1 for 8 shares already held at a premium of Rs. 11 per share on 10 June 2023. Transaction costs of Rs. 4 million were also incurred.

- iii. The total comprehensive income for the years ended 31 December 2022 and 2023 are as follows:

	2023	2022
	Rs. m	Rs. m
Profit after tax	400	350
Other comprehensive income		
Gain (loss) on revaluation	(4)	20
Total comprehensive income	396	370

Revaluation was carried on 1st January 2022 for the first time; the related assets had remaining useful life of 5 years. Another revaluation of same assets was carried on 1st January 2023, however, there is no change in useful life. KCL transfers revaluation surplus to retained earnings on annual basis.

- iv. The details of cash dividend and bonus issues of ordinary shares (as dividend) declared and paid during the three years are as follows:

For the year ended	Cash dividend		Bonus	
	Interim*	Final**	Interim*	Final**
31 December 2021	5%	-	-	10%
31 December 2022	-	10%	15%	-
31 December 2023	15%	-	-	7.5%

*In August with dispatch of half-yearly accounts

** In April when annual general meeting of shareholders was held

- v. KCL follows a policy of transferring 10% of its profit after tax to general reserve.

Required:

Prepare statement of changes in equity for the year ended 31 December 2023, along with comparatives. (total column is not required)

► Answer:

Kashif Construction Limited**Statement of changes in equity****For the year ended 31 December 2023**

	Ordinary share capital	Preference share capital	Share premium	General reserve	Retained earnings	Revaluation surplus
	Rs. m	Rs. m	Rs. m	Rs. m	Rs. m	Rs. m
Balance as on 1 Jan 2022	900	360	200	150	600	-
Bonus dividend 10% (Final 2021)	90				(90)	
Right issue 20%	198		158.4			
Transaction costs on issue			(3)			
Interim bonus dividend 15%	178.2				(178.2)	
Total comprehensive income						
Profit for the year					350	
Other comprehensive income						20
Transfer [20/5]					4	(4)
Transfer to general reserve				35	(35)	
Preference dividend 10%					(36)	
Balance as on 1 Jan 2023	1,366.2	360	355.4	185	614.8	16
Cash dividend 10% (Final 2022)					(136.62)	
Right issue (1 for 8)	170.78		187.85			
Transaction costs on issue			(4)			
Interim cash dividend 15%					(230.55)	
Total comprehensive income						
Profit for the year					400	
Other comprehensive income						(4)
Transfer [12/4]					3	(3)
Transfer to general reserve				40	(40)	
Preference dividend 10%					(36)	
Balance as on 31 Dec 2023	1,536.98	360	539.25	225	574.6	9

5 OBJECTIVE BASED Q&A

1. Which TWO of the following are separately identified in statement of changes in equity?
 - a) Gross profit
 - b) Transactions with owners
 - c) Net profit
 - d) Non-owner changes in equity
2. Which of the following issued by an entity is treated as liability?
 - a) Ordinary share capital
 - b) Redeemable preference share capital
 - c) Irredeemable preference share capital
 - d) None of above
3. A company has profit after tax of Rs. 80 million for the financial year ended on 30 June 2019. It has share capital of Rs. 500 million. During the year company has declared interim dividend of 10%.
How this dividend shall be presented in financial statements for the year ended 30 June 2019?
 - a) Rs. 8 million deducted from retained earnings in statement of changes in equity
 - b) Rs. 50 million deducted from retained earnings in statement of changes in equity
 - c) Rs. 50 million deducted from profit or loss as finance cost
 - d) It shall not be recorded, only disclosure shall be made
4. A company has profit after tax of Rs. 80 million for the financial year ended on 30 June 2019. It has share capital of Rs. 500 million. The board of directors proposed a final dividend of 10% just after the year end, for the year ended 30 June 2019
How this dividend shall be presented in financial statements for the year ended 30 June 2019?
 - a) Rs. 8 million deducted from retained earnings in statement of changes in equity
 - b) Rs. 50 million deducted from retained earnings in statement of changes in equity
 - c) Rs. 50 million deducted from profit or loss as finance cost
 - d) It shall not be recorded, only disclosure shall be made
5. Which TWO of the following are usually shown in statement of changes in equity when right issue of shares is made?
 - a) Increase in share capital
 - b) Decrease in share premium
 - c) Increase in share premium
 - d) Increase in retained earnings
6. Which TWO of the following are usually shown in statement of changes in equity when bonus issue of shares is made?
 - a) Increase in share capital
 - b) Decrease in share premium
 - c) Increase in share premium
 - d) Increase in retained earnings

7. Transaction costs relating to issue of shares are usually debited to:
- Profit or loss
 - Share capital
 - Share premium
 - Revaluation surplus
8. Incremental depreciation has following effects on statement of changes in equity:
- Increase in revaluation surplus and decrease in retained earnings
 - Decrease in revaluation surplus and increase in retained earnings
 - Decrease in revaluation surplus and decrease in retained earnings
 - No effect
9. A company has following balances on 1 January 2019:

	Rs. m
Share capital (Rs. 100 each)	100
Share premium	30
Revaluation surplus	20
Retained earnings	35

The company made a right issue of 1 for 5 shares already held at Rs. 145 per share.

What amount of share capital shall be presented in statement of changes in equity as at 31 December 2019?

- Rs. 80 million
 - Rs. 100 million
 - Rs. 120 million
 - Rs. 140 million
10. A company has following balances on 1 January 2019:

	Rs. m
Share capital (Rs. 100 each)	100
Share premium	30
Revaluation surplus	20
Retained earnings	35

The company made a right issue of 1 for 5 shares already held at Rs. 145 per share.

What amount of share premium shall be presented in statement of changes in equity as at 31 December 2019?

- Rs. 26 million
- Rs. 39 million
- Rs. 48 million
- Rs. 45 million

11. A company has following balances on 1 January 2019:

	Rs. m
Share capital (Rs. 100 each)	100
Share premium	30
Revaluation surplus	20
Retained earnings	35

The company made a bonus issue of 2 for 5 shares already held.

What amount of share capital shall be presented in statement of changes in equity as at 31 December 2019?

- a) Rs. 80 million
- b) Rs. 100 million
- c) Rs. 120 million
- d) Rs. 140 million

12. A company has following balances on 1 January 2019:

	Rs. m
Share capital (Rs. 100 each)	100
Share premium	30
Revaluation surplus	20
Retained earnings	35

The company made a bonus issue of 2 for 5 shares already held.

What amount of share premium shall be presented in statement of changes in equity as at 31 December 2019?

- a) Rs. Nil
- b) Rs. 2.5 million
- c) Rs. 5 million
- d) Rs. 7.5 million

13. A company has following balances on 1 January 2019:

	Rs. m
Share capital (Rs. 100 each)	100
Share premium	30
Revaluation surplus	20
Retained earnings	35

On 2 January 2019, all the revalued assets were disposed of for Rs. 90 million.

Profit for the year ended was Rs. 32 million.

Interim dividend of 5% was paid in July 2019 and final dividend of 8% has been proposed by directors.

What amount of retained earnings shall be presented in statement of changes in equity as at 31 December 2019?

- a) Rs. 48 million
- b) Rs. 63 million
- c) Rs. 82 million
- d) Rs. 90 million

14. Which of the following does not appear in statement of changes in equity?
- Share premium
 - Retained earning
 - Goodwill
 - Revaluation surplus
15. Which of the following statements is likely to be true, for a company making profits?
- The operating profit will be less than the profit for the year
 - The profit for the year will be greater than the gross profit
 - Retained profits at the year-end will be greater than shareholders' equity
 - Retained profits at the year-end will be greater than retained profits at the beginning of the year
16. Which of the following is NOT a component of the statement of changes in equity?
- Total comprehensive income for the period
 - The revaluation gain
 - The amount of cash that the company has on hand
 - Dividends paid to shareholders during the period
17. Which of the following statements is not true about preferred stock/shares?
- The rate of dividend is usually fixed
 - Shareholders always have a voting right
 - Shareholders' usually have a preference as to assets upon liquidation of the corporation
 - Shareholders' usually have a preference as to dividends
18. Redeemable preferred shares is required to be reported as:
- Liability
 - Equity
 - Asset
 - None of the above
19. Any unpaid dividend is carried forward to the future periods for which type of stock?
- Ordinary shares
 - Cumulative preferred shares
 - Non-cumulative preferred shares
 - All of the above
20. What is the impact of dividend payments to shareholders on the statement of changes in equity?
- It increases the retained earnings balance
 - It decreases the retained earnings balance
 - It increases the share capital balance
 - It decreases the share capital balance
21. What is the impact of an additional share issue on the statement of changes in equity?
- It increases the share capital balance
 - It increases the retained earnings balance
 - It decreases the share capital balance
 - It decreases the retained earnings balance

22. Xavier Limited issued 5,000 shares of its Rs.10 par value to its shareholder. These shares were issued at a premium at a price of Rs.25 per share.

The correct journal entry to record this transaction is:

- a) Cash Rs.125,000 (Debit); Share capital Rs.125,000 (Credit)
 - b) Cash Rs.50,000 (Debit); Share capital Rs.50,000 (Credit)
 - c) Share capital Rs.50,000 (Debit); Share premium Rs.75,000 (Debit); Cash Rs.125,000 (Credit)
 - d) Cash Rs.125,000 (Debit); Share capital Rs.50,000 (Credit); Share premium Rs.75,000 (Credit)
23. Dynasty Limited issues 1 million, Rs.10 shares at Rs.50 for each share. Which of the following statements is true?
- a) Ordinary share capital will increase by Rs.10 million and share premium will increase by Rs.50 million
 - b) Ordinary share capital will increase by Rs.10 million and share premium will increase by Rs.40 million
 - c) Ordinary share capital will increase by Rs.20 million and share premium will increase by Rs.50 million
 - d) Ordinary share capital will increase by Rs.10 million and share premium will increase by Rs.30 million
24. Handsome Limited statement of financial position shows ordinary share capital of Rs.150 million and share premium of Rs.50 million at the beginning of a financial year. If the ordinary share capital is Rs.250 million and share premium is Rs.120 million at the end of the financial year, how much did the ordinary share with share premium issue raise?
- a) Rs.100 million
 - b) Rs.150 million
 - c) Rs.160 million
 - d) Rs.170 million
25. Gigantic Limited opening retained earning balance was Rs.150 million. It made a net profit for the year ended 31 March 2020 of Rs.30 million. During that year, an ordinary dividend of Rs.50 paise per share was paid on 40 million ordinary shares. What was the retained profit for the year ended 31 March 2020?
- a) Rs.150 million
 - b) Rs.160 million
 - c) Rs.165 million
 - d) Rs.170 million
26. SK Limited paid Rs.10 million in debenture interest and an ordinary dividend of 10 paise per share on 50 million ordinary shares. The retained profit was Rs. 120 million. What was SK Limited profit for the year?
- a) Rs. 125 million
 - b) Rs.135 million
 - c) Rs. 130 million
 - d) Rs.140 million
27. Which of the following would be an entry in the statement of changes in equity?
- a) Taxation
 - b) Long term loans
 - c) Gain on revaluation
 - d) Non-current asset carried at revalued amount

28. A debit balance on the retained earnings account indicates that the company has:
- a) made more dividend payments than the profit earned
 - b) redeemed some of its share capital
 - c) accumulated losses
 - d) issued bonus shares
29. Which of the following is not considered as transaction with owners with reference to statement of changes in equity?
- a) Issuance of shares at par
 - b) Issuance of shares at premium
 - c) Profit for the year
 - d) Bonus issue of shares
30. Which TWO of the following would be shown as a deduction from the column of retained earnings in statement of changes in equity?
- a) Transfer of incremental depreciation
 - b) Issuance of shares at discount
 - c) Cash dividend
 - d) Transfer to general reserves
31. When there is no balance in the share premium account, transaction costs relating to issue of shares are debited to:
- a) profit or loss
 - b) share capital
 - c) revaluation surplus
 - d) retained earnings
32. Which of the following is a specific reserve created out of retained earnings to ensure that dividends remain stable irrespective of changes in earnings?
- a) General reserve
 - b) Dividend equalization reserve
 - c) Revenue reserve
 - d) Capital reserve
33. Which of the following is correct regarding balance of share premium?
- a) It is reported as revenue reserve
 - b) It can be used to provide for the premium payable on the redemption of redeemable preference shares
 - c) It arises due to dividend declared in excess of retained earnings' balance
 - d) It arises due to company issuing shares at more than the market price

34. On 1 January 2023, Beta Limited (BL) has share capital of Rs. 50 million (Rs. 10 each), share premium of Rs. 15 million and accumulated loss of Rs. 25 million. During the year 2023, BL earned profit of Rs. 15 million.

The following shares were issued during the year 2023:

- On 1 July 2023, 10% right shares were issued at Rs. 20 per share, with a transaction cost of Rs. 1 million.
- On 1 November 2023, bonus shares were issued at a ratio of 1 share for every 5 shares held.

Which of the following reflects the correct balances as at 31 December 2023?

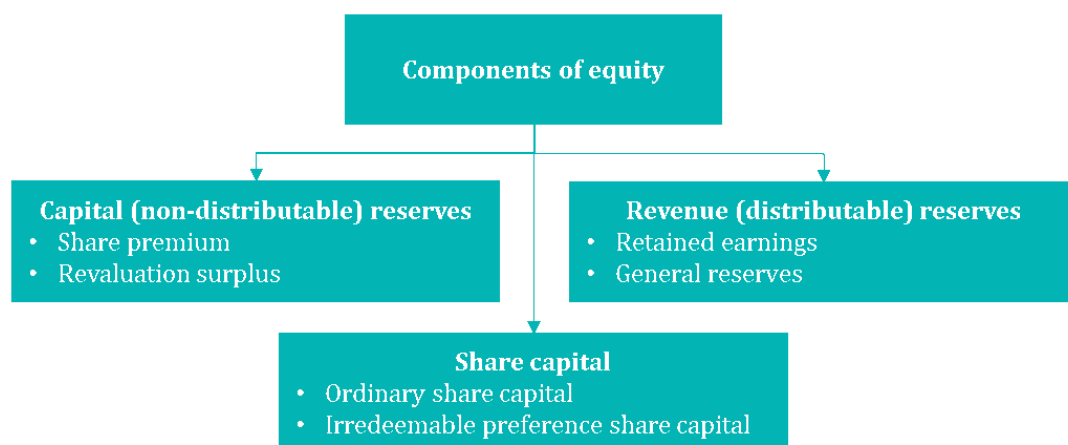
	Share capital	Share premium	Retained earnings
	Rs. in million		
(a)	66	19	(10)
(b)	66	8	(10)
(c)	60	9	(11)
(d)	66	3	(5)

ANSWERS

01.	(b) & (d)	Transactions with owners in their capacity as owners, showing separately contributions by and distributions to owners are separately presented from other transactions.
02.	(b)	Redeemable preference share capital is treated as liability because entity has obligation to settle the amount.
03.	(b)	Rs. 500 million $\times$ 10% = Rs. 50 million to be recognised in statement of changes in equity.
04.	(d)	This dividend shall be recognised next year. This year the proposed dividend shall be disclosed only.
05.	(a) & (c)	Right issue is usually at premium.
06.	(a) & (b)	Share capital will increase and reserve (e.g. share premium) will decrease.
07.	(c)	Transaction costs relating to equity are never included in profit or loss. These are usually debited to share premium account or retained earnings account.
08.	(b)	Debit Revaluation surplus (decrease) and Credit Retained earnings (increase).
09.	(c)	Rs. 100 million + Rs. 100 million / Rs. 100 $\times$ 1/5 $\times$ Rs. 100] = Rs. 120 million
10.	(b)	Rs. 30 million + Rs. 100 million / Rs. 100 $\times$ 1/5 $\times$ Rs. 45] = Rs. 39 million
11.	(d)	Rs. 100 million + Rs. 100 million / Rs. 100 $\times$ 2/5 $\times$ Rs. 100] = Rs. 140 million
12.	(a)	Rs. 100 million / Rs. 100 $\times$ 2/5 $\times$ Rs. 100] = Rs. 40 million shares issued Rs. 30 million from share premium and remaining Rs. 10 million from retained earnings.
13.	(c)	Rs. 35 million + Rs. 20 million from revaluation surplus + Profit of Rs. 32 million – Rs. 5 million dividends = Rs. 82 million Proposed dividend shall be disclosed only.
14.	(c)	Goodwill is not presented in statement of changes in equity.
15.	(d)	Usually not all profits are distributed and this would lead to higher credit balance of retained earnings at year end.
16.	(c)	Cash in hand in current asset, not a component of equity.
17.	(b)	Preference shareholders usually have no or limited voting rights.
18.	(a)	Liability because entity has obligation to settle/pay.
19.	(b)	Any unpaid cumulative dividends pass to future years and have to be paid out before dividends for ordinary shareholders.
20.	(b)	Retained earnings will decrease with distribution of dividend.
21.	(a)	The balance of share capital would increase due to issue of shares
22.	(d)	Debit Cash /Bank [Rs. 25 $\times$ 5,000] Rs. 125,000 Credit Share capital [Rs. 10 $\times$ 5,000] Rs. 50,000 Credit Share premium [Rs. 15 $\times$ 5,000] Rs. 75,000
23.	(b)	Share capital will increase by par value of Rs. 10 million. Share premium will increase by excess amount of Rs. 40 million (i.e. Rs. 50 million – 10 million).
24.	(d)	[Rs. 250m + 120m] – [Rs. 150m + 50m] = Rs. 170 million
25.	(b)	Rs. 150m + 30m – (40m $\times$ 0.50) = Rs. 160 million

26.	(a)	Rs. 120m + add back (50m shares x Rs. 0.10) = Rs. 125 million
27.	(c)	Gain on revaluation is presented as part of other comprehensive income in the statement of changes in equity.
28.	(c)	Payment of dividend and bonus issue of shares is conditional on availability of credit balance.
29.	(c)	All types of share issue are transactions with owners.
30.	(c) & (d)	Transfer for incremental depreciation increases retained earnings and discount on issue of shares is usually debited to share premium account.
31.	(d)	retained earnings
32.	(b)	Dividend equalization reserve
33.	(b)	It can be used to provide for the premium payable on the redemption of redeemable preference shares.
34.	(b)	Share capital 50 + 10% Right issue 5 + one for five bonus issue 11 = 66 Share premium 15 + right issue 5 – transaction cost 1 – bonus issue 11 = 8 Retained earnings -25 + profit 15 = -10

STICKY NOTES



Journal entries for equity transactions

Transaction	Journal entry
Issue of shares at par value	Debit Bank Credit Share capital
Issue of shares above par value (at premium)	Debit Bank Credit Share capital Credit Share premium
Issue of shares below par value (at discount)	Debit Bank Debit Share premium / Retained earnings Credit Share capital
Transaction costs on share issue	Debit Share premium / Retained earnings Credit Bank/accrual
Bonus issue of shares	Debit Share premium / Retained earnings Credit Share capital
Cash dividend	Debit Retained earnings Credit Dividend payable / Bank
Bonus dividend	Debit Retained earnings Credit Share capital
Transfer due to incremental depreciation	Debit Revaluation surplus Credit Retained earnings
Transfer on disposal of revalued asset	Debit Revaluation surplus Credit Retained earnings
Transfer to general reserve	Debit Retained earnings Credit General reserve

CONCEPTUAL AND REGULATORY FRAMEWORK FOR FINANCIAL REPORTING

IN THIS CHAPTER:

AT A GLANCE

SPOTLIGHT

1. Conceptual Framework
2. Qualitative characteristics of useful financial information
3. Recognition and derecognition
4. Measurement
5. Concept of capital and capital maintenance
6. Regulatory Framework
7. Comprehensive Examples
8. Objective Based Q&A

STICKY NOTES

AT A GLANCE

International Accounting Standards Board (IASB) issued the *Conceptual Framework for Financial Reporting* in September 2010 and it was subsequently revised in March 2018.

The *Conceptual Framework* is the theoretical set of concepts and principles with the main purpose to:

- assist IASB in the development of future IFRS and the review of existing standards by setting out the underlying concepts;
- assist the preparers of financial statements when no IFRS is applicable to particular transaction or when an IFRS allows choice of accounting policy; and
- assist all stakeholders to understand and interpret.

The *Conceptual Framework* being the single reference document helps avoid inconsistencies in accounting treatments.

The *Conceptual Framework* is divided into eight chapters.

This Chapter covers key concepts from chapter 2, 5, 6 and 8 of the *Conceptual Framework*. The chapter 1 and 4 of *Conceptual Framework* had been covered in earlier studies.

The regulatory framework in accounting ensures the accuracy, transparency, and comparability of financial reporting, thereby safeguarding investors and promoting financial stability. The IFRS Foundation is global regulatory body, which oversees the IASB and ISSB. The IASB develops IFRS standards for high-quality global accounting practices, while the ISSB focuses on sustainability-related disclosures. The IFRS Advisory Council provides stakeholder feedback, while the IFRS Interpretations Committee offers timely guidance on emerging accounting matters. The IASB follows a structured process to develop IFRS standards, encouraging stakeholder involvement and ensuring robust consensus.

1 INTRODUCTION

1.1 Purpose [Conceptual Framework: SP1.1 & SP1.5]

The Conceptual Framework for Financial Reporting (Conceptual Framework) describes the objective of, and the concepts for, general purpose financial reporting.

The purpose of the Conceptual Framework is to assist:

- the International Accounting Standards Board (IASB) to develop IFRSs that are based on consistent concepts;
- preparers of financial statements to develop consistent accounting policies when no Standard applies to a particular transaction or other event, or when a Standard allows a choice of accounting policy; and
- all parties to understand and interpret the Standards.

The Conceptual Framework contributes to the stated mission of the IFRS Foundation and IASB i.e. to develop Standards that bring transparency, accountability and efficiency to financial markets around the world.

The Conceptual Framework provides the foundation for Standards (IASs and IFRSs) that:

- contribute to transparency by enhancing the international comparability and quality of financial information, enabling investors and other market participants to make informed economic decisions.
- strengthen accountability by reducing the information gap between the providers of capital and management. IFRSs and Conceptual Framework are also source of information for regulators.
- contribute to economic efficiency i.e. the use of a single, trusted accounting language derived from Standards based on the Conceptual Framework lowers the cost of capital and reduces international reporting costs.

1.2 Contents of Conceptual Framework

The Conceptual Framework is divided into eight chapters, namely:

Chapter 1 — The Objective of General Purpose Financial Reporting

Chapter 2 — Qualitative Characteristics of Useful Financial Information

Chapter 3 — Financial Statements and The Reporting Entity

Chapter 4 — The Elements of Financial Statements

Chapter 5 — Recognition and Derecognition

Chapter 6 — Measurement

Chapter 7 — Presentation and Disclosure

Chapter 8 — Concepts of Capital and Capital Maintenance

1.3 Status [Conceptual Framework: SP1.2 to SP1.4]

The Conceptual Framework is not a Standard and nothing in the Conceptual Framework overrides any Standard (IASs or IFRSs) or any requirement in a Standard.

IASB may sometimes specify requirements, in a Standard, that depart from aspects of the Conceptual Framework. Further, the Conceptual Framework may be revised from time to time and revisions of the Conceptual Framework will not automatically lead to changes to the Standards.

1.4 Elements of financial statements [Conceptual Framework: 4.1 & 4.2]

The elements of financial statements defined in the conceptual framework are:

- assets, liabilities and equity, which relate to a reporting entity's financial position; and
- income and expenses, which relate to a reporting entity's financial performance

These elements are linked to the economic resources, claims and changes in economic resources and claims and are explained as under:

Item discussed	Elements	Definition or description
Economic resource	Asset	A present economic resource controlled by the entity as a result of past events. An economic resource is a right that has the potential to produce economic benefits.
Claim	Liability	A present obligation of the entity to transfer an economic resource as a result of past events.
	Equity	The residual interest in the assets of the entity after deducting all its liabilities.
Changes in economic resources and claims, reflecting financial performance	Income	Increases in assets, or decreases in liabilities, that result in increase in equity, other than those relating to contributions from holders of equity claims.
	Expenses	Decreases in assets, or increases in liabilities, that result in decreases in equity, other than those relating to distributions to holder of equity claims.
Other changes in economic resources and claims	-	Contributions from holders of equity claims, and distributions to them.
	-	Exchanges of assets or liabilities that do not result in increases or decreases in equity.

2 QUALITATIVE CHARACTERISTICS OF USEFUL FINANCIAL INFORMATION

2.1 Information to be useful for decision making [Conceptual Framework: 2.4]

If financial information is to be useful, it must be relevant and faithfully represent what it purports to represent. The usefulness of financial information is enhanced if it is comparable, verifiable, timely and understandable.

It means information must have certain characteristics in order for it to be useful for decision making. The IASB Conceptual Framework describes:

- fundamental qualitative characteristics; and
- enhancing qualitative characteristics

2.2 Fundamental qualitative characteristics [Conceptual Framework: 2.5]

The fundamental qualitative characteristics are:

- relevance; and
- faithful representation

2.2.1 Relevance [Conceptual Framework: 2.6 & 2.11]

Relevant financial information is capable of making a difference in the decisions made by users. Information may be capable of making a difference in a decision even if some users choose not to take advantage of it or are already aware of it from other sources.

The relevance of information is affected by its materiality. Information is material if omitting it or misstating it or obscuring it could influence decisions that users make on the basis of financial information about a specific reporting entity.

2.2.2 Faithful representation (true and fair view) [Conceptual Framework: 2.12 & 2.13]

Financial reports represent economic phenomena in words and numbers. To be useful, financial information must not only represent relevant phenomena, but it must also faithfully represent the substance of the phenomena that it purports to represent. Although, in many circumstances, the substance of an economic phenomenon and its legal form are the same, an accountant should be careful to identify when this might not be the case.

To be a perfectly faithful representation, a depiction would have three characteristics. It would be:

- complete (all information necessary for a user to understand the phenomenon being depicted);
- neutral (without bias in the selection and presentation of financial statements); and
- free from error (does not mean accurate in all respects, a reliable estimate is acceptable).

Of course, perfection is seldom, if ever, achievable. The objective is to maximise those qualities to the extent possible.

2.3 Enhancing qualitative characteristics [Conceptual Framework: 2.23]

The qualitative characteristics that enhance the usefulness of information that is relevant and a faithful representation are:

- comparability;
- verifiability;
- timeliness; and
- understandability.

2.3.1 Comparability [Conceptual Framework: 2.25, 2.26 & 2.29]

Comparability enables users to identify and understand similarities in, and differences among, items. Information about a reporting entity is more useful if it can be compared with similar information about other entities and with similar information about the same entity for another period or another date.

Consistency is related to comparability but is not the same. Consistency refers to the use of the same methods for the same items, either from period to period within a reporting entity or in a single period across entities. Consistency helps to achieve the goal of comparability.

A single economic phenomenon can be faithfully represented in multiple ways, permitting alternative accounting methods for the same economic phenomenon diminishes comparability. This is why, Standards allow minimum possible alternative accounting treatments.

2.3.2 Verifiability [Conceptual Framework: 2.30 & 2.31]

This quality helps to assure users that information faithfully represents the economic phenomena it purports to represent. Verifiability means that different knowledgeable and independent observers could reach consensus that a particular depiction is a faithful representation. Quantified information need not be a single point estimate to be verifiable. A range of possible amounts and the related probabilities can also be verified.

Verification can be direct or indirect.

- Direct verification means verification through direct observation, e.g. by counting cash or inventory.
- Indirect verification means checking the inputs to a model, formula or other technique and recalculating the outputs using the same methodology. For example, the carrying amount of inventory might be verified by checking the inputs (e.g. costs) and recalculating the closing inventory using the same assumption (e.g. FIFO).

2.3.3 Timeliness [Conceptual Framework: 2.33]

This means having information available to decision-makers in time to be capable of influencing their decisions. Generally, the older the information is the less useful it is.

2.3.4 Understandability [Conceptual Framework: 2.34 to 2.36]

Information is made understandable by classifying, characterising and presenting it in a clear and concise manner. Some phenomena are inherently complex and cannot be made easy to understand, however, excluding the relevant information is not justified in such circumstances.

Financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyse the information diligently.

2.4 Cost constraint on useful financial reporting [Conceptual Framework: 2.39 to 2.41]

Cost is a pervasive constraint on the information that can be provided by financial reporting. Reporting financial information imposes costs, and it is important that those costs are justified by the benefits of reporting that information.

The benefits obtained from financial information should exceed the cost of obtaining and providing it. Information should not be provided if the cost is not worth the benefit. However, users ultimately bear cost of providing information in the form of reduced returns and they will have to incur additional costs to obtain or estimate the information, if needed information is not provided. Therefore, a preparer of financial statement must not omit mandatory disclosure of a Standard on the pretext that cost of information may not be justified.

3 RECOGNITION AND DERECOGNITION

3.1 Recognition criteria [Conceptual Framework: 5.6, 5.7 & 5.11]

Only items that meet the definition of an asset, a liability or equity are recognised in the statement of financial position. Similarly, only items that meet the definition of income or expenses are recognised in the statement(s) of financial performance.

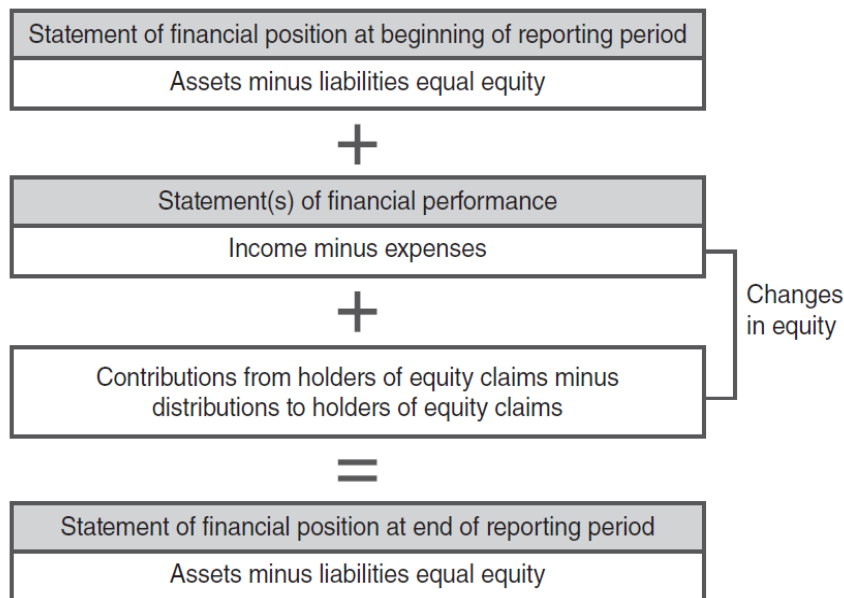
However, not all items that meet the definition of one of those elements are recognised. Not recognising an item that meets the definition of one of the elements makes the statement of financial position and the statement(s) of financial performance less complete and can exclude useful information from financial statements. On the other hand, in some circumstances, recognising some items that meet the definition of one of the elements would not provide useful information.

An asset or liability is recognised only if recognition of that asset or liability and of any resulting income, expenses or changes in equity provides users of financial statements with information that is useful, i.e. with:

- relevant information about the asset or liability and about any resulting income, expenses or changes in equity; and
- a faithful representation of the asset or liability and of any resulting income, expenses or changes in equity.

Items that fail to meet the criteria for recognition should not be included in the financial statements. However, some of these items may have to be disclosed as additional details in a note to the financial statements.

3.2 How recognition links elements of financial statements [Conceptual Framework: 5.3]



► Example 01:

- A manufacturing unit valuing Rs. 5 million, owned and controlled by the Company
- A fleet of trucks valuing Rs 100 million, controlled by another company
- A highly skilled workforce, getting an annual compensation of Rs. 12.5 million

Required:

Which of the above assets will be recognised in the financial statements of a company in accordance with the recognition criteria?

► **Answer:**

- i. It will be recognised as an asset. It meets the definition of an asset being present economic resource controlled by the entity.
- ii. The fleet of truck will not be recognised because it is not controlled by the entity.
- iii. Workforce will not be recognised by the entity because there is no control on as workers can quit the entity at any time. However, in case advance salaries have been paid, the entity has present right to future services from the workforce.

► **Example 02:**

ABC Associates received Rs. 160,000 in cash on 20 December 2004 from RM Enterprises in return for having provided financial advice during the 2004 financial year.

Required:

- a) Explain, with reference to the relevant definitions, which elements should possibly be recognised in the 2004 financial year.
- b) Briefly identify whether and/ or how your answer would change if the cash received had been received for financial advice to be provided in the 2005 financial year.

► **Answer:****Part (a)**

The cash received meets the definition of an asset i.e. present resource now controlled by the entity and entity may spend it as it may wish. Services have already been provided, therefore, there is no obligation (no change in liability). Increase in equity shall be recognised as an income.

An asset and an income shall be recognised in year 2004.

Part (b)

The cash received meets the definition of an asset i.e. present resource now controlled by the entity and entity may spend it as it may wish. Services have not been provided and there is present obligation to provide services, resulting in increase in liability. No income can be recognised as there is no equity increase.

An asset and a liability shall be recognised in year 2004.

► **Example 03:**

Read the following scenarios:

- i. An amount paid to landlord totalling Rs.120,000 on 1st January 2012 against the rent for the year ended 31st December 2012. Year end of the entity is 30 June 2012.
- ii. An expenditure incurred on repairs and maintenance of plant amounting Rs.300,000.
- iii. There has been legal dispute between the entity and its customer and company expects the outflow of Rs. 200,000 in order to settle the dispute.
- iv. Entity purchased goods costing Rs. 20,000 for trading purposes and the same was sold for Rs. 25,000.

Required:

Which of the above, would be recognised as expense &/or asset in the financial statements of a company in accordance with the criteria given in conceptual framework.

► *Answer:*

- i. Increase in asset (advance rent: Future benefits) Rs. 60,000 and decrease in asset (Cash) Rs. 120,000 resulting in net decrease in equity is Rent expense (Rs. 60,000).
- ii. Decrease in asset (Cash) Rs. 300,000 and no increase in other assets (unless increase in present resources) resulting in net decrease in equity is Repair expense (Rs. 300,000).
- iii. Increase in liability (obligation to settle) Rs. 200,000 and no increase in any assets resulting in net decrease in equity is Expense (Rs. 200,000).
- iv. When purchased inventory, it was a present economic resource and recognised as an asset. When sold, it becomes expense (cost of sales) due to decrease in assets resulting in decrease in equity.

► *Example 04:*

Read the following scenarios

- i. Advance received from customer amounting Rs. 50,000 against the goods to be delivered after 6 months
- ii. Services provided to ABC and Co. on credit amounting Rs.30,000.
- iii. Account Receivables already written off in previous years amounting Rs. 30,000 were received during the year.

Required:

Which of the above, would be recognised as income &/or liability in the financial statements of a company in accordance with the criteria given in conceptual framework.

► *Answer:*

- i. Increase in asset (Cash) Rs. 50,000 and also an increase in liability (obligation to deliver) Rs. 50,000 and there is no income as no increase in equity.
- ii. Increase in asset (right to receive) Rs. 30,000 and no increase in liability (services already provided) and resulting net increase in equity Rs. 30,000 recognised as income.
- iii. Increase in asset (cash) Rs. 30,000 but no decrease in asset (receivable was already written off) resulting in net increase in equity is Income.

3.3 Derecognition [Conceptual Framework: 5.26]

Derecognition is the removal of all or part of a recognised asset or liability from an entity's statement of financial position. Derecognition normally occurs when that item no longer meets the definition of an asset or of a liability:

- a) for an asset, derecognition normally occurs when the entity loses control of all or part of the recognised asset; and
- b) for a liability, derecognition normally occurs when the entity no longer has a present obligation for all or part of the recognised liability.

For example, when an item of property, plant and equipment is sold or destroyed, it will be derecognised. Similarly, a liability will be derecognised when it is paid or settled otherwise.

4 MEASUREMENT

4.1 Measurement bases [Conceptual Framework: 6.1 & 6.2]

Elements recognised in financial statements are quantified in monetary terms. This requires the selection of a measurement basis. A measurement basis is an identified feature, for example, historical cost, fair value or fulfilment value, of an item being measured.

Applying a measurement basis to an asset or liability creates a measure for that asset or liability and for related income and expenses. Consideration of the qualitative characteristics of useful financial information and of the cost constraint is likely to result in the selection of different measurement bases for different assets, liabilities, income and expenses.

4.2 Historical cost [Conceptual Framework: 6.4 to 6.8]

Historical cost measures provide monetary information about assets, liabilities and related income and expenses, using information derived, at least in part, from the price of the transaction or other event that gave rise to them.

The historical cost of an asset when it is acquired or created is the value of the costs incurred in acquiring or creating the asset, comprising the consideration paid to acquire or create the asset plus transaction costs. The historical cost of a liability when it is incurred or taken on is the value of the consideration received to incur or take on the liability minus transaction costs.

In some cases, a current value of the asset or liability is used as a deemed cost on initial recognition and that deemed cost is then used as a starting point for subsequent measurement at historical cost. Unlike current value, historical cost does not reflect changes in values, except to the extent that those changes relate to impairment of an asset or a liability becoming onerous.

The historical cost of an asset is updated over time to depict, if applicable:

- the consumption of asset (depreciation or amortisation);
- payments received that extinguish part or all of the asset;
- the effect of events that cause asset to be no longer recoverable (impairment); and
- accrual of interest to reflect any financing component of the asset.

The historical cost of a liability is updated over time to depict, if applicable:

- fulfilment of part or all of the liability (payment);
- the effect of events that increase the value of the obligation (estimate change); and
- accrual of interest to reflect any financing component of the liability.

4.3 Current value [Conceptual Framework: 6.10 & 6.11]

Current value measures provide monetary information about assets, liabilities and related income and expenses, using information updated to reflect conditions at the measurement date. Because of the updating, current values of assets and liabilities reflect changes, since the previous measurement date, in estimates of cash flows and other factors reflected in those current values. Unlike historical cost, the current value of an asset or liability is not derived, even in part, from the price of the transaction or other event that gave rise to the asset or liability.

Current value measurement bases include:

- fair value
- value in use for assets and fulfilment value for liabilities
- current cost

4.3.1 Fair value [Conceptual Framework: 6.12 to 6.14 & 6.16]

Fair value is the price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants at the measurement date.

Fair value reflects the perspective of market participants i.e. participants in a market to which the entity has access. The asset or liability is measured using the same assumptions they would use when pricing the asset or liability while acting in their economic best interest.

In some cases, fair value can be determined directly by observing prices in an active market. In other cases, it is determined indirectly using measurement techniques, for example, cash-flow-based measurement techniques, reflecting all the following factors:

- estimates of future cash flows.
- possible variations caused by the uncertainty inherent in the cash flows.
- the time value of money.
- the price for bearing the uncertainty inherent in the cash flows (a risk premium or risk discount).
- other factors, for example, liquidity, if market participants would take those factors into account in the circumstances.

The fair value is not increased or decreased by the transaction costs incurred when acquiring the asset and when the liability is incurred or taken on. In addition, fair value does not reflect the transaction costs that would be incurred on the ultimate disposal of the asset or on transferring or settling the liability.

4.3.2 Value in use and fulfilment value [Conceptual Framework: 6.17 to 6.20]

Value in use is the present value of the cash flows, or other economic benefits, that an entity expects to derive from the use of an asset and from its ultimate disposal. Fulfilment value is the present value of the cash, or other economic resources, that an entity expects to be obliged to transfer as it fulfils a liability.

Those amounts of cash or other economic resources include not only the amounts to be transferred to the liability counterparty, but also the amounts that the entity expects to be obliged to transfer to other parties to enable it to fulfil the liability.

Value in use and fulfilment value do not include transaction costs incurred on acquiring an asset or taking on a liability. However, value in use and fulfilment value include the present value of any transaction costs an entity expects to incur on the ultimate disposal /fulfilment.

Value in use and fulfilment value reflect entity-specific assumptions rather than assumptions by market participants. In practice, there may sometimes be little differences. Value in use and fulfilment value cannot be observed directly and are determined using cash-flow-based measurement techniques. Value in use and fulfilment value reflect the same factors described for fair value, but from an entity-specific perspective rather than from a market-participant perspective.

4.3.3 Current cost [Conceptual Framework: 6.21 & 6.22]

The current cost of an asset is the cost of an equivalent asset at the measurement date, comprising the consideration that would be paid at the measurement date plus the transaction costs that would be incurred at that date. The current cost of a liability is the consideration that would be received for an equivalent liability at the measurement date minus the transaction costs that would be incurred at that date.

Current cost, like historical cost, is an entry value: it reflects prices in the market in which the entity would acquire the asset or would incur the liability. Hence, it is different from fair value, value in use and fulfilment value, which are exit values. However, unlike historical cost, current cost reflects conditions at the measurement date.

In some cases, current cost cannot be determined directly by observing prices in an active market and must be determined indirectly by other means. For example, if prices are available only for new assets, the current cost of a used asset might need to be estimated by adjusting the current price of a new asset to reflect the current age and condition of the asset held by the entity.

Measurement bases for assets and liabilities – summary

Measurement bases	Definitions	Characteristics
Historical cost	Asset: The consideration paid to acquire or create the asset <i>plus</i> transaction costs. Liability: The consideration received to incur or taken the liability <i>minus</i> transaction costs.	Derived from past transaction /event. Reflects conditions existing at the time of acquisition. Entry value. Transaction costs at time of disposal are not relevant.
Fair value	Asset: The price that would be received to sell an asset in an orderly transaction between market participants at the measurement date. Liability: The price that would be paid to transfer a liability in an orderly transaction between market participants at the measurement date.	Derived using information updated to reflect conditions at the measurement date. Reflects market-participant assumptions. Exit value. Transaction costs are not relevant on acquisition as well as on disposal.
Value in use or Fulfilment value	Asset: The present value of the cash flows, or other economic benefits, that an entity expects to derive from the use of an asset and from its ultimate disposal. Liability: The present value of the cash, or other economic resources, that an entity expects to be obliged to transfer as it fulfils a liability.	Derived using information updated to reflect conditions at the measurement date. Reflects entity specific assumptions. Exit value. Transaction costs on acquisition are not relevant, however, present value of transaction costs on ultimate disposal/transfer are included in calculation.
Current cost	Asset: The cost of an equivalent asset that would be paid at the measurement date <i>plus</i> the transaction costs. Liability: The consideration that would be received for an equivalent liability at the measurement date <i>minus</i> the transaction costs.	Derived using information updated to reflect conditions at the measurement date. Reflects prices in market in which entity would acquire the asset or incur a liability. Entry value. Transaction costs at time of disposal are not relevant.

► Example 05:

Adeel Limited (AL) owns a machine which it purchased two years ago for Rs. 200,000. The accumulated depreciation on the machine to date is Rs. 80,000 based on 5 years life using straight line method.

The machine could be sold in the market for Rs. 100,000 but there would be dismantling costs of Rs. 10,000.

The cash flows from the existing machine are estimated to be Rs. 50,000 for the next two years followed by Rs. 40,000 in the last year. Relevant discount rate is 10%.

To replace the machine with a new version would cost Rs. 220,000.

Required:

Measure the machine using different measurement bases for AL using the above information.

► *Answer:*

Historical cost	Rs.
Cost	200,000
Less: Accumulated depreciation	(80,000)
	120,000

Fair value

The fair value is market value (exit price) of Rs. 100,000 without deducting cost to sell of Rs. 10,000.

Value in use		Rs.
Year 1	Rs. 50,000 x 1.1 ⁻¹	45,455
Year 2	Rs. 50,000 x 1.1 ⁻²	41,322
Year 3	Rs. 40,000 x 1.1 ⁻³	30,053
		116,830

Current cost		Rs.
Cost of new asset		220,000
Less: Accumulated depreciation*	Rs. 220,000 / 5 x 2 years	(88,000)
		132,000

*The replacement cost is of new machine and needs to be adjusted for two years usage.

► *Example 06:*

Briefly describe the measurement bases that may be used to measure the value of assets in the financial statements.

► *Answer:***Historical cost**

The historical cost of an asset, when it is acquired or created is the value of the cost incurred in acquiring or creating the asset, comprising the consideration paid to acquire or create the asset plus transaction cost.

Current value

Current value measures provide monetary information about assets using information updated to reflect conditions at the measurement date.

Current value measurement bases include:

- Fair value
- Value in use for assets
- Current cost

Fair value: Fair value is the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date. Fair value reflects the perspective of market participants.

Value in use: Value in use is the present value of the cash flows or other economic benefit that an entity expects to derive from the use of an asset and from its ultimate disposal. Value in use reflect entity specific assumptions rather than assumptions by market participants.

Current cost: The current cost of an asset is the cost of an equivalent asset at the measurement date comprising the consideration that would be paid at the measurement date plus the transaction cost that would be incurred at that date.

Current cost, like historical cost is an entry value; while fair value is an exit value. However, unlike historical cost, current cost reflects conditions at the measurement date.

4.4 Measurement of equity [Conceptual Framework: 6.87 & 6.88]

The total carrying amount of equity (total equity) is not measured directly. It equals the total of the carrying amounts of all recognised assets less the total of the carrying amounts of all recognised liabilities (i.e. equity = total assets – total liabilities).

Because the general purpose financial statements are not designed to show an entity's value, the total carrying amount of equity will not generally equal:

- the aggregate market value of equity claims on the entity;
- the amount that could be raised by selling the entity as a whole on a going concern basis; or
- the amount that could be raised by selling all of the entity's assets and settling all of its liabilities.

5 CONCEPT OF CAPITAL AND CAPITAL MAINTENANCE

5.1 Concept of capital [Conceptual Framework: 8.1]

5.1.1 Financial concept of capital

Under a financial concept of capital, such as invested money or invested purchasing power, capital is synonymous with the net assets or equity of the entity.

5.1.2 Physical concept of capital

Under a physical concept of capital, such as operating capability, capital is regarded as the productive capacity of the entity based on, for example, units of output per day.

Consider the basic accounting equation:

Assets = Liabilities + Equity

Or

Assets – Liabilities = Equity (net assets)

Like any other equation, changes on one side of the accounting equation are matched by changes in the other side. Therefore, profit or loss for a period can be calculated from the difference between the opening and closing net assets after adjusting for any distributions during the period.

Change in equity = Closing equity – Opening equity

Increase in equity = Profit + capital introduced – distributions

Profit = Increase in equity – capital introduced + distributions

This shows that the value ascribed to opening equity is crucial in the measurement of profit.

5.2 Capital maintenance concepts and determination of profit [Conceptual Framework: 8.3]

Only inflows of assets in excess of amounts needed to maintain capital may be regarded as profit and therefore as a return on capital. Hence, profit is the residual amount that remains after expenses (including capital maintenance adjustments, where appropriate) have been deducted from income.

5.2.1 Financial capital maintenance

Under this concept a profit is earned only if the financial (money) amount of the net assets at the end of the period exceeds the net assets at the beginning of the period excluding any distributions to, and contributions from, owners during the period.

Financial capital maintenance can be measured in either:

- nominal monetary units (also called Historical Cost Accounting); or
- units of constant purchasing power (also called Constant Purchasing Power Accounting).

5.2.2 Physical capital maintenance

Under this concept a profit is earned only if the physical productive capacity (or operating capability of the entity or the resources or funds needed to achieve that capacity) at the end of the period exceeds the net assets at the beginning of the period excluding any distributions to, and contributions from, owners during the period.

This is also called Current Cost Accounting as the physical capital maintenance concept requires the adoption of the current cost basis of measurement.

5.3 Capital maintenance adjustments [Conceptual Framework: 8.7 & 8.8]

5.3.1 Financial capital maintenance (money terms)

Profit represents the increase in nominal money capital over the period. Thus, increases in the prices of assets held over the period, i.e. holding gains, are, conceptually, profits. They may not be recognised as such until disposal.

As mostly historical costs is used, no adjustments to profit is required.

5.3.2 Financial capital maintenance (real terms)

Profit represents the increase in invested purchasing power over the period. Thus, only that part of the increase in the prices of assets that exceeds the increase in the general level of prices is regarded as profit. The rest of the increase is treated as a capital maintenance adjustment and, hence, as part of equity.

The journal entry for capital maintenance adjustment is:

Debit	Statement of profit or loss
Credit	Inflation reserve

5.3.3 Physical capital maintenance

Profit represents the increase in physical capital over the period. All (specific) price changes affecting the assets and liabilities of the entity are viewed as changes in the measurement of the physical productive capacity of the entity; hence, they are treated as capital maintenance adjustments that are part of equity and not as profit.

The journal entry for capital maintenance adjustment is:

Debit	Statement of profit or loss
Credit	Current cost reserve

► Example 07:

X Limited commenced business on 1 January Year 1 with a single item of inventory which costs Rs. 10,000.

During the year it sold the item for Rs. 14,000 (cash).

During the year general inflation was 5% but the inflation specific to the item was 10%.

Required:

Calculate profit and prepare summary statement of financial position as of 31 December Year 1 under the following capital maintenance concepts:

- Financial capital maintenance (money terms)
- Financial capital maintenance (real terms)
- Physical capital maintenance

► Answer:

	Capital maintenance concept		
	Financial (money terms)	Financial (real terms)	Physical
Profit calculation	Rs.	Rs.	Rs.
Revenue	14,000	14,000	14,000
Cost of sale	(10,000)	(10,000)	(10,000)
Inflation adjustment:			
5% x Rs.10,000		(500)	
10% x Rs.10,000			(1,000)
	4,000	3,500	3,000

**inflation rate applied to opening equity*

	Capital maintenance concept		
	Financial (money terms)	Financial (real terms)	Physical
Statement of financial position	Rs.	Rs.	Rs.
Cash	14,000	14,000	14,000
Total assets	14,000	14,000	14,000
Equity:			
Before adjustment	10,000	10,000	10,000
Inflation or current cost reserve		500	1,000
	10,000	10,500	11,000
Retained profit (profit for the year)	4,000	3,500	3,000
	14,000	14,000	14,000

Commentary on the above example

Under historical cost accounting, the profit is Rs. 4,000. If the business paid this out as a dividend it would have Rs. 10,000 left.

Rs. 10,000 is the opening equity expressed as a number of units of currency. This means that the company would have maintained its equity expressed as a number of units of currency. However, inflation in the period has caused the purchasing power of the currency to decline. This means that Rs. 10,000 no longer has the same purchasing power that it had a year ago. The company has not maintained its capital in real terms.

To maintain its opening equity in real terms the company would have to ensure that it had the same purchasing power at the year-end as it had at the start. Inflation was 5% so the company would need Rs. 10,500 at the year-end in order to have the same purchasing power as it had at the start of the year. The company can achieve this by transferring Rs.500 from profit and loss into an inflation reserve. Profit would then be reported as Rs. 3,500.

If the business paid out Rs. 3,500 as a dividend it would have Rs. 10,500 left. This is not enough to buy the same asset that it had at the start of the year. The asset has been subject to specific inflation of 10% therefore the company would need Rs. 11,000 at the year-end in order to buy the same asset.

This means that the company would not have the same capacity to operate as it had a year ago.

To maintain its opening equity in physical terms the company would have to ensure that it had the same ability to operate at the year-end as it had at the start. In other words, it would need to have Rs. 11,000. The company can achieve this by transferring Rs. 1,000 from profit and loss into an inflation reserve. Profit would then be reported as Rs. 3,000.

5.4 Comparing the two concepts [Conceptual Framework: 8.2]

Neither the *Conceptual Framework* nor accounting standards require the use of a specific capital maintenance concept. In practice, almost all entities use money financial capital maintenance, but both concepts can provide useful information.

Thus, a financial concept of capital should be adopted if the users of financial statements are primarily concerned with the maintenance of nominal invested capital or the purchasing power of invested capital. If, however, the main concern of users is with the operating capability of the entity, a physical concept of capital should be used.

Financial capital maintenance is likely to be the most relevant to investors as they are interested in maximizing the return on their investment and therefore its purchasing power.

Physical capital maintenance is likely to be most relevant to management and employees as they are interested in assessing an entity's ability to maintain its operating capacity. This is particularly true for manufacturing businesses, where management may need information about the ability of the business to continue to produce the same or a greater volume of goods.

6 REGULATORY FRAMEWORK

6.1 Purpose of regulatory framework in accounting

The regulatory system in accounting aims to ensure accuracy, transparency, and comparability of financial reporting, protecting investors and maintaining financial stability by establishing rules and standards that govern financial reporting practices. Therefore, it is important to understand the role of standard-setting bodies, their due process and coordination among them.

6.2 Role of IFRS Foundation

IFRS Foundation is supervisory body, responsible for governance issues and ensuring proper funding, for International Accounting Standards Board (IASB) and International Sustainability Standards Board (ISSB).

The IFRS Foundation aims to develop globally accepted standards for financial reporting and sustainability disclosures through the IASB and ISSB. These standards ensure high-quality, transparent, and comparable information for decision-making in capital markets. Additionally, the foundation promotes the rigorous application of IFRS Standards, considers diverse economic contexts, and facilitates their adoption by aligning them with national and regional standards.

6.3 Role of International Accounting Standards Board (IASB)

IASB is responsible for developing IFRS and IFRS for SMEs and for promoting their use and application. Its objective is to establish a single set of high-quality, clear, and enforceable global accounting standards. However, since IASB lacks the authority to enforce IFRS compliance, it relies on the collaboration of national standard setters.

6.4 Role of International Sustainability Standards Board (ISSB)

In 2021, the IFRS Foundation established the ISSB with the aim of creating a globally consistent framework for sustainability-related disclosure standards to address the investors need for corporate reporting on climate, as well as other environmental, social, and governance (ESG) issues, that is transparent, reliable, comparable, and of high quality. So far, ISSB has issued sustainability standards IFRS S1 and IFRS S2 in 2023.

6.5 IFRS Advisory Council (IFRS AC)

IFRS AC serves as a platform for IASB and ISSB to engage with a diverse group of stakeholders impacted by its activities. Its key objectives include:

- Offering guidance to IASB and ISSB on agenda-setting decisions and prioritization of its work;
- Communicating to IASB and ISSB the perspectives of organizations and individuals on significant standard-setting initiatives; and
- Providing additional advice to IASB, ISSB or the Trustees as needed.

6.6 IFRS Interpretations Committee (IFRS IC)

IFRS IC provides timely guidance on accounting matters where varying interpretations of IFRS Standards have emerged. All IFRIC interpretations require approval from the IASB. These interpretations focus on issues of significant and widespread relevance, rather than those affecting only a small minority of entities. They address:

- newly identified financial reporting challenges that are not explicitly covered within IFRS Standards; and
- issues where conflicting or inadequate interpretations have arisen, or are likely to arise, in the absence of authoritative guidance, aiming to establish consensus on the appropriate accounting treatment.

6.7 Procedure for the development of an IFRS Standard

The summarised procedure for the development of an IFRS Standard is as follows:

- IASB identifies a subject and appoints an advisory committee to advise on the issues.
- IASB may issue a discussion paper on IFRS to be issued to encourage comments from stakeholders.
- IASB publishes an exposure draft of IFRS to be issued
- After consideration of comments received on the exposure draft, IASB publishes the final text of the IFRS.

The publication of an IFRS, exposure draft or IFRIC Interpretation requires the votes of at least eight of the fifteen Board members of IASB.

7 COMPREHENSIVE EXAMPLES

► Example 08:

Carrie starts in business on 1 January Year 1. Carrie's sole shareholder contributed capital of Rs. 1,000. Carrie purchased one item of inventory for Rs. 1,000 and sold that inventory for cash of Rs. 1,400. At the end of Year 1 the replacement cost of the same item of inventory is Rs. 1,100. General inflation during the year was 7%.

Required:

Calculate profit and prepare summary statement of financial position as of 31 December Year 1 under the following capital maintenance concepts:

- Physical capital maintenance
- Financial capital maintenance: Historical cost accounting
- Financial capital maintenance: Constant purchasing power accounting

► Answer:

	Physical Capital Maintenance	Financial Capital Maintenance	
		Historical cost accounting	Constant purchasing power accounting
Profit calculation	Rs.	Rs.	Rs.
Sales	1,400	1,400	1,400
Cost of sales	(1,000)	(1,000)	(1,000)
Inflation adjustment			
Specific (1,100 – 1,000)	(100)		
General (1,000 x 7%)			(70)
Profit	300	400	330
Statement of financial position			
Cash	1,400	1,400	1,400
Total assets	1,400	1,400	1,400
Equity:			
Before adjustment	1,000	1,000	1,000
Inflation or current cost reserve	100	-	70
	1,100	1,000	1,070
Retained profit (profit for the year)	300	400	330
	1,400	1,400	1,400

Tutorial note: Share capital at the year end is restated under the physical capital maintenance concept for an increase in specific price changes and under Constant Purchasing Power accounting for general price changes.

► *Example 09:*

Read the following statements:

- i. In case of conflict between requirements of conceptual framework and IFRS, the requirements of conceptual framework shall prevail.
- ii. Conceptual framework is not an International financial reporting standard (IFRS)
- iii. HR related cost is recognised as an asset in the financial statements since economic benefit is probable from human resource
- iv. Internally generated goodwill is recognised as asset and measured at fair value in the financial statements
- v. When economic benefits arise over several accounting periods, and the association with income can only be decided in broad terms, expenses should be recognised in profit and loss of each accounting period on the basis of systematic and rational allocation procedure
- vi. When an item of expenditure is not expected to provide any future economic benefit, it is recognised as an asset in the financial statements
- vii. In fair value method, assets are measured at the amount that would be paid to purchase the same or a similar asset currently.

Required:

Analyse the above statements as true or false along with reasons for the selected answer.

► *Answer:*

- i. False. Nothing in the Conceptual Framework overrides any Standard or any requirement in a Standard.
- ii. True. The Conceptual Framework is not a Standard. However, it provides foundation for consistent development for IFRSs.
- iii. False. HR related cost can never be capitalised as it does not meet the definition criteria of asset “controlled by the entity”
- iv. False. Internally generated goodwill is not recognised because its cost or value cannot be measured reliably. IAS 38 specifically prohibits recognition of internally generated goodwill.
- v. True, because of matching principle
- vi. False. Instead, an expense shall be recognised in that case.
- vii. False. This describes “current cost” which is entry value. “Fair value” is an exit value.

► *Example 10:*

Consider the following statements with reference to ‘Conceptual framework for financial reporting’:

- i. Physical capital maintenance measures profit in terms of increase in the productive capacity of an entity.
- ii. In times of rising prices, profits will be overstated and assets will be understated when financial statements are prepared on the basis of historical cost.
- iii. Income represents all increases in assets or decreases in liabilities that result in increase in equity.
- iv. To be a perfectly faithful representation, a depiction would have three characteristics. It would be complete, relevant and verifiable.
- v. In value in use method, assets are measured at the amount that would be paid to purchase the same or a similar asset currently.
- vi. Current cost and fair value are exit values.
- vii. Requirements of a standard overrides the requirements of conceptual framework.
- viii. Financial capital maintenance is likely to be the most relevant to investors as they are interested in maximizing the return on their investment and purchasing power.

Required:

Identify whether each of the above statements is TRUE or FALSE. Give reasons for statements identified as FALSE.

► **Answer:**

- i. True
- ii. True
- iii. False. Income does not include those increase in equity which are relating to contributions from holders of equity claims.
- iv. False. The three characteristics are complete, neutral and free from error.
- v. False. Value in use is the present value of the cash flows, or other economic benefits that an entity expects to derive from the use of an asset and from its ultimate disposal.
- vi. False. Current cost is an entry value while fair value is an exit value.
- vii. True
- viii. True

► **Example 11:**

On 1 March 2022, Inca Empire Limited (IEL) commenced business with a capital of Rs. 60,000 which was used to purchase two items of inventory. Details of their cost and sales for the year ended 28 February 2023 are as follows:

	Cost	Sale
	----- Rupees -----	
Product A	25,000	55,000
Product B	35,000	70,000

Additional information:

- ix. General inflation during the year is 8%.
- x. Inflation specific to product A during the year is 12%.
- xi. Replacement cost of the product B at the end of the year is Rs. 45,000.

Required:

Prepare the statement of profit or loss and the statement of financial position (equity portion only) of IEL according to the concept of 'Physical Capital Maintenance'.

► **Answer:**

Statement of profit or loss		Rs. in '000
Sales	55+70	125
Cost of sale	25+35	(60)
Gross profit		65
Inflation adjustment		
- Specific (Product A)	25×12%	(3)
- Specific (Product B)	45-35	(10)
		(13)
Profit for the year		52

Statement of financial position

Equity:	Rs. in '000
Opening equity	60
Inflation reserve	13
Equity after adjustment	73
Profit for the year	52
	125

► **Example 12:**

During the review of the statement of financial position of Nerunkot Limited (NL), the junior accountant is uncertain whether the following items should be reflected in the books to accurately represent the financial position of NL:

- An asset for loyal customers, as they are expected to bring future business.
- An asset for plant and related liability, since the contract for the purchase has been signed, but the plant will be delivered next year.
- A liability for the full year's office rent for the next year, as contract has been signed.

Required:

As an accounting manager of NL, discuss whether the above items should be recognised in the statement of financial position as per the Conceptual Framework for Financial Reporting.

► **Answer:**

Part (i)

Loyal customers do not meet the recognition criteria for an asset. Although they may generate future economic benefits, the company does not exert control over them as it would over other assets. Further, the future economic benefits derived from loyal customers are uncertain and cannot be measured reliably. Therefore, loyal customers should not be recognised as an asset in the statement of financial position.

Part (ii)

According to the conceptual framework, an asset or liability arises from past events. Since the plant has not yet been delivered, the recognition criteria are not met. Recognition will occur when the plant is delivered or payment is made. Consequently, no asset or liability is recorded at this stage. Transactions involving future obligations or unrealized assets should not be recognised until the relevant criteria are met.

Part (iii)

Future rent payments do not meet the recognition criteria for a liability until the related service (use of office space) is received. A liability is recognised when there is a present obligation resulting from past events. Hence, the office rent for the next year should not be recognised as a liability in the statement of financial position.??

8 OBJECTIVE BASED Q&A

1. Which of the following measurement basis is an 'entry value' and 'reflects the conditions at the measurement date'?
 - a) Historical cost
 - b) Fair value
 - c) Value in use / fulfilment value
 - d) Current cost
2. Financial capital maintenance (money terms) is also referred to as:
 - a) Historical cost accounting
 - b) Current cost accounting
 - c) Constant purchasing power accounting
 - d) Fair value accounting
3. Which of the following concepts measures profit in terms of an increase in the productive capacity of an entity?
 - a) Physical capital maintenance
 - b) Historical cost accounting
 - c) Financial capital maintenance
 - d) Going concern concept
4. Which of the following statements is true about historical cost accounts in times of rising prices?
 - a) Profits will be overstated, and assets will be understated
 - b) Asset values will be overstated
 - c) Unrecognised gains will be recorded incorrectly
 - d) Depreciation will be overstated
5. Which of the following measurement basis fulfils following two conditions when measuring an asset or liability:
 - Transactions costs at acquisition are ignored in valuation
 - Transaction costs at disposal or ultimate disposal are considered in valuation
 - a) Historical cost
 - b) Fair value
 - c) Value in use / fulfilment value
 - d) Current cost
6. Which of the following is NOT a purpose of the International Accounting Standards Board's Conceptual Framework?
 - a) To assist the Board in the preparation and review of IFRS Standards
 - b) To assist auditors in forming an opinion on whether financial statements comply with IFRS Standards
 - c) To assist in determining the treatment of items not covered by an existing IFRS Standards
 - d) To be authoritative where a specific IFRS Standard conflicts with the Conceptual Framework

7. Which of the following items should be recognised as an asset in the statement of financial position of an entity?
- a) A skilled and efficient workforce which has been very expensive to train. Some of these staff is still employed by the entity
 - b) A highly lucrative contract signed during the year which is due to commence shortly after the year-end
 - c) A government grant relating to the purchase of an item of plant several years ago which has a remaining life of four years
 - d) A receivable from a customer, an agency has been hired for collection, however, the reporting entity will bear the loss in case of default by the customer
8. Which of the following criticisms does NOT apply to historical cost financial statements during a period of rising prices?
- a) They contain mixed values, some items are at current values, some at out-of-date values
 - b) They are difficult to verify as transactions could have happened many years ago
 - c) They understate assets and overstate profit
 - d) They overstate gearing in the statement of financial position
9. Financial capital maintenance (real terms) is also referred to as:
- a) Historical cost accounting
 - b) Current cost accounting
 - c) Constant purchasing power accounting
 - d) Fair value accounting
10. Physical capital maintenance is also referred to as:
- a) Historical cost accounting
 - b) Current cost accounting
 - c) Constant purchasing power accounting
 - d) Fair value accounting
11. In which of the following, no adjustment for inflation is considered?
- a) Financial capital maintenance (money terms)
 - b) Financial capital maintenance (real terms)
 - c) Physical capital maintenance
 - d) Fair value accounting
12. In which of the following, inflation adjustment is made on general rate of inflation?
- a) Financial capital maintenance (money terms)
 - b) Financial capital maintenance (real terms)
 - c) Physical capital maintenance
 - d) Fair value accounting
13. In which of the following, inflation adjustment is made on specific rate of inflation?
- a) Financial capital maintenance (money terms)
 - b) Financial capital maintenance (real terms)
 - c) Physical capital maintenance
 - d) Fair value accounting

14. Financial capital maintenance is likely to be most relevant to:
- Investors
 - Management and employees
 - Neither (a) nor (b)
 - Capital maintenance is always irrelevant to decision making
15. Physical capital maintenance is likely to be most relevant to:
- Investors
 - Management and employees
 - Neither (a) nor (b)
 - Capital maintenance is always irrelevant to decision making
16. An entity made a profit of Rs. 350,000 for the year 2019 based on historical cost accounting principles. It had opening capital of Rs. 1,000,000.
- Specific price indices increase during the year by 20% and general price indices by 5%.
- How much profit should be recorded for 2019 under money financial capital maintenance concept?
- Rs. 450,000
 - Rs. 350,000
 - Rs. 400,000
 - Rs. 300,000
17. An entity made a profit of Rs. 350,000 for the year 2019 based on historical cost accounting principles. It had opening capital of Rs. 1,000,000.
- Specific price indices increase during the year by 20% and general price indices by 5%.
- How much profit should be recorded for 2019 under real financial capital maintenance concept?
- Rs. 450,000
 - Rs. 350,000
 - Rs. 400,000
 - Rs. 300,000
18. An entity made a profit of Rs. 350,000 for the year 2019 based on historical cost accounting principles. It had opening capital of Rs. 1,000,000.
- Specific price indices increase during the year by 20% and general price indices by 5%.
- How much profit should be recorded for 2019 under physical capital maintenance concept?
- Rs. 100,000
 - Rs. 125,000
 - Rs. 150,000
 - Rs. 175,000
19. An entity acquired an item of plant on 1 October 2012 at a cost of Rs. 500,000. It is being depreciated over five years, using straight-line depreciation and an estimated residual value of 10% of its historical cost or current cost as appropriate. As at 30 September 2014, the manufacturer of the plant still makes the same item of plant and its current price is Rs. 600,000.
- What is the correct carrying amount to be shown in the statement of financial position as at 30 September 2014 under historical cost accounting?

- a) Rs. 320,000
- b) Rs. 420,000
- c) Rs. 520,000
- d) Rs. 620,000

20. An entity acquired an item of plant on 1 October 2012 at a cost of Rs. 500,000. It is being depreciated over five years, using straight-line depreciation and an estimated residual value of 10% of its historical cost or current cost as appropriate. As at 30 September 2014, the manufacturer of the plant still makes the same item of plant and its current price is Rs. 600,000.

What is the correct carrying amount to be shown in the statement of financial position as at 30 September 2014 under current cost accounting?

- a) Rs. 425,000
- b) Rs. 295,000
- c) Rs. 384,000
- d) Rs. 485,000

21. An entity made a profit of Rs. 480,000 for the year 2018 based on historical cost accounting principles. It had opening capital of Rs. 1,100,000. During 2018, specific price indices increased by 15% while general price indices increased by 12%. How much profit should be recorded for 2018 under real financial capital maintenance concept?

- a) Rs. 480,000
- b) Rs. 315,000
- c) Rs. 348,000
- d) Rs. 645,000

22. Which of the following statements is correct about financial statements based on historical cost in times of rising prices?

- a) Profits will be overstated and assets will be understated
- b) Assets will be overstated
- c) Profits as well as assets will be understated
- d) Depreciation will be overstated

23. The IASB's Framework identifies qualitative characteristics.

- i. Relevance
- ii. Comparability
- iii. Verifiability
- iv. Understandability
- v. Faithful representation

Which of the above are not listed as enhancing characteristics?

- a) (i), (iv) and (v)
- b) (ii), (iii) and (iv)
- c) (ii) and (iii)
- d) (i) and (v)

24. The IASB's Conceptual Framework for Financial Reporting identifies qualitative characteristics of financial statements.

Which TWO of the following characteristics are NOT fundamental qualitative characteristics according to the IASB's The Conceptual Framework for Financial Reporting?

- a) Relevance
 - b) Reliability
 - c) Faithful representation
 - d) Comparability
25. Which of the following is NOT a measurement base for assets as referred in the Conceptual Framework?
- a) Value in use
 - b) Fulfilment value
 - c) Current cost
 - d) Fair value
26. An entity made a profit of Rs. 550,000 for the year 2020 based on historical cost accounting principles. It had opening capital of Rs. 1,500,000. During 2020, specific prices indices increased by 15% while general price indices increased by 10%. How much profit should be recorded for 2020 under physical capital maintenance concept?
- a) Rs. 325,000
 - b) Rs. 400,000
 - c) Rs. 467,500
 - d) Rs. 495,000
27. Which of the following concepts measures profit in terms of an increase in the productive capacity of an entity?
- a) Physical capital maintenance
 - b) Historical cost accounting
 - c) Financial capital maintenance (money terms)
 - d) Financial capital maintenance (real terms)
28. Which of the following statements is/are correct?
- i. The Conceptual Framework is not an IFRS and nothing in the Conceptual Framework overrides any specific IFRS.
 - ii. One of the purpose of Conceptual Framework is to assist IASB to develop IFRSs that are based on consistent concepts.
- a) Only (I) is correct
 - b) Only (II) is correct
 - c) Both are correct
 - d) None is correct
29. Which of the following best describes the role of the IFRS Advisory Council?
- a) To prepare interpretations of IFRS Standards
 - b) To select and appoint members of IASB
 - c) To promote the use of IFRS Standards globally
 - d) To offer guidance to IASB on agenda-setting decisions and prioritization of its work

30. Which of the bodies listed below is responsible for the approval of Draft Interpretations?
- IFRS Interpretations Committee
 - IFRS Foundation
 - IFRS Advisory Council
 - International Accounting Standards Board
31. Which of the bodies listed below acts as the overall supervisory body?
- IFRS Interpretations Committee
 - IFRS Foundation
 - IFRS Advisory Council
 - International Accounting Standards Board
32. A multi-national manufacturing company needs to report on sustainability-related metrics, including environmental and social impacts. The management wants assurance that their reporting aligns with internationally recognised standards and meets investor expectations for transparency and comparability. Which body is responsible for setting globally consistent sustainability-related disclosure standards?
- IFRS Interpretations Committee
 - International Accounting Standards Board (IASB)
 - IFRS Advisory Council
 - International Sustainability Standards Board (ISSB)
33. During a review of financial statements, an entity encounters conflicting interpretations of an IFRS standard, affecting their reporting accuracy. They seek guidance to address this issue. Which body provides timely guidance on accounting matters where varying interpretations of IFRS Standards have emerged?
- IFRS Interpretations Committee
 - International Accounting Standards Board (IASB)
 - IFRS Advisory Council
 - International Sustainability Standards Board (ISSB)
34. Which TWO of the following characteristics are considered fundamental qualitative characteristics according to the IASB's conceptual framework for financial reporting?
- Timeliness
 - Faithful representation
 - Relevance
 - Comparability
35. Which of the following is NOT included in the Conceptual framework for financial reporting?
- Objective of general purpose financial reporting
 - Structure and content of financial statements
 - Elements of financial statements
 - Qualitative characteristics of useful financial information

36. Which of the following statements is/are correct?

- i. Relevance and faithful representation are the two fundamental qualities that make accounting information useful for decision making.
 - ii. Comparability is an enhancing quality that makes accounting information useful for decision-making.
- a) Only (I) is correct
 - b) Only (II) is correct
 - c) Both are correct
 - d) None is correct

37. Alpha Enterprises (AE) earned a profit of Rs. 700,000 for the year 2023 based on historical cost accounting principles. AE had opening capital of Rs. 2 million. During 2023, specific price indices and general price indices increased by 12% and 21% respectively.

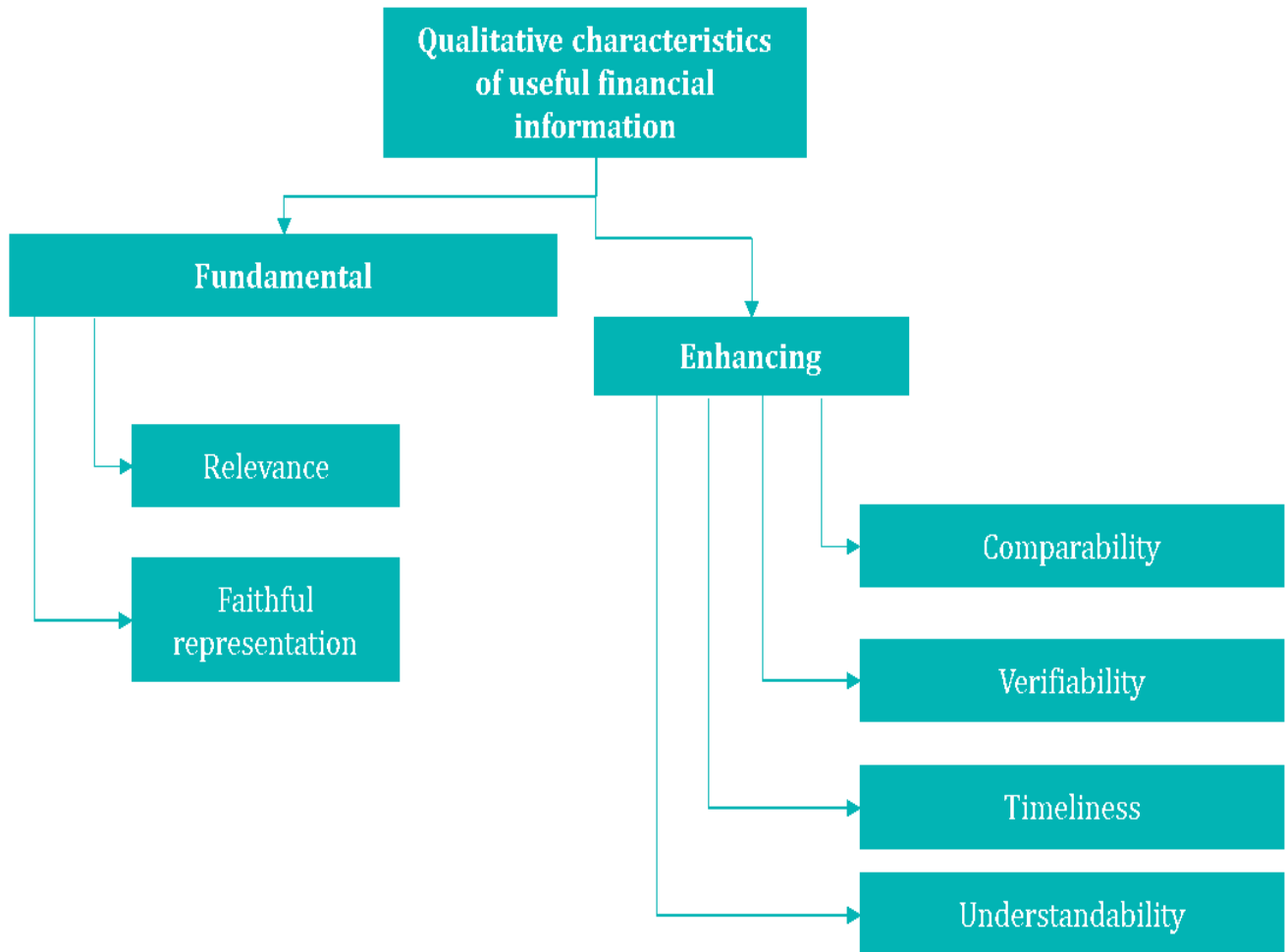
How much profit should be recorded for 2023 under the physical capital maintenance concept?

- a) Rs. 280,000
- b) Rs. 460,000
- c) Rs. 700,000
- d) Rs. 940,000

ANSWERS

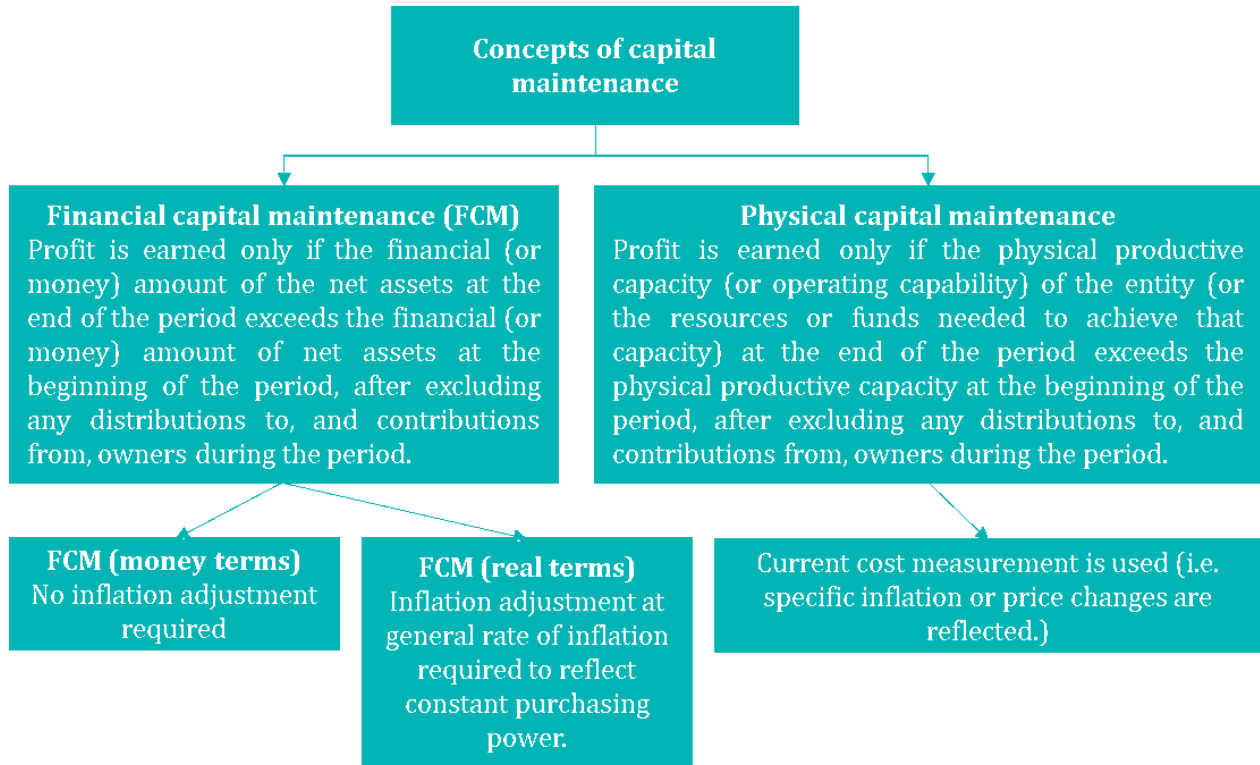
01.	(d)	Historical cost and current cost both are entry values (unlike fair value and value in use), however, historical costs reflects conditions on acquisition date and current cost reflects conditions at measurement date.
02.	(a)	Historical cost accounting
03.	(a)	Physical capital maintenance looks at profit in terms of the physical productive capacity of the business, taking into account specific price changes relevant to the entity.
04.	(a)	In times of rising prices, asset values will be understated, as historical cost will not be a true representation of the asset values. Additionally, the real purchase cost of replacement items will not be incorporated, meaning that profits are overstated.
05.	(c)	Value in use and fulfilment value do not include transaction costs incurred on acquiring an asset or taking on a liability. However, value in use and fulfilment value include the present value of any transaction costs an entity expects to incur on the ultimate disposal /fulfilment.
06.	(d)	Where there is conflict between the conceptual framework and an IFRS Standard, the IFRS Standard will prevail. An example of this is IAS 20 <i>Government grants</i> , where deferred grant income is held as a liability, despite not satisfying the definition of a liability.
07.	(d)	As the receivable is 'sold' with recourse it must remain as an asset on the statement of financial position and is not derecognised.
08.	(b)	Historical cost is the easiest to verify as the cost can be proved back to the original transaction. Fair value is often more difficult to verify as it may involve elements of estimation.
09.	(c)	Constant purchasing power accounting
10.	(b)	Current cost accounting
11.	(a)	Financial capital maintenance (money terms)
12.	(b)	Financial capital maintenance (real terms)
13.	(c)	Physical capital maintenance
14.	(a)	Investors
15.	(b)	Management and employees
16.	(b)	Rs. 350,000. Money financial capital maintenance looks at the actual physical cash. No inflation adjustment is required.
17.	(d)	$\text{Rs. } 350,000 - (1,000,000 \times 5\%) = \text{Rs. } 300,000$
18.	(c)	$\text{Rs. } 350,000 - (1,000,000 \times 20\%) = \text{Rs. } 150,000$
19.	(a)	Historical cost annual depreciation = $\text{Rs. } 90,000 ((500,000 \times 90\%)/5 \text{ years})$. After two years carrying amount would be $\text{Rs. } 320,000 = (500,000 - (2 \times 90,000))$.
20.	(c)	Current cost annual depreciation = $\text{Rs. } 108,000 ((600,000 \times 90\%)/5 \text{ years})$. After two years carrying amount would be $\text{Rs. } 384,000 = (600,000 - (2 \times 108,000))$.
21.	(c)	Rs. 348,000
22.	(a)	Profits will be overstated and assets will be understated.
23.	(d)	Relevance and faithful representation are fundamental characteristics. Without these characteristics, information cannot be useful.

24.	(b) & (d)	It is important to learn that the two fundamental characteristics are relevance and faithful representation.
25.	(b)	Fulfilment value is measurement base for liabilities
26.	(a)	Rs. 550,000 – (Rs. 1,500,000 x 15%) = Rs. 325,000
27.	(a)	Physical capital maintenance
28.	(c)	Both statements are correct.
29.	(d)	To offer guidance to IASB on agenda-setting decisions and prioritization of its work
30.	(d)	International Accounting Standards Board
31.	(b)	IFRS Foundation
32.	(d)	International Sustainability Standards Board (ISSB)
33.	(a)	IFRS Interpretations Committee
34.	(b) and (c)	Faithful representation Relevance
35.	(b)	Structure and content of financial statements
36.	(c)	Both are correct
37.	(b)	Profit based on HCA Rs. 700,000 – specific inflation adjustment Rs. 2m x 12% = Rs. 460,000

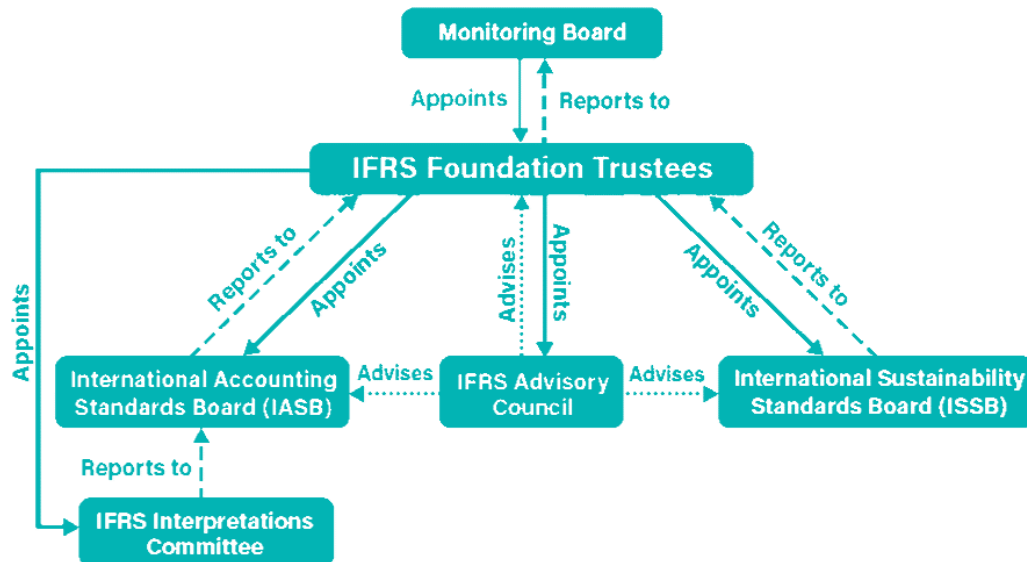
STICKY NOTES

Characteristics of measurement basis

Measurement bases	Characteristics
Historical cost	• Derived from past transaction /event. • Reflects conditions existing at the time of acquisition. • Entry value. • Transaction costs at time of disposal are not relevant.
Fair value	• Derived using information updated to reflect conditions at the measurement date. • Reflects market-participant assumptions. • Exit value. • Transaction costs are not relevant on acquisition as well as on disposal.
Value in use or Fulfilment value	• Derived using information updated to reflect conditions at the measurement date. • Reflects entity specific assumptions. • Exit value. • Transaction costs on acquisition are not relevant, however, present value of transaction costs on ultimate disposal/transfer are included in calculation.
Current cost	• Derived using information updated to reflect conditions at the measurement date. • Reflects prices in market in which entity would acquire the asset or incur a liability. • Entry value. • Transaction costs at time of disposal are not relevant.



Structure of IFRS Foundation



IAS 8 ACCOUNTING POLICIES, CHANGES IN ACCOUNTING ESTIMATES AND ERRORS

IN THIS CHAPTER:

AT A GLANCE

SPOTLIGHT

1. Introduction
2. Change in accounting policy
3. Correction of prior period errors
4. Comprehensive Examples
5. Objective Based Q&A

STICKY NOTES

AT A GLANCE

IAS 8 prescribes the criteria for selecting and applying accounting policies, and accounting treatment and disclosure of changes in accounting policies, changes in accounting estimates, and corrections of material prior period errors.

Accounting policies are determined by applying the IFRS that specifically applies to the transaction or other events. In absence of specifically applicable IFRS, the accounting policy is developed and applied that results in relevant and reliable information considering the guidance of similar IFRS, the Conceptual Framework, and other standard-setting bodies. Accounting policies are applied consistently unless change is required by an IFRS, or entity changes its accounting policy to provide more relevant and reliable information to users of financial statements.

A change in accounting policy is accounted for as follows:

- a) on the initial application of a policy to revalue assets (from cost model), in accordance with IAS 16 or IAS 38.
- b) when change in accounting policy is required by an IFRS and IFRS prescribes transitional provisions, in accordance with those transitional provisions.
- c) Otherwise, apply the change retrospectively (unless impracticable) by restating comparative amounts and/or restating the opening balances of assets, liabilities and equity for the earlier prior period presented.

A change in accounting estimate (change in residual value, useful life, method of depreciation, etc.) results from new information not previously available and are not corrections of errors. The effect of a change in an accounting estimate is recognised prospectively by including the impact in current year; and future years if it affects both.

The material prior period errors are also corrected, after their discovery, retrospectively (unless impracticable) by restating the comparative amounts and/or restating the opening balances of assets, liabilities and equity for the earliest prior period presented.

1 INTRODUCTION

1.1 Scope [IAS 8: 3]

IAS 8 shall be applied in:

- Selecting and applying accounting policies.
- Accounting for changes in accounting policies.
- Accounting for changes in accounting estimates.
- Accounting for correction of prior period errors.

1.2 Definitions: basic [IAS 8: 5,32 & 35 and IAS 1: 7]

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

An accounting policy may relate to:

- Recognition criteria (e.g. capitalising borrowing costs in the cost of qualifying asset rather than charging it as an expense);
- Measurement basis (e.g. measuring investment property applying either cost model or fair value model); or
- Presentation (e.g. presenting deferred government grant related to asset either separately or by deducting from carrying amount of related asset).

Accounting estimates are monetary amounts in financial statements that are subject to measurement uncertainty.

Examples of accounting estimates include:

- a) The expense of bad and doubtful debts;
- b) The net realisable value of an item of inventory;
- c) The fair value of an asset or liability;
- d) The depreciation expense (useful life, depreciation method and residual value); and
- e) Provision for warranty obligations.

When it is difficult to distinguish a change in an accounting policy from a change in an accounting estimate, the change is treated as a change in accounting estimate.

Prior period errors are omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that:

- was available when financial statements for those periods were authorised for issue; and
- could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.

Such errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud.

Information is **material** if omitting, misstating or obscuring it could reasonably be expected to influence decisions that the primary users of general-purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity.

► **Example 01:**

Whether the following are changes in accounting policies, changes in accounting estimates or prior period errors:

- i. An entity changed its accounting for land and buildings from cost model to revaluation model.
- ii. The useful life of plant was revised downwards following impairment loss.
- iii. The depreciation method for furniture was changed from straight line method to reducing balance method.
- iv. The cost formula used for valuation of inventories was changed from FIFO to weighted average.
- v. It was discovered that last year company's inventory sheets were under-casted.
- vi. It was discovered that actual NRV of inventory was much lower than expected.
- vii. Presentation changed from current/non-current to order of liquidity in statement of financial position.

► **Answer:**

- i. Change in accounting policy
- ii. Change in accounting estimate
- iii. Change in accounting estimate
- iv. Change in accounting policy
- v. Prior period error
- vi. Change in accounting estimate
- vii. Change in accounting policy

1.3 Definitions: accounting treatment [IAS 8: 5]

Retrospective application is applying a new accounting policy to transactions, other events and conditions as if that policy had always been applied.

Retrospective restatement is correcting the recognition, measurement and disclosure of amounts of elements of financial statements as if a prior period error had never occurred.

Prospective application of a change in accounting policy and of recognising the effect of a change in an accounting estimate, respectively, are:

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

Applying a requirement is **impracticable** when the entity cannot apply it after making every reasonable effort to do so.

1.4 Selection and application of accounting policies [IAS 8: 7 & 10 to 13]

When an IFRS specifically applies to a transaction, event or condition, the accounting policies applied to that item shall be determined by applying the IFRS.

In absence of an IFRS that is applicable specifically, the management shall use its judgement in developing and applying an accounting policy that results in information that is:

- a) relevant to the economic decision-making needs of users; and
- b) reliable, in that the financial statements:
 - represent faithfully the information;

- reflect the economic substance (not merely the legal form);
- are neutral, i.e. free from bias;
- are prudent; and
- are complete in all material respects.

In making such judgement, the management should consider following sources:

- IFRS dealing with similar and related issues; and
- Conceptual Framework for Financial Reporting; and
- Recent pronouncement of other standard-setting bodies, other accounting literature and accepted industry practices (to the extent not in conflict with afore-mentioned sources).

Accounting policies should be applied consistently for similar transactions unless required or permitted by IFRSs.

► **Example 02:**

IAS 16 Property, plant and equipment allows the use of the cost model or the revaluation model for measurement after recognition. This is an example of where IFRS permits categorisation of items for which different policies may be appropriate.

However, either of the measurement model must be applied to an entire class of property, plant and equipment consistently.

Consistency also implies that same accounting policies be applied in different accounting periods unless a change in policy is required or permitted. For example, if an entity applies weighted average cost formula for certain type of inventory in one period, the same policy shall be applied in subsequent periods.

1.5 Change in accounting estimates [IAS 8: 32 to 34, 36, 37, 39 & 40]

An accounting policy may require items in financial statements to be measured in a way that involves measurement uncertainty i.e. monetary amounts that cannot be observed directly and must instead be estimated. The use of reasonable estimates is an essential part of preparation of financial statements and does not undermine their reliability.

An accounting estimate may need revision if changes occur in the circumstances on which the accounting estimate was based or as a result of new information or more experience. A change in accounting estimate does not relate to prior periods is not correction of prior period error.

Accounting and disclosure

Profit or loss	The effect of change in an accounting estimate relating to profit or loss shall be recognised prospectively by including it in profit or loss in: (a) The period of change if the change affects that period only; or (b) The period of change and future periods if the change affects both.
Assets, liabilities and equity	To the extent that a change in an accounting estimate gives rise to changes in assets and liabilities, or relates to an item of equity, it shall be recognised by adjusting the carrying amount of the related asset, liability or equity item in the period of change.
Disclosure	The nature and amount of a change in an accounting estimate that has an effect in the current period or is expected to have an effect in future periods, except for the effect on future periods when it is impracticable (disclose this fact if this is the case) to estimate that effect.

► *Example 03:*

A non-current asset was purchased for Rs. 200,000 on 1st January 2021, when its expected useful life was ten years, and its expected residual value was nil. The asset is being depreciated using straight-line method.

A review of the non-current assets during year 2023 revealed that due to technological change, the useful life of the asset is only six years in total, and the asset therefore has a remaining useful life of four years.

The original depreciation charge was Rs. 20,000 per year (Rs. 200,000/10 years) and at the beginning of 2023, its carrying value was Rs. 160,000 [Rs. 200,000 – (Rs. 20,000 x 2 years)].

The change in the estimate occurred in 2023 and should be applied prospectively, from year 2023 to onwards. The annual charge for depreciation for year 2023 (the current year) and for the future years (2024 to 2026) will be changed from Rs. 20,000 to Rs. 40,000 (Rs. 160,000/4 years).

1.6 Comparative information [IAS 1: 10, 38, 38A & 40A]

An entity shall include comparative information for narrative and descriptive information if it is relevant to understanding the current period's financial statements.

An entity shall present, as a minimum, two statements of financial position, two statements of profit or loss and other comprehensive income, two separate statements of profit or loss (if presented), two statements of cash flows and two statements of changes in equity, and related notes.

An additional (third) statement of financial position as at the beginning of the preceding period is also required when an entity:

- a) applies an accounting policy retrospectively (IAS 8); or
- b) makes a retrospective restatement of items in its financial statements (IAS 8); or
- c) reclassifies items in its financial statements (IAS 1).

2 CHANGE IN ACCOUNTING POLICY

2.1 When allowed? [IAS 8: 14 & 16]

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

- a) is required by an IFRS; or
- b) results in the financial statements providing reliable and more relevant information (voluntary change).

However, the following are NOT changes in accounting policies:

- a) the application of an accounting policy for transactions and events that differ in substance from those previously occurring; and
- b) the application of a new accounting policy for transactions and events that did not occur previously or were immaterial.

2.2 Application of IAS 8 [IAS 8: 17 to 19]

The initial application of revaluation model under IAS 16 or IAS 38 shall be dealt in accordance with IAS 16 or IAS 38 respectively, and not in accordance with IAS 8.

The initial application of an IFRS may result in change in accounting policy, which should be accounted for in accordance with Transitional Provisions of that IFRS.

If the IFRS does not include any transitional provisions or the change in accounting policy is voluntary, the entity shall apply the change retrospectively subject to certain limitations. For example, retrospective application of accounting policy is made in accordance with IAS 8 when an entity:

- a) changes measurement basis of its investment property from cost model to fair value model; or
- b) changes cost formula for measurement of its inventory from weighted average to first-in, first-out (FIFO) basis.
- c) Changes measurement basis from revaluation model to cost model under IAS 16.

2.3 Retrospective application [IAS 8: 19, 22 & 23]

Change in accounting policy shall be applied retrospectively (as if the new accounting policy had always been applied) except to the extent that it is impracticable to determine either period specific effects or cumulative effect of change.

Retrospective application has three steps:

- a) Apply new policy in current period (e.g., year 2023 is current period).
- b) Apply new policy in comparative period as if the new accounting policy had always been applied (e.g., year 2022 is comparative period presented).
- c) For periods before the comparative period, adjust the opening balances of earliest comparative period of each affected component of equity and related asset or liability as if the new accounting policy had always been applied (e.g., opening balances of year 2022 shall be adjusted).

► Example 04:

A company presents comparatives for the previous year only.

During the year ended 31 December 2023 it changes an accounting policy, and this change must be applied retrospectively.

If there were no change in accounting policy the company would present statements of financial position as at December 2023 and December 2022 only.

However, because there is a change in policy the company must also present a statement of financial position as at 1 January 2022 (the beginning of the earliest comparative period).

The change in accounting policy is applied retrospectively. This means that the change should be applied to the balances as at 1 January 2022 as if the new policy had always been applied.

Similarly, any other comparative amounts in previous periods should be adjusted as if the new accounting policy had always been applied.

► **Example 05:**

Following information have been extracted from the financial statements of Kashif Engineering Limited (KEL) for the year ended 31 December 2024:

	2024	2023	2022
	Draft	Audited	Audited
	Rs. m	Rs. m	Rs. m
Depreciation expense*	(27)	(28)	(22)
Net profit	84	98	72
Property, plant and equipment	1,457	1,569	1,534
Investment property	134	138	142
Retained earnings	458	374	276

*Relates to property, plant and equipment and investment property

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 KEL is a building purchased on 1 January 2021 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.

Required:

Prepare the extracts (including comparative amounts) of:

- Statement of financial position of KEL as at 31 December 2024.
- Statement of profit or loss of KEL for the year ended 31 December 2024.
- Statement of changes in equity (retained earnings column) of KEL for the year ended 31 December 2024.

► **Answer:**

Part (a) Statement of financial position as at 31 December 2024

	2024	2023	2022
		(Restated)	Restated
	Rs. m	Rs. m	Rs. m
Property, plant and equipment	1,457	1,569	1,534
Investment property	189.37 [134 + 55.37]	178.65 [138 + 40.65]	168.54 [142 + 26.54]
Retained earnings	513.37 [458 + 55.37]	414.65 [374 + 40.65]	302.54 [276 + 26.54]

Part (b) Statement of profit or loss for the year ended 31 December 2024

	2024	2023
		(Restated)
	Rs. m	Rs. m
Depreciation	(23) [27 - 4]	(24) [28 - 4]
Gain on investment property	10.72	10.11
Net profit	98.72 [84 + 14.72]	112.11 [98 + 14.11]

Part (c) Statement of changes in equity for the year ended 31 December 2024

	Retained earnings
	Rs. m
Balance 1 January 2023 (as reported earlier)	276
Effect of change in accounting policy	26.54
Balance 1 January 2023 (restated)	302.54
Profit for the year (restated)	112.11
Balance 31 December 2023	414.65
Profit for the year	98.72
Balance 31 December 2024	513.37

Working:

	2024	2023	2022	2021
	Rs. m	Rs. m	Rs. m	Rs. m
Fair value gain @6%	10.72	10.11	9.54	9
Reversal of depreciation*	4	4	4	4
Periodic effect	14.72	14.11	13.54	13
Cumulative effect	55.37	40.65	26.54	13

* $[(150 \times 60\% - 10) / 20 \text{ years}]$

2.4 Limitation to retrospective application [IAS 8: 23 to 25]

When it is impracticable to determine the period specific effects, the entity shall apply the new accounting policy retrospectively from the earliest date practicable.

When it is impracticable to determine the cumulative effect, at the beginning of the current period, of applying a new accounting policy to all prior periods, the entity shall adjust the comparative information to apply the new accounting policy prospectively from the earliest date practicable.

2.5 Disclosure [IAS 8: 28 & 29]

When a change in accounting policy has an effect on the current period or any prior period (or would have an affected that period except that it is impracticable to determine the amount of the adjustment) or might have an effect on future periods the following must be disclosed:

Disclosure:	Change due to IFRS	Voluntary change
The title of the IFRS.	✓	
The nature of the change in accounting policy.	✓	✓
When applicable, that the change in accounting policy is made in accordance with its transitional provisions and a description of those transitional provisions and their effect on future periods.	✓	
The reason why the new accounting policy provides reliable and more relevant information.		✓
For the current and previous period(s), to the extent practicable, the amount of the adjustment for each financial statement line item affected and EPS (if IAS 33 is applicable).	✓	✓
To the extent practicable, the adjustment relating to accounting periods before those presented.	✓	✓
If retrospective application is impracticable, the circumstances that led to existence of that condition and a description of how and from when the change in accounting policy has been applied.	✓	✓

The financial statements of subsequent periods need not repeat these disclosures.

► Example 06:

Following information have been extracted from the financial statements of Kashif Engineering Limited (KEL) for the year ended 31 December 2024:

	2024	2023	2022
	Draft	Audited	Audited
	Rs. m	Rs. m	Rs. m
Depreciation expense*	(27)	(28)	(22)
Net profit	84	98	72
Property, plant and equipment	1,457	1,569	1,534
Investment property	134	138	142
Retained earnings	458	374	276

**Relates to property, plant and equipment and investment property*

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 KEL is a building purchased on 1 January 2021 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.

Required:

Prepare the disclosure note relating to the change in accounting policy in the financial statements of KEL for the year ended 31 December 2024.

► Answer:

Notes to the financial statements for the year ended 31 December 2024**Change in accounting policy**

KEL changed its measurement basis for investment property from cost model to fair value model to provide more relevant and reliable information to stakeholders because fair value model better reflects the purpose and effect of investment property on KEL's financial position and performance.

The effect of change in accounting policy in current and prior periods is as follows:

	2024	2023	2022
Statement of financial position	Rs. m	Rs. m	Rs. m
Increase in investment property	55.37	40.65	26.54
Increase in retained earnings	55.37	40.65	26.54
Effect on statement of profit or loss			
Decrease in depreciation expense	4	4	
Increase in gain on investment property	10.72	10.11	
Increase in net profit	14.72	14.11	

Working:

	2024	2023	2022	2021
	Rs. m	Rs. m	Rs. m	Rs. m
Fair value gain @6%	10.72	10.11	9.54	9
Reversal of depreciation*	4	4	4	4
Periodic effect	14.72	14.11	13.54	13
Cumulative effect	55.37	40.65	26.54	13

* $[(150 \times 60\% - 10) / 20 \text{ years}]$

3 CORRECTION OF PRIOR PERIOD ERRORS

3.1 Prior period errors [IAS 8: 41]

Errors can arise in respect of the recognition, measurement, presentation or disclosure of elements of financial statements. Financial statements do not comply with IFRSs if they contain either material errors or immaterial errors made intentionally to achieve a particular presentation of an entity's financial position, financial performance or cash flows.

Potential current period errors discovered in that period are corrected before the financial statements are authorised for issue. Material errors are sometimes not discovered until a subsequent period, and these prior period errors are corrected in the comparative information presented in the financial statements for that subsequent period.

3.2 Retrospective restatement [IAS 8: 42 & 43]

Unless Impracticable, an entity shall correct material prior period errors retrospectively in the first set of financial statements authorised for issue after their discovery by:

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

► Example 07:

Following information has been extracted from the draft financial statements of Marvellous Limited (ML) for the year ended 30 June 2017:

	2017	2016
	Rs. in million	Rs. in million
Statement of financial position		
Property, plant and equipment	700	612
Retained earnings	275	240
Statement of profit or loss		
Profit for the year	65	85

The following matters are under consideration of the management:

- It was identified that ML had incorrectly charged Rs. 36.75 million as maintenance expense, incurred on installation of the plant. The plant was available for use on 1 July 2014 and had been depreciated on straight line basis over a useful life of four years.
- In view of significant change in the expected pattern of economic benefits from an item of the equipment, it has been decided to change the depreciation method from reducing balance to straight line. The equipment was purchased on 1 July 2015 at a cost of Rs. 80 million having estimated useful life of 5 years and residual value of Rs. 16 million. The depreciation at the rate of 27.5% on reducing balance method is included in the above draft financial statements.

The following balances pertain to ML's statement of financial position as on 30 June 2015:

	Rs. in million
Property, plant and equipment	650
Retained earnings	180

Required:

Prepare extracts from the statement of financial position, statement of profit or loss and statement of changes in equity (including comparative figures) for the year ended 30 June 2017.

► Answer:

Part (a) Statement of financial position as at 30 June 2017

	2017	2016	2015
		(Restated)	Restated
	Rs. m	Rs. m	Rs. m
Property, plant and equipment	714.63 [700 + 9.18 + 5.45]	630.37 [612 + 18.37]	677.56 [650 + 27.56]
Retained earnings	289.63 [275 + 9.18 + 5.45]	258.37 [240 + 18.37]	207.56 [180 + 27.56]

Part (b) Statement of profit or loss for the year ended 30 June 2017

	2017	2016
		(Restated)
	Rs. m	Rs. m
Net profit	61.26 [65 - 9.19 + 5.45]	75.81 [85 - 9.19]

Part (c) Statement of changes in equity for the year ended 30 June 2017

	Retained earnings
	Rs. m
Balance 1 July 2015 (as reported earlier)	180
Effect of correction of prior period error	27.56
Balance 1 July 2015 (restated)	207.56
Profit for the year (restated)	75.81
Dividend [240 - 85 - 180]	(25)
Balance 30 June 2016 (restated)	258.37
Profit for the year	61.26
Dividend [275 - 65 - 240]	(30)
Balance 30 June 2017	289.63

Working:

Correction of error	2017	2016	2015
	Rs. m	Rs. m	Rs. m
Reversal of maintenance expense			36.75
Depreciation 36.75 / 4	(9.19)	(9.19)	(9.19)
Periodic effect	(9.19)	(9.19)	27.56
Cumulative effect	9.18	18.37	27.56

Change in accounting estimate:

Depreciation 2016: Rs. 80m x 27.5% = Rs. 22 m

Depreciation 2017 (previous estimate) = Rs. 80 – 22 m = Rs. 58 m x 27.5% = Rs. 15.95 m

Depreciation 2017 (new estimate) = (Rs. 58 – 16 m) / 4 years = Rs. 10.50 m

Depreciation to be reduced by = Rs. 15.95 m – 10.50 m = Rs. 5.45 m

3.3 Limitations on retrospective restatement [IAS 8: 44 & 45]

When it is impracticable to determine the period-specific effects of an error on comparative information for one or more prior periods presented, the entity shall restate the opening balances of assets, liabilities and equity for the earliest period for which retrospective restatement is practicable (which may be the current period).

When it is impracticable to determine the cumulative effect, at the beginning of the current period, of an error on all prior periods, the entity shall restate the comparative information to correct the error prospectively from the earliest date practicable.

3.4 Disclosure [IAS 8: 49]

An entity shall disclose the following:

- the nature of the prior period error;
- for each prior period presented, to the extent practicable, the amount of the correction for each financial statement line item and EPS (if IAS 33 is applicable);
- the amount of the correction at the beginning of earliest prior period presented; and
- if retrospective restatement is impracticable for a particular prior period, the circumstances that led to the existence of that condition and a description of how and from when the error has been corrected.

Financial statements of subsequent periods need not repeat these disclosures.

► Example 08:

Following information has been extracted from the draft financial statements of Marvellous Limited (ML) for the year ended 30 June 2017:

	2017	2016
	Rs. in million	Rs. in million
Statement of financial position		
Property, plant and equipment	700	612
Retained earnings	275	240
Statement of profit or loss		
Profit for the year	65	85

The following matters are under consideration of the management:

- It was identified that ML's had incorrectly charged Rs. 36.75 million as maintenance expense, incurred on installation of the plant. The plant was available for use on 1 July 2014 and had been depreciated on straight line basis over a useful life of four years.
- In view of significant change in the expected pattern of economic benefits from an item of the equipment, it has been decided to change the depreciation method from reducing balance to straight line. The equipment was purchased on 1 July 2015 at a cost of Rs. 80 million having estimated useful life of 5 years and residual value of Rs. 16 million. The depreciation at the rate of 27.5% on reducing balance method is included in the above draft financial statements.

The following balances pertain to ML's statement of financial position as on 30 June 2015:

	Rs. in million
Property, plant and equipment	650
Retained earnings	180

Required:

Prepare the following notes to the financial statements for the year ended 30 June 2017:

- Correction of error
- Change in accounting estimate

► **Answer:**

Notes to the financial statements for the year ended 30 June 2017

Part (a) Correction of error note

It was identified in current year that installation costs of Rs. 36.75 million to be capitalised was incorrectly charged as maintenance expense on 1 July 2014. The effect of correcting this error are as follows:

	2016	2015
	Rs. m	Rs. m
Effect on statement of financial position		
Increase in property, plant and equipment	18.37	27.56
Increase in retained earnings	18.37	27.56
Effect on statement of profit or loss		
Increase in depreciation expense	9.19	
Decrease in profit	(9.19)	

Part (b) Change in accounting estimate note

The depreciation method for equipment was revised from reducing balance method to straight line method resulting in reduction in depreciation expense by Rs. 5.45 in the current year. The depreciation expense over remaining life would also change due to this change of estimate.

Working:

Correction of error	2017	2016	2015
	Rs. m	Rs. m	Rs. m
Reversal of maintenance expense			36.75
Depreciation 36.75 / 4	(9.19)	(9.19)	(9.19)
Periodic effect	(9.19)	(9.19)	27.56
Cumulative effect	9.18	18.37	27.56

Change in accounting estimate:

Depreciation 2016: Rs. 80m x 27.5% = Rs. 22 m

Depreciation 2017 (previous estimate) = Rs. 80 – 22 m = Rs. 58 m x 27.5% = Rs. 15.95 m

Depreciation 2017 (new estimate) = (Rs. 58 – 16 m) / 4 years = Rs. 10.50 m

Depreciation to be reduced by = Rs. 15.95 m – 10.50 m = Rs. 5.45 m

4 COMPREHENSIVE EXAMPLES

► Example 09:

Mohani Manufacturing Limited is engaged in manufacturing of spare parts for motor car assemblers. The audited financial statements for the year ended December 31, 2014, disclosed that the profit and retained earnings were Rs. 21 million and Rs. 89 million respectively.

The draft financial statements for the year show a profit of Rs. 15 million. However, following adjustments are required to be made:

- The management of the company has decided to change the method for valuation of raw materials from FIFO to weighted average. The value of inventory under each method is as follows:

	FIFO	Weighted Average
	Rs. m	Rs. m
December 31, 2013	37.0	35.5
December 31, 2014	42.3	44.5
December 31, 2015	58.4	54.4

- In 2014, the company purchased a plant for Rs. 100 million. Depreciation on plant was recorded at Rs. 25 million instead of Rs. 10 million. This error was discovered after the publication of financial statements for the year ended December 31, 2014. The error is considered to be material.

Required:

Produce an extract showing the movement in retained earnings, as would appear in the statement of changes in equity for the year ended December 31, 2015 (*including comparative amounts*).

► Answer:

Statement of changes in equity (retained earnings)

For the year ended 31 December 2015	Retained earnings
	Rs. m
Balance 31 December 2013 (as reported earlier) [89 – 21]	68
Effect of change in accounting policy	(1.5)
Balance 31 December 2013 (restated)	66.5
Total comprehensive income (restated) [21 + 3.7 + (25 - 10)]	39.7
Balance 31 December 2014 (restated)	106.2
Total comprehensive income [15 – 6.2]	8.8
Balance 31 December 2015	115

Working:

Effect on profit (change in policy)	2015	2014	2013
	Rs. m	Rs. m	Rs. m
Increase (decrease) in closing inventory	(4)	2.2	(1.5)
(Increase) decrease in opening inventory	(2.2)	1.5	
Periodic effect	(6.2)	3.7	(1.5)

► **Example 10:**

The following information has been taken from the financial statements of Asif Engineering Limited (AEL) for the year ended 31 December 2015:

	2015 (draft)	2014	2013
	Rs. million	Rs. million	Rs. million
Property, plant and equipment	2,430	2,402	2,105
Stores and spares	73	80	70
Retained earnings as at 31 December	353	224	101
Net profit	129	123	112

In the above financial statements, AEL has recognised consumption of spare parts as expense. AEL has now decided to change its above policy and classify consumption of spares having useful life of more than one year as capital spares under property, plant and equipment.

Following information pertains to capital spares consumed during the past three years:

Year ended	Parts issued during the year	Useful life of the issued parts
31 December 2013	Rs. 55 million	5 years
31 December 2014	Rs. 39 million	3 years
31 December 2015	Rs. 44 million	4 years

Depreciation on these parts is to be charged using straight line method over its useful life.

Required:

In accordance with the requirements of International Financial Reporting Standards, prepare the revised extracts (including comparative figures) of the following:

- statement of financial position as at 31 December 2015
- statement of comprehensive income for the year ended 31 December 2015
- statement of changes in equity for the year ended 31 December 2015

► **Answer:****Part (a) Statement of financial position as at 31 December 2015**

	2015	2014	2013
		(Restated)	Restated
	Rs. m	Rs. m	Rs. m
Property, plant and equipment	2,498 [2,430 + 68]	2,461 [2,402 + 59]	2,149 [2,105 + 44]
Stores and spares	73	80	70
Retained earnings	421 [353 + 68]	283 [224 + 59]	145 [101 + 44]

Part (b) Statement of profit or loss for the year ended 31 December 2015

	2015	2014
		(Restated)
	Rs. m	Rs. m
Net profit	138 [129 + 9]	138 [123 + 15]

Part (c) Statement of changes in equity for the year ended 31 December 2015

	Retained earnings
	Rs. m
Balance 1 January 2014 (as reported earlier)	101
Effect of retrospective change in accounting policy	44
Balance 1 January 2014 (restated)	145
Profit for the year (restated)	138
Balance 31 December 2014 (restated)	283
Profit for the year	138
Balance 31 December 2015	421

Working:

	2015	2014	2013
	Rs. m	Rs. m	Rs. m
Reversal of stores expense	44	39	55
Depreciation 55 / 5 years	(11)	(11)	(11)
Depreciation 39 / 3 years	(13)	(13)	
Depreciation 44 / 4 years	(11)		
Periodic effect	9	15	44
Cumulative effect	68	59	44

► **Example 11:**

Wonder Limited (WL) is engaged in the manufacturing and sale of textile machinery. Following are the draft extracts of the statement of financial position and the statement of profit or loss for the year ended 30 June 2015:

	2015	2014
	Rs. m	Rs. m
Statement of Financial Position		
Property, plant and equipment	189	130
Retained earnings	198	108
Statement of profit or loss		
Profit for the year	90	78

Following additional information has not been taken into account in the preparation of the above financial statements:

- i. Cost of repairs amounting to Rs. 20 million was erroneously debited to the machinery account on 1 October 2013. The estimated useful life of the machine is 10 years.
- ii. On 1 July 2014, WL reviewed the estimated useful life of its plant and revised it from 5 years to 8 years. The plant was purchased on 1 July 2013 at a cost of Rs. 70 million.

Depreciation is provided under the straight-line method.

Required:

Prepare extracts of statement of profit or loss and the following notes to the financial statements for the year ended 30 June 2015:

- Correction of error
- Change in accounting estimate

► *Answer:*

Statement of profit or loss for the year ended 31 December 2015

	2015	2014
		(Restated)
	Rs. m	Rs. m
Net profit	98 [90 + 2 + 6]	59.5 [78 – 18.5]

Notes to the financial statements for the year ended 30 June 2015

Correction of error note

During the year ended June 30, 2014, the repair work was erroneously included in machine account. The effect of correction of this error is as follows:

	2014
	Rs. m
Effect on statement of financial position	
Decrease in property, plant and equipment	(18.5)
Decrease in retained earnings	(18.5)
Effect on statement of profit or loss	
Increase in repair expense	20
Decrease in depreciation expense	(1.5)
Decrease in profit	(18.5)

Change in accounting estimate note

The remaining useful life estimate of a plant was revised from 4 to 7 years resulting in reduction of depreciation by Rs. 6 million in current period and for the remaining life of the plant.

Working:

Correction of error	2015	2014
	Rs. m	Rs. m
Recording of repair expense		(20)
Reversal of depreciation: Rs. 20 m / 10 years x 9/12		1.5
Reversal of depreciation: Rs. 20m / 10 years	2	
Periodic effect	2	(18.5)
Cumulative effect	(16.5)	(18.5)

Change in accounting estimate:

Carrying amount at beginning of the year = Rs. 70m – (70/5 years) = Rs. 56m

Depreciation 2015 (previous estimate) = Rs. 56 m / 4 years = Rs. 14 m

Depreciation 2017 (new estimate) = Rs. 56 m / 7 years = Rs. 8 m

Depreciation to be reduced by = Rs. 14 m – 8 m = Rs. 6 m

► **Example 12:**

Chand Paints Limited (CPL) is engaged in the manufacturing of chemicals and paints. In April 2016 it was discovered that certain errors had been made in the financial statements for the year ended 30 June 2015. The errors were corrected in 2016. The details are as follows:

	2016	2015	2015
	(Draft)	After correction of errors	Audited
	Rs. m	Rs. m	Rs. m
Statement of comprehensive income			
Sales tax, commission and discounts	(7,939)	(8,246)	(7,916)
Cost of sales	(45,508)	(44,606)	(44,633)
Selling and distribution expenses	(2,940)	(2,635)	(2,441)
Administration expenses	(2,356)	(2,254)	(2,149)
Other operating charges	(495)	(467)	(515)
Other operating income	920	427	509
Profit for the year	4,089	3,723	4,359
Statement of financial position			
Trade and other receivables	1,839	1,613	2,025
Trade and other payables	11,600	8,894	8,670

The share capital and un-appropriated profit of CPL as on 1 July 2014 was Rs. 10,400 million and Rs. 19,089 million respectively.

The details of dividend declared are as follows:

	2016	2015
Cash dividend – Interim	10%	5%
– Final	15%	10%

Required:

- Prepare a correction of error note, to be included in the financial statements for the year ended 30 June 2016.
- Prepare the statement of changes in equity for the year ended 30 June 2016

► *Answer:*

Part (a) Notes to the financial statements for the year ended 30 June 2016

The effect of retrospective restatement on statement of comprehensive income:

Increase / (decrease) in income	2015
	Rs. m
Increase in sales tax, commission and discounts (7,916 – 8,246)	(330)
Decrease in cost of sales (44,633 – 44,606)	27
Increase in selling and distribution expenses (2,441 – 2,635)	(194)
Increase in administration expenses (2,149 – 2,254)	(105)
Decrease in operating income	(602)
Decrease in other operating charges (515 – 467)	48
Decrease in other operating income (509 – 427)	(82)
Decrease in profit for the year	(636)

The effect of retrospective restatement on statement of financial position for 2015:

Decrease in trade debts (2,025 – 1,613)	(412)
Increase in trade and other payables (8,894 – 8,670)	224
Decrease in un-appropriated profit	(636)

Part (b) Statement of changes in equity for the year ended 30 June 2016

	Share capital	Retained earnings	Total
	----- Rs. in million -----		
Balance 1 July 2014	10,400	19,089	29,489
Interim dividend 2015 (10,400×5%)		(520)	(520)
Profit for the year 2015 - restated		3,723	3,723
Balance 30 June 2015	10,400	22,292	32,692
Final dividend 2015 (10,400×10%)		(1,040)	(1,040)
Interim dividend 2016 (10,400×10%)		(1,040)	(1,040)
Profit for the year 2016		4,089	4,089
Balance 30 June 2016	10,400	24,301	34,701

► **Example 13:**

Retained earnings column extracted from the draft statement of changes in equity of Zahidi Limited (ZL) for the year ended 31 December 2020, is as follows:

	Retained earnings
	Rs. in million
Balance as at 31 December 2018	351
Final cash dividend for the year 2018	(15)
Total comprehensive income for the year 2019	68
Balance as at 31 December 2019	404
Total comprehensive income for the year 2020	82
Balance as at 31 December 2020	486

On 1 January 2018, ZL had acquired a building at cost of Rs. 200 million and had rented it out on the same day for three years. On 31 December 2020, the tenant vacated the building and ZL decided to transfer its head office to such building.

The finance manager was considering the reporting implications of change in use of the building. He came to know that the building has erroneously been reported as property, plant and equipment since inception and was being depreciated on straight line basis over 20 years. The fair value of the building has increased by 10% in each year since acquisition.

ZL follows cost model for property, plant and equipment and fair value model for investment property.

Required:

Prepare the following extracts from ZL's financial statements for the year ended 31 December 2020 in accordance with IFRSs:

- Correction of error note
- Retained earnings column as would appear in the statement of changes in equity.

(Show comparative figures)

► **Answer:****Part (a) Correction of error note**

It was identified in current year that an investment property was erroneously reported as property, plant and equipment since acquisition i.e. 1 January 2018. The error has been corrected by retrospective restatement of prior year amount which has been summarized as follows:

	2019	2018
	Rs. m	Rs. m
Effect on statement of financial position		
Increase in investment property	242	220
Decrease in property, plant and equipment	(180)	(190)
Increase in retained earnings	62	30
Effect on statement of profit or loss		
Reversal of depreciation expense	10	
Increase in fair value gain (investment property)	22	
Increase in profit	32	

Part (b) Extracts of retained earnings

	Retained earnings
	Rs. m
Balance 31 December 2018 (as reported earlier)	351
Effect of correction of prior period errors	30
Balance 31 December 2018 (restated)	381
Final cash dividend	(15)
Total comprehensive income (restated) [68 + 32]	100
Balance 31 December 2019 (restated)	466
Total comprehensive income [82 + 34]	116
Balance 31 December 2024	582

Working:

	2020	2019	2018
	Rs. m	Rs. m	Rs. m
Reversal of depreciation [200 x 5%]	10	10	10
Fair value gain @10%	24	22	20
Periodic effect	34	32	30
Cumulative effect	96	62	30

► **Example 14:**

For the purpose of preparation of statement of changes in equity for the year ended 31 December 2017, Daffodil Limited (DL) has extracted the following information:

	2017	2016	2015
	Draft	Audited	Audited
	----- Rs. in million -----		
Net profit	650	318	214
Transfer to general reserves	112	-	141
Transfer of incremental depreciation	-	49	55
Final cash dividend	-	-	7.5%

Additional information:

i. Details of share issues:

- 25% right shares were issued on 1 May 2016 at 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.
- A bonus issue of 15% was made on 1 September 2017 as interim dividend.

- ii. After preparing draft financial statements, it was discovered that depreciation on a plant costing Rs. 700 million has been charged @ 25% under reducing balance method, from the date of commencement of manufacturing i.e. 1 July 2014. However, the plant was available for use on 1 February 2014.
- iii. Share capital and reserves as at 31 December:

	2015	2014
	----- Rs. in million -----	
Ordinary share capital (Rs. 10 each)	1,600	1,600
General reserves	1,850	1,709
Retained earnings	1,430	1,302
Revaluation surplus	49	104

Required:

Prepare DL's statement of changes in equity for the year ended 31 December 2017 along with comparative figures. The column for total is not required.

► *Answer:*

Daffodil Limited

Statement of changes in equity for the year ended 31 December 2017

	Share capital	Share premium	General reserve	Retained earnings	Revaluation surplus
	Rs. m	Rs. m	Rs. m	Rs. m	Rs. m
Balance as on 1 January 2016	1,600	-	1,850	1,430	49
Effect of correction of error				(54.69)	
Balance as on 1 January 2016: (restated)	1,600	-	1,850	1,375.31	49
Final cash dividend 7.5%				(120)	
Right issue 25%	400	320			
Profit: restated [318 + 13.67]				331.67	
Transfer (Incremental dep.)				49	(49)
Balance as on 31 Dec 2016	2,000	320	1,850	1,635.98	0
Final bonus dividend 10%	200			(200)	
Right issue 50m shares	500	250			
Interim bonus dividend 15%	405			(405)	
Profit [650 + 10.25]				660.25	
Transfer to general reserve			112	(112)	
Balance as on 31 Dec 2017	3,105	570	1,962	1,579.23	0

Working:	Depreciation		
	Correct @25%	Incorrect @25%	Effect on profit
	Rs. in million		
Cost	700	700	
2014	160.42 $(700 \times 25\% \times 11 \div 12)$	87.50 $(700 \times 25\% \times 6 \div 12)$	(72.92)
2015	134.90 $(700 - 160.42) \times 25\%$	153.13 $(700 - 87.50) \times 25\%$	18.23
		Cumulative	(54.69)
2016	101.17 $(134.90 \times 75\%)$	114.84 $(153.13 \times 75\%)$	13.67
2017	75.88 $(101.17 \times 75\%)$	86.13 $(114.84 \times 75\%)$	10.25

► **Example 15:**

During the year, it was discovered that due to some calculation error in excel sheet, fair value of Coal Limited's (CL's) office building was taken incorrectly as Rs. 460 million instead of Rs. 360 million. Resultantly, the building was recorded based on incorrect revaluation amount in CL's financial statements for the year ended 30 June 2017.

This building was acquired on 1 July 2015 for Rs. 500 million and then revalued for the first time on 30 June 2017. CL follows revaluation model for subsequent measurement of its building classified as property, plant and equipment and charges depreciation over its useful life of 10 years using straight line method. CL accounts for revaluation on net replacement value method and transfers the maximum possible amount from the revaluation surplus to retained earnings on an annual basis.

As on 30 June 2019, the revalued amount of building has been determined at Rs. 320 million.

Required:

Prepare extracts from CL's statement of financial position and related notes to the financial statements for the year ended 30 June 2019 alongwith comparative figures for the above. (Note on Property, plant and equipment is not required).

► **Answer:**

Coal Limited	2019	2018	2017
Statement of Financial Position (Extracts)		(Restated)	(Restated)
As at 30 June 2019	Rs. m	Rs. m	Rs. m
Non-current assets: Building	320	315 $[360 - 360/8]$	360
Equity: Revaluation Surplus W1	20	-	-

Coal Limited

Notes to the financial statements (Extracts) for the year ended 30 June 2019

Correction of error note

It was identified in current year that revalued amount of one of buildings was taken as Rs. 460 million instead of Rs. 360 million in 2017's financial statements.

	2018	2017
	Rs. m	Rs. m
Effect on statement of profit or loss		
Decrease in depreciation [100 / 8 years]	(12.5)	
Effect on statement of financial position		
Decrease in PPE [100 – 100/8] & [360 – 460]	(87.5)	(100)
Decrease in revaluation surplus [60 – 60 / 8] & [400 – 460]	(52.5)	(60)
Decrease in retained earnings [40 – 40/8] & [360 – 400]	(35)	(40)

W1: Revaluation surplus	Rs. m
Revalued amount	320
Carrying amount 31 Dec 2019 [360 – 360/8 x 2 years]	270
Revaluation gain	50
Reversal in profit or loss [40 loss – 40/8 x 2 years]	(30)
Recognise in OCI and accumulated in revaluation surplus	20

► **Example 16:**

Supreme Cement Company Limited (SCCL) is in process of finalization of its accounts for the year ended 31 December 2012. The following information is available:

- i. Shareholders' equity as at 31 December 2011 and 2010 consisted of:

	2011	2010
	Rs. In million	Rs. In million
Share capital (Rs. 10 each)	10,340	7,833
Unappropriated profit	6,945	4,508

- ii. The total comprehensive income for the years ended 31 December 2010, 2011, and 2012 (unaudited) was Rs. 4,240 million, Rs. 4,944 million and Rs. 5,090 million respectively.
- iii. During the year ended 31 December 2012 it was observed that machinery purchased on 01 July 2011 for Rs. 350 million, was erroneously debited to stock-in-trade instead of property, plant and equipment. SCCL depreciates machinery at the rate of 20% per annum on the reducing balance method. No adjustment has been made yet in respect of this error. SCCL uses perpetual inventory method.
- iv. Cash dividends and bonus dividends declared during the last three years are as follows:

For the year ended:	Cash dividend		Bonus dividend	
	Interim*	Final	Interim*	Final
31 December 2010	10%	-	-	20%
31 December 2011	-	15%	10%	-
31 December 2012	10%	-	-	5%

*Declared at the time of announcement of half-yearly financial results.

- v. Right shares were issued on 30 November 2012 in the ratio of 4 right shares for every 5 shares held by the shareholders of the company. The right issue was made at Rs. 18 per share

Required:

Prepare the statement of changes in equity for the year ended 31 December 2012 *(including comparative figures, total column is not required)*.

► *Answer:*

Statement of changes in equity for the year ended 31 December 2012

	Share capital	Share premium	Retained earnings
	Rs. m	Rs. m	Rs. m
Balance 1 January 2011	7,833	-	4,508
Final bonus dividend 2010 20%	1,567		(1,567)
Interim bonus issue 10%	940		(940)
Profit for the year: restated [4,944 – 35*]			4,909
Balance 31 December 2011 (restated)	10,340	-	6,910
Final cash dividend 2011: 15%			(1,551)
Interim cash dividend 10%			(1,034)
Right issue 80%	8,272	6,618	
Profit for the year: [5,090 – 63**]			5,027
Balance 31 December 2012	18,612	6,618	9,352

*Extra depreciation 2011: Rs.350m x 20% x 6/12 = Rs. 35m

** Extra depreciation 2012: (Rs.350 – 35 m) x 20% = Rs. 63m

► *Example 17:*

The following information pertains to draft financial statements of Pak Ocean Limited (POL) for the year ended 31 December 2014:

	2014	2013
	Rs. In million	
Profit for the year	78	52
Gain (loss) on revaluation of buildings	12	(5)
Incremental depreciation	1.5	2.3

- i. Installation of an assembly plant was completed in December 2012 at a cost of Rs. 60 million and it was ready for use on 1 February 2013. However, depreciation for the year ended 31 December 2013 amounting to Rs. 4.5 million was worked out from the date of production i.e. 1 April 2013. The additional depreciation of Rs. 1 million was included in the depreciation expense for the year ended 31 December 2014, in an attempt to correct the error.

ii. Shareholders' equity as at 1 January 2013 was as follows:

	Rs. in million
Share capital (Rs. 100 each)	200
Retained earnings	145
Revaluation surplus (buildings)	20

iii. On 30 November 2014, POL issued 25% right shares to its ordinary shareholders at Rs. 120 per share.

iv. Cash dividend and bonus dividend declared during the last three years:

For the year ended:	Cash dividend		Bonus dividend	
	Interim*	Final	Interim*	Final
31 December 2012	16%	-	-	15%
31 December 2013	18%	-	20%**	-
31 December 2014	-	25%	-	10%

*Declared with half-yearly accounts.

**Not entitled to cash dividends declared on the same day.

Required:

Prepare statement of changes in equity for the year ended 31 December 2014 (*including comparative figures, total column is not required*).

► *Answer:*

Statement of changes in equity for the year ended 31 December 2014

	Share capital	Share premium	Retained earnings	Revaluation surplus
	Rs. m	Rs. m	Rs. m	Rs. m
Balance 1 January 2013	200	-	145	20
Final bonus dividend 2012 15%	30		(30)	
Interim cash dividend 18%			(41.4)	
Interim bonus dividend 20%	46		(46)	
Total comprehensive income (restated)				
Profit for the year [52 – 1]			51	
Other comprehensive income				(5)
Transfer (Incremental depreciation)			2.3	(2.3)
Balance 31 December 2013	276	-	80.9	12.7
Right issue 25%	69	13.8		
Total comprehensive income				
Profit for the year [78 + 1]			79	
Other comprehensive income				12
Transfer (Incremental depreciation)			1.5	(1.5)
Balance 31 December 2014	345	13.8	161.4	23.2

► **Example 18:**

Roman Limited (RL) has extracted the following information for the purpose of preparation of statement of changes in equity for the year ended 31 December 2022:

	2022	2021	2020
	Draft	Audited	Audited
	----- Rs. in million -----		
Net profit	285	195	177
Revaluation surplus arising during the year	-	115	(78)
Transfer of incremental depreciation	30	26	28

Additional information:

- On 1 February 2021, a bonus issue of 10% was made as final dividend for 2020.
- On 15 May 2021, RL issued right shares for Rs. 20 per share. Right shares were issued in a proportion of 1 right share for every 4 ordinary shares held. Transaction cost of Rs. 0.5 per share was also incurred.
- On 1 May 2022, an item of property, plant and equipment was disposed of at its carrying value. An amount of Rs. 75 million was remaining in the revaluation surplus account in respect of this item's previous revaluations.
- On 1 July 2022, 50 million irredeemable preference shares having par value Rs. 10 each were issued at Rs. 15 per share.
- In October 2022, an interim 5% cash dividend on all shares was made.
- The revalued amount of RL's head office building was determined as Rs. 400 million as on 31 December 2021. However, revaluation was not incorporated as the change in revalued amount was considered to be temporary by RL's management. The head office building had a carrying value of Rs. 350 million on 31 December 2021 and had a remaining useful life of 10 years. A revaluation loss of Rs. 24 million was recorded on 31 December 2019 on its previous revaluation.
- Share capital and reserves as at 1 January:

	2021	2020
	----- Rs. in million -----	
Ordinary share capital (Rs. 10 each)	800	800
Retained earnings	715	510
Revaluation surplus	399	505

Required:

Prepare RL's statement of changes in equity for the year ended 31 December 2022 along with comparative figures. (Column for total is not required)

► Answer:

Roman Limited**Statement of changes in equity****For the year ended 31 December 2022**

	Ordinary share capital	Preference share capital	Share premiu m	Retaine d earnings	Revaluatio n surplus
	Rs. m				
Balance at 1 January 2021	800			715	399
Final bonus dividend [10% x 800]	80			(80)	
Right issue (W1)	220		220		
Transaction costs (W1)			(11)		
Total comprehensive income (restated)					
Profit [195 + 20 W2]				215	
Other comprehensive income [115 + 30 W2]					145
Transfer of incremental depreciation				26	(26)
Balance at 31 December 2021 (restated)	1,100	-	209	876	518
Transfer upon disposal				75	(75)
Issue of preference shares (50m shares)		500	250		
Interim cash dividend [5% x (1,100+500)]				(80)	
Total comprehensive income					
Profit [285 - 5 W3]				280	
Transfer of incremental dep. [30 + 3 W3]				33	(33)
Balance at 31 December 2022	1,100	500	459	1,184	410

W1: Share issue		Rs. m
Share Capital	[80m+8m] shares x 1/4 x Rs. 10	220
Share premium	[80m+8m] shares x 1/4 x Rs. 10	220
Transaction costs	[80m+8m] shares x 1/4 x Rs. 0.5	11

W2: Revaluation on 31 Dec 2021					Rs. m
Revaluation gain	[Rs. 400m fair value - 350m carrying amount]				50
Loss to be reversed in PL					
Loss recognised in 2019					24
Depreciation decrease 2020 & 2021	[Rs. 24m / 12 years x 2 years]				(4)
					20
Gain in OCI					30

W3: Effect of correction on 2022					Rs. m
Extra depreciation expense in PL	[Rs. 50m increase / 10 years]				5
Extra transfer of incremental dep.	[Rs. 30m increase / 10 years]				3

► **Example 19:**

The retained earnings column, extracted from the draft statement of changes in equity of Puffer Limited (PL) for the year ended 31 December 2022, is as follows:

	Rs. in million
Balance as at 31 December 2020	928
Final cash dividend @ 10% for the year 2020	(114)
Profit for the year 2021	258
Balance as at 31 December 2021	1,072
Profit for the year 2022	328
Balance as at 31 December 2022	1,400

The following changes have not been incorporated into the draft financial statements of PL:

- viii. PL has decided to change the method for valuation of inventory from 'first-in, first-out' (FIFO) to the weighted average. The value of inventory under each method has been determined as follows:

	FIFO	Weighted average
	----- Rs. in million -----	
As at 31 December 2020	438	460
As at 31 December 2021	560	520
As at 31 December 2022	601	618

- ix. In view of increasing bad debts, PL has decided to double the provision for doubtful receivables. The balance of provision for doubtful receivables prior to this change were as follows:

	Rs. in million
As at 31 December 2020	15
As at 31 December 2021	19
As at 31 December 2022	23

- x. PL has also decided to recognise all borrowing costs incurred in a year as an expense. Previously, borrowing costs related to qualifying assets were capitalised as part of the cost of that asset. Total borrowing costs incurred during the years 2022 and 2021 amounted to Rs. 87 million and Rs. 95 million, respectively. Of these, Rs. 53 million and Rs. 38 million were capitalised in the cost of head office building in 2022 and 2021, respectively. The construction of the building is expected to complete in 2023.

Required:

- Briefly discuss how the above changes should be incorporated in PL's financial statements.
- Prepare the retained earnings column as would appear in PL's statement of changes in equity for the year ended 31 December 2022, in accordance with IFRSs.

► **Answer:**

- Part (a)
 - This is a change in accounting policy, which will be applied retrospectively.
 - This is a change in accounting estimate, which will be applied prospectively.
 - IAS 23 requires to capitalise all related borrowing costs incurred on qualifying asset. PL cannot change this accounting policy so no effect on financial statements.
- Part (b)

Puffer Limited

Statement of changes in equity

For the year ended 31 December 2022

		Retained earnings
		Rs. in million
Balance as at 31 December 2020		928
Effect of change in accounting policy	(W-1)	22
Balance as at 31 December 2020 (Restated)		950
Final cash dividend @ 10% for the year 2020		(114)
Profit for the year 2021(Restated)	258-62(W-1)	196
Balance as at 31 December 2021(Restated)		1,032
Profit for the year 2022	328-23+57(W-1)	362
Balance as at 31 December 2022		1,394

W-1: Effect on profit (change in policy)

	2020	2021	2022
	----- Rs. in million -----		
Increase/(decrease) in closing inventory	22	(40)	17
(Increase)/decrease in opening inventory	-	(22)	40
	22	(62)	57

► **Example 20:**

Financial statements of Bard Limited (BL) for the year ended 31 December 2023 are under preparation. During the review of the draft financial statements of BL, the following matters have been identified:

- i. Statement of changes in equity was not prepared in the draft financial statements. In this respect, the following details have been gathered:

- Share capital and reserves as at 1 January:

	2022	2021
	---- Rs. in million ----	
Ordinary share capital (Rs. 10 each)	2,400	2,400
Share premium	563	563
Retained earnings	1,345	1,153

- BL's profit for the year 2023 (draft), 2022 and 2021 were Rs. 575 million, Rs. 477 million and Rs. 321 million respectively.
 - Final dividend for the year ended 31 December 2021 comprised of 15% cash dividend and 10% bonus shares. The bonus issue was made from share premium, and the shares were issued in April 2022 after payment of cash dividend.
 - A bonus issue of 25% was made in July 2023 as interim dividend.
 - 40 million right shares were issued in October 2023 at Rs. 18 per share. Transaction costs of Rs. 3 million were also incurred.
- ii. On 1 January 2020, BL had received a government grant of Rs. 600 million to acquire a manufacturing plant. However, the grant was treated as income on receipt.

The manufacturing plant was acquired at a total cost of Rs. 1,000 million on 1 January 2020. It was estimated to have a useful life of 8 years and residual value of Rs. 100 million.

- iii. BL had decided to adopt the revaluation model from 1 January 2023 for subsequent measurement of land and buildings included in property, plant and equipment. However, this change has not been accounted for in the draft financial statements.

The following information pertains to BL's property, plant and equipment:

Assets	WDV as on 1 January 2023	Revalued amounts as on 1 January 2023	Remaining useful life as on 1 January 2023
	----- Rs. in million ----		Years
Land	1,000	1,250	-
Office building	750	1,200	9
Factory building	1,000	550	5

On 1 November 2023, BL sold 40% of its land.

Depreciation on buildings has been recorded using straight line method. BL transfers the maximum possible revaluation surplus to retained earnings.

Required:

Prepare BL's statement of changes in equity along with comparative figures for the year ended 31 December 2023. (The column of total is not required)

► Answer:

Bard Limited	Share Capital	Share premium	Retained earnings	Revaluation surplus
Statement of changes in equity				
For the year ended 31 December 2023	Rs. M			
Balance at 1 January 2022	2,400	563	1,345	0
Effect of correction of error (W1)			(450)	
Balance at 1 January 2022 - Restated	2,400	563	895	0
Final cash dividend 2021 @15% x 2,400			(360)	
Final bonus issue 2021 @10% x 2,400	240	(240)		
Profit 2022 (restated) [477 + 75 W1]			552	
Balance at 31 December 2022 (restated)	2,640	323	1,087	0
Interim bonus dividend 2023 @25% x 2,640	660		(660)	
Issue of right shares [40m x Rs. 10 & Rs. 8]	400	320		
Transaction costs		(3)		
Total comprehensive income				
Profit W3			140	
Other comprehensive income W2				700
Transfer of incremental dep. [450 / 9 years] W3			50	(50)
Transfer on disposal [250 x 40%] W3			100	(100)
Balance at 31 December 2023	3,700	640	717	550

W1: Correction of government grant	2023	2022	2021	2020
	Rs. M			
Reversal of grant income in 2020				(600)
Transfer of grant to PL [600 / 8 years]	75	75	75	75
Period wise effect on PL	75	75	75	(525)
Cumulative effect			(450)	(525)

W2: Revaluation	Land	Office building	Factory building	Total
	Rs. M			
Fair value	1,250	1,200	550	
Carrying amount	(1,000)	(750)	(1,000)	
Revaluation surplus (OCI)	250	450		700
Revaluation loss (PL)			(450)	(450)

W3: Profit for 2023			Rs. M
Profit as per draft FS			575
Transfer of government grant to PL	W1		75
Revaluation loss on factory building	W2		(450)
Increase in depreciation expense (office building)	[Rs. 450m W2 / 9 years]		(50)
Decrease in depreciation expense (factory building)	[Rs. 450m W2 / 5 years]		90
Correction of gain on land disposal (due to revaluation)	[Rs. 250m x 40%]		(100)
			140

► **Example 21:**

The following information pertains to the intangible assets of Hadero Limited (HL):

- On 1 May 2022, HL acquired an eight year license at a cost of Rs. 174 million. HL plans to use the license for six years. Licenses are traded in an active market. As on 31 December 2022, the fair value of a new license valid for eight years is Rs. 192 million, while older licenses sell at a fair value of new license value less Rs. 2 million for each month the license has already been used.
- On 1 July 2022, HL acquired operation management software at a cost of Rs. 410 million. HL also incurred a cost of Rs. 20 million for consulting charges to select and evaluate the appropriate software in alignment with HL's needs.

HL expects that indefinite life can be achieved if HL incurs future expenditures to enhance its performance standards by integrating 'artificial intelligence' into this software. Without such expenditures, the software is projected to become technologically obsolete in five years.

After the acquisition of the new software, the existing software would henceforth serve limited purposes. The existing software was acquired for Rs. 240 million, and as on 31 December 2021, Rs. 126 million had been amortized, based on a useful life of ten years.

On 31 December 2022, HL has estimated the value in use of the existing software to be Rs. 58 million. This valuation has been computed using cash flows projected over the revised remaining useful life of two years.

- During the year 2022, it was discovered that the entire cost of Rs. 1,050 million incurred on 'product development' has been recorded as intangible asset without considering the following pertinent facts:
 - The product development was commenced on 1 August 2021. Up till the launch date of 1 October 2022, the following directly attributable costs were incurred:

	Rs. in million
Staff salary	150
Equipment (having useful life of five years)	420
Consumables	160
Consultant fee	320
Total	1,050

- The recognition criteria for capitalization of internally generated intangible assets was met on 1 February 2022. All costs have been incurred evenly during the period except the equipment which was purchased specifically for this product development on 1 September 2021. The useful life of the developed product is estimated at eight years.

- iv. HL uses the revaluation model for the subsequent measurement of its intangible assets, wherever possible, and accounts for revaluation using the net replacement value method. Depreciation and amortisation are charged using the straight line basis.

Required:

Prepare the notes on 'Intangible assets' and 'Correction of error' for inclusion in HL's financial statements for the year ended 31 December 2022, in accordance with the requirements of IFRSs.

► Answer:

Hadero Limited

Notes to the financial Statements

For the year ended 31 December 2022

	License	Software	Product development
	Rs. in million		
1. Intangible assets			
Cost / Revalued amount			
1 January	0	240	0
Separate acquisition	174	410	
Revaluation (adjustment)	(14)		
Revaluation gain	16 W4		
Development			416 W7
31 December	176	650	416
Accumulated amortisation and impairment			
1 January	0	126	0
Amortisation	14 W2	79 W5	13 W8
Impairment		18 W6	
Revaluation (adj.)	(14)		
31 December	0	223	13
Carrying amount	176	427	403
Measurement basis	Revaluation	Cost	Cost
Useful life	6 years	3 to 5 years	8 years
Depreciation method	Straight line	Straight line	Straight line
Revaluation date	31 Dec 2022		
Valuation basis	Active market		

Workings:		Rs. M
1. Residual value of license	[2 years x 12 months x Rs. 2m]	48
2. Amortisation of license	[(174 - 48) / 6 years x 8/12]	14
3. Fair value of license	[192m - (8 months x 2m)]	176
4. Revaluation gain	[176 - (174 - 14)]	16
5. Amortisation new software	[410 / 5 years x 6/12]	41
Amortisation old software	[(240 - 126) / 3 years]	38
		79
6. Impairment old software	[58 - (240 - 126 - 38)]	18
7. Correct product development		
Costs except equipment	[(1,050 - 420) x 8/14 months]	360
Depreciation of equipment	[420 / 5 years x 8/12]	56
		416
8. Amortisation product Development	[416 / 8 years x 3/12]	13

2. Correction of error note

It was identified during the year that the amount capitalised as product development in 2021 was incorrect. The effects of correction of amounts reported in 2021 are as follows:

Effect on profit or loss:		Rs. M
Increase in research expense	[(1,050 - 420) x 5/14 months]	(225)
Increase in depreciation on equipment	[420 / 5 years x 4/12 months]	(28)
		(253)
Effect on statement of financial position:		Rs. M
Decrease in intangible assets	[225 as in SPL + 420 of equipment]	(645)
Increase in property, plant & equipment	[420 - 28 depreciation]	392
		(253)

1. OBJECTIVE BASED Q&A

1. Which TWO of the following situations would not require a prior year adjustment as per IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors?
 - a) In last year's financial statements, inventories were understated by a material amount due to system error
 - b) A company has changed its allowance for irrecoverable receivables from 10% of outstanding debt to everything over 120 days old
 - c) A new accounting standard has been issued that requires a company to change its accounting policy but gives no guidance on the specific application of the change itself
 - d) A company has decided to move from charging depreciation on the straight-line basis to the reducing balance basis
2. In accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors how is a change in accounting estimate accounted for?
 - a) By changing the current year figures but not the previous years' figures
 - b) By changing the current year figures and the previous years' figures
 - c) No alteration of any figures but disclosure in the notes
 - d) Neither alteration of any figures nor disclosure in the notes
3. According to IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors, how should a material error in the previous financial reporting period be accounted for in the current period?
 - a) By making an adjustment in the financial statements of the current period through the statement of profit or loss and disclosing the nature of the error in a note
 - b) By making an adjustment in the financial statements of the current period as a movement on reserves and disclosing the nature of the error in a note
 - c) By restating the comparative amounts for the previous period at their correct value and disclosing the nature of the error in a note
 - d) By restating the comparative amounts for the previous period at their correct value, but without the requirement for a disclosure of the nature of the error in a note
4. Which of these changes would be classified as 'a change in accounting policy' as determined by IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors?
 - a) Increased the allowance for irrecoverable receivables from 5% to 10% of outstanding debts
 - b) Changed the method of valuing inventory from FIFO to average cost
 - c) Changed the depreciation of plant and equipment from straight line depreciation to reducing balance depreciation
 - d) Changed the useful life of motor vehicles from six years to four years
5. In which TWO of the following situations can a change in accounting policy be made by an entity?
 - a) If the change is required by an IFRS
 - b) If the entity thinks that a new accounting policy would be easier to report
 - c) If a new accounting policy would show more favourable results
 - d) If a new accounting policy results in more reliable and relevant presentation of events or transactions
6. Which one of the following would be treated under IAS 8 Accounting policies, changes in accounting estimates and errors as a change of accounting policy?
 - a) A change in valuation of inventory from a weighted average to a FIFO basis
 - b) A change of depreciation method from straight line to reducing balance
 - c) Adoption of the revaluation model for non-current assets previously held at cost
 - d) Capitalisation of borrowing costs which have arisen for the first time

7. Which of the following would be a change in accounting policy in accordance with IAS 8 Accounting policies, changes in accounting estimates and errors?
 - a) Adjusting the residual value amount based on latest information received
 - b) A change in reporting depreciation charges as cost of sales rather than as administrative expenses
 - c) Depreciation charged on reducing balance method rather than straight line
 - d) Reducing the value of inventory from cost to net realisable value

8. Which of the following items is a change of accounting policy under IAS 8 Accounting policies, changes in accounting estimates and errors?
 - a) Classifying commission earned as revenue in the statement of profit or loss, having previously classified it as other operating income
 - b) Switching to hiring plants on leases from a previous policy of purchasing plants for cash
 - c) Reversal of write down to NRV of inventory after sales prices increased significantly this year
 - d) Revising the remaining useful life of a depreciable asset

9. The directors of Tom Limited are disappointed by the draft profit for the year ended 30 September 2013. The company's assistant accountant, Jerry, has suggested following:

A major item of plant that cost Rs. 20 million to purchase and install on 1 October 2010 is being depreciated on a straight-line basis over a five-year period. On 1 October 2012, the production manager believed that the plant was likely to last eight years in total (i.e. from the date of its purchase).

Jerry believes that as the useful life estimate has increased, the previous years' depreciation was overstated, and it depreciation expense should be reversed in current year leading to increased profit.

What is the nature of the change being proposed by Jerry and how should it be applied?

 - a) Change of accounting policy: Retrospective application
 - b) Change of accounting policy: Prospective application
 - c) Change of accounting estimate: Retrospective application
 - d) Change of accounting estimate: Prospective application

10. If it is impractical to make a retrospective application to a period:
 - a) Make the change only to the current period
 - b) Apply the change to the earliest period that is practical
 - c) Do not make the change at all
 - d) Make the change in next year

11. Which TWO of the following would be treated as a change of accounting policy?
 - a) Entity has received its first government grant and is applying the deferred income method
 - b) Entity has revalued its properties. Up to now they had all been carried at historical cost
 - c) Entity has reclassified certain expense from other operating expenses to cost of sales
 - d) Entity has increased its irrecoverable debt allowance from 10% to 12%

12. Correcting the recognition, measurement and disclosure of amounts in financial statements as if a prior-period error had never occurred. This is:
 - a) Retrospective restatement
 - b) Retrospective application
 - c) Change in accounting estimate
 - d) Prospective restatement

13. Specific principles, bases conventions, rules and practices applied by an entity in presenting financial statements. This defines:
- Accounting estimates
 - Accounting policies
 - Prospective application
 - Accounting method
14. Adjustment of the carrying amount of an asset or a liability or the consumption of an asset as a result of change in assessment. This defines:
- A change in accounting estimate
 - Accounting policies
 - Misstatements
 - Correction of error
15. Applying a new policy to transactions as if that policy had always been applied. This is:
- Retrospective restatement
 - Retrospective application
 - Change in accounting estimate
 - Prospective application
16. The directors of Tom Limited are disappointed by the draft profit for the year ended 30 September 2013. The company's assistant accountant, Jerry, has suggested following:
- A major item of plant that cost Rs. 20 million to purchase and install on 1 October 2010 is being depreciated on a straight-line basis over a five-year period. On 1 October 2012, the production manager believed that the plant was likely to last eight years in total (i.e. from the date of its purchase).
- Jerry believes that as the useful life estimate has increased, the previous years' depreciation was overstated, and it depreciation expense should be reversed in current year leading to increased profit.
- Adjusting for the change of useful life correctly, what will be the carrying amount of the plant at 30 September 2013?
- Rs. 20 million
 - Rs. 16 million
 - Rs. 12 million
 - Rs. 10 million
17. Imad Textile Limited (ITL) purchased a plant on January 01, 2011 for Rs. 1,120,000. At this date the useful life of the asset was estimated at 10 years after which it can be sold for Rs. 120,000. However, during 2013 ITL estimates the remaining useful life of this plant as 6 years and expects to fetch residual value of Rs. 170,000. ITL uses straight line method for depreciating such plants.
- Calculate the amount of depreciation for the year ended on 31 December 2018.
- Rs. 170,000
 - Rs. 125,000
 - Rs. 120,000
 - Rs. 100,000

18. A company is preparing its financial statements for the year ended 31 December 2019 and discovered that in previous years following amounts were incorrectly capitalised in an intangible asset with indefinite useful life.

Year	Rs. m
2018	5
2017	4
2016	4
2015	3

What amount should be deducted from retained earnings in statement of changes in equity on 1 January 2018 for correction of above error?

- Rs. 16 million
 - Rs. 11 million
 - Rs. 7.7 million
 - Rs. 13 million
19. A company is preparing its financial statements for the year ended 31 December 2019 and discovered that in previous years following amounts were incorrectly capitalised in an intangible asset with indefinite useful life.

Year	Rs. m
2018	5
2017	4
2016	4
2015	3

Calculate the effect on profit for the year ended 31 December 2018 correction of above error.

- Rs. 5 million
 - Rs. 3.5 million
 - Rs. 9 million
 - Rs. 6.3 million
20. Most of entity's competitors value their inventory using the average cost (AVCO) basis, whereas the entity uses the first in first out (FIFO) basis.

The value of inventory at 30 September 2013 (on the FIFO basis) is Rs. 20 million, however on the AVCO basis it would be valued at Rs. 18 million. By adopting the same method (AVCO) as its competitors. The inventory at 30 September 2012 was reported as Rs. 15 million, however on the AVCO basis it would have been reported as Rs. 13.4 million.

What will be the effect of the change on profits for the year ended 30 September 2013?

- Increase by Rs. 1.6 million
- Increase by Rs. 0.4 million
- Decrease by Rs. 1.6 million
- Decrease by Rs. 0.4 million

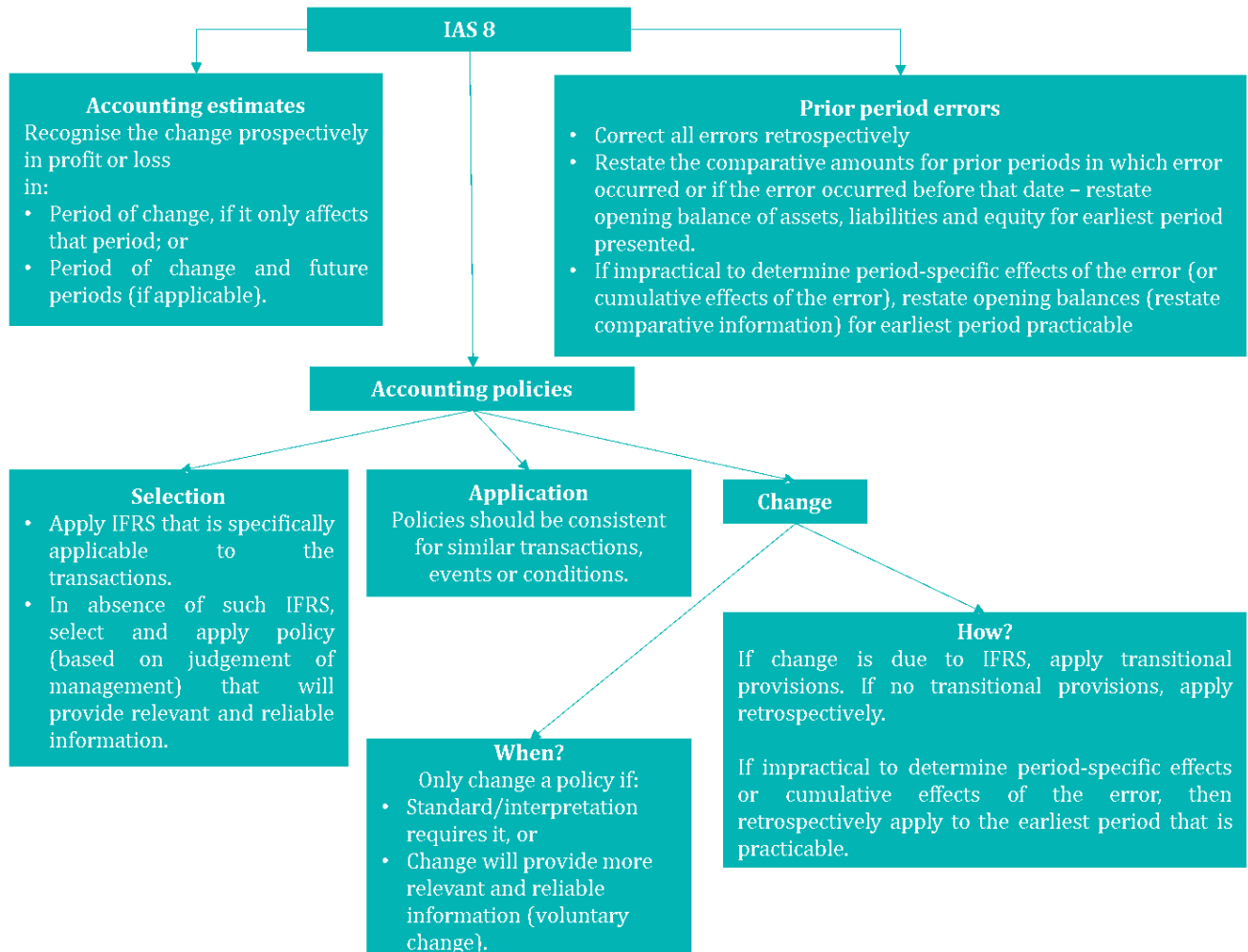
21. Disclosure requirements of IAS 8 in respect of change in accounting policy are NOT applicable in case of:
- change in method for inventory valuation from FIFO to weighted average
 - initial adoption of revaluation model for property, plant and equipment
 - change in revenue recognition policy
 - none of the above
22. Which of the following changes would be considered as change in accounting policy?
- Changing the subsequent measurement model for property, plant and equipment from cost model to revaluation model.
 - Changing the inventory valuation method from FIFO to Weighted average.
- Only (I) is change in accounting policy
 - Only (II) is change in accounting policy
 - Both are change in accounting policy
 - None is change in accounting policy
23. Which TWO of the following situations would require prior year adjustment as per IAS 8?
- Changing the depreciation method from straight line basis to the reducing balance basis in respect of a building held for the last 10 years.
 - Changing the measurement model for Investment property from cost model to fair value model
 - Incorporating the effects of a material understatement found in last year closing inventories due to incorrect formula in excel sheet
 - Adopting the requirements of IAS 20 for a government grant received by an entity for the first time
24. If it is impractical to apply a change in accounting policy retrospectively, then:
- apply the change prospectively
 - apply the change to the earliest period that is practically possible
 - such a change is not allowed
 - defer the change until the retrospective application becomes possible
25. Which of the following is NOT a source for selecting and applying accounting policies under IAS 8 when no standard specifically applies?
- The most recent pronouncements of other standard-setting bodies
 - Published accounting literature
 - Practices that are widely recognised and prevalent in the industry
 - Internal financial reporting guidelines developed by the entity

ANSWERS

01.	(b) & (d)	A change in the calculation of the allowance for irrecoverable receivables, and a change in the depreciation method, are changes in accounting estimate so therefore require prospective adjustment only.												
02.	(a)	Change in accounting estimates results in alteration of figures but not retrospectively. The change is made prospectively.												
03.	(c)	The prior period error is corrected by restating the comparative amounts for the previous period at their correct value. A note to the accounts should disclose the nature of the error, together with other details.												
04.	(b)	A change in the method of inventory valuation would be classed as a change in accounting policy under IAS 8. The allowance for receivables, useful life and depreciation method are all accounting estimates.												
05.	(a) & (d)	A change in accounting policy may be made firstly if this is required by an IFRS Standard. If there is no requirement, an entity can choose to change their accounting policy if they believe a new accounting policy would result in a more reliable and relevant presentation of events and transactions. Entities cannot change their accounting policies simply to make financial reporting easier, or to try and show a more favourable picture of results.												
06.	(a)	A change of depreciation method is treated as a change of accounting estimate. Adoption of the revaluation method is dealt with under IAS 16. Application of a new accounting policy (such as capitalisation of borrowing costs) for transactions that did not previously occur is not a change in accounting policy according to IAS 8.												
07.	(b)	This is a change in presentation which will affect calculation of gross profit and will be retrospectively adjusted when presenting comparatives. (a) and (d) are simply adjustments made during preparation of the financial statements, (c) is a change of accounting estimate.												
08.	(a)	This is a change in presentation so qualifies as a change in accounting policy.												
09.	(d)	This is a change of accounting estimate so does not need to be retrospectively applied.												
10.	(b)	In this situation, change is applied to the earliest period possible.												
11.	(b) & (c)	This is change in measurement basis, so it is a change in accounting policy. This is a change in presentation, so it is a change of accounting policy.												
12.	(a)	Correction of error in previous period is called retrospective restatement.												
13.	(b)	Accounting policies are the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements.												
14.	(a)	Change in assessment is change in estimate.												
15.	(b)	Retrospective application is applying a policy as if it had always been applied.												
16.	(d)	<table><tr><td></td><td>Rs. m</td></tr><tr><td>Original cost 1 October 2010</td><td>20</td></tr><tr><td>Two years depreciation ((20/5) × 2)</td><td>(8)</td></tr><tr><td>Carrying amount at 1 October 2012</td><td>12</td></tr><tr><td>Depreciation to 30 September 2013 (12 / 6)</td><td>(2)</td></tr><tr><td>Carrying amount at 30 September 2013</td><td>10</td></tr></table>		Rs. m	Original cost 1 October 2010	20	Two years depreciation ((20/5) × 2)	(8)	Carrying amount at 1 October 2012	12	Depreciation to 30 September 2013 (12 / 6)	(2)	Carrying amount at 30 September 2013	10
	Rs. m													
Original cost 1 October 2010	20													
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Depreciation to 30 September 2013 (12 / 6)	(2)													
Carrying amount at 30 September 2013	10													

17.	(b)	<table><tr><th>Per year depreciation</th><th>Rs.</th></tr><tr><td>Year 2011 (Rs. 1,120,000 – 120,000) / 10 years</td><td>100,000</td></tr><tr><td>Year 2012</td><td>100,000</td></tr><tr><td></td><td></td></tr><tr><td>Year 2013 ((Rs. 920,000 – 170,000) / 6 years</td><td>125,000</td></tr></table>	Per year depreciation	Rs.	Year 2011 (Rs. 1,120,000 – 120,000) / 10 years	100,000	Year 2012	100,000			Year 2013 ((Rs. 920,000 – 170,000) / 6 years	125,000														
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Year 2013 ((Rs. 920,000 – 170,000) / 6 years	125,000																									
18.	(b)	Adjustment in opening balance of retained earnings Rs. 4m + 4m + 3m = Rs. 11																								
19.	(a)	Effect on profit for the year ended 31 December 2018 Rs. 5m																								
20.	(d)	<table><tr><th></th><th><i>FIFO</i></th><th><i>AVCO</i></th><th><i>Profit</i></th></tr><tr><th></th><th>Rs. m</th><th>Rs. m</th><th>Rs. m</th></tr><tr><td>Year to 30 September 2012</td><td>15</td><td>13.4</td><td>(1.6)</td></tr><tr><td>B/f 1 October 2012</td><td></td><td></td><td>1.6</td></tr><tr><td>Year to 30 September 2013</td><td>20</td><td>18</td><td>(2.0)</td></tr><tr><td>At 30 September 2013</td><td></td><td></td><td>(0.4)</td></tr></table> The net effect at 30 September 2013 of this will be to reduce current year profits by Rs. 400,000.		<i>FIFO</i>	<i>AVCO</i>	<i>Profit</i>		Rs. m	Rs. m	Rs. m	Year to 30 September 2012	15	13.4	(1.6)	B/f 1 October 2012			1.6	Year to 30 September 2013	20	18	(2.0)	At 30 September 2013			(0.4)
	<i>FIFO</i>	<i>AVCO</i>	<i>Profit</i>																							
	Rs. m	Rs. m	Rs. m																							
Year to 30 September 2012	15	13.4	(1.6)																							
B/f 1 October 2012			1.6																							
Year to 30 September 2013	20	18	(2.0)																							
At 30 September 2013			(0.4)																							
21.	(b)	Initial adoption of revaluation model for property, plant and equipment.																								
22.	(c)	Both are change in accounting policy																								
23.	(b) & (c)	Option a) is change in accounting estimate and option d) is application of new accounting policy rather than change in accounting policy.																								
24.	(b)	apply the change to the earliest period that is practically possible																								
25.	(d)	Internal financial reporting guidelines developed by the entity																								

STICKY NOTES



IAS 1 PRESENTATION OF FINANCIAL STATEMENTS

IN THIS CHAPTER:

AT A GLANCE

SPOTLIGHT

1. Introduction
2. General features
3. Statement of financial position
4. Statement of comprehensive income
5. Statement of changes in equity
6. Notes to the financial statements
7. Comprehensive Examples
8. Objective Based Q&A

STICKY NOTES

AT A GLANCE

IAS 1 provides guidance on overall requirements for financial statements, including:

- General features of financial statements such as fair presentation, compliance with IFRS, going concern, accrual basis of accounting, materiality and aggregation, offsetting, frequency of reporting, comparative information and consistency of presentation;
- Structure of financial statements;
- Minimum requirements for their content; and
- the current/non-current distinction.

According to IAS 1, a complete set of financial statements comprises:

- a statement of financial position as at the end of the period;
- a statement of profit or loss and other comprehensive income for the period;
- a statement of changes in equity for the period;
- a statement of cash flows for the period;
- notes, comprising significant accounting policies and other explanatory information.

The standard lists the minimum content to be presented in each of the above-mentioned financial statements and the content that is either presented in the statement or in the notes, except for the statement of cash flows (IAS 7 applies).

IAS 1 requires that the notes shall contain a statement of compliance with IFRSs, summary of significant accounting policies, disaggregation for the amounts presented in the financial statements and other disclosures.

1 INTRODUCTION

1.1 Key definitions [IAS 1: 7]

“General purpose financial statements” (referred to as ‘financial statements’) are those intended to meet the needs of users who are not in a position to require an entity to prepare reports tailored to their particular information needs.

“International Financial Reporting Standards (IFRSs)” are Standards and Interpretations issued by the International Accounting Standards Board (IASB). They comprise:

- a) International Financial Reporting Standards;
- b) International Accounting Standards;
- c) IFRIC Interpretations; and
- d) SIC Interpretations.

Information is **“material”** if omitting, misstating or obscuring it could reasonably be expected to influence decisions that the primary users of general purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity.

1.2 Purpose of financial statements [IAS 1: 9]

Financial statements are a structured representation of the financial position and financial performance of an entity.

The objective of financial statements is to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions. Financial statements also show the results of the management’s stewardship of the resources entrusted to it. To meet this objective, financial statements provide information about an entity’s:

- a) assets;
- b) liabilities;
- c) equity;
- d) income and expenses, including gains and losses;
- e) contributions by and distributions to owners in their capacity as owners; and
- f) cash flows.

This information, along with other information in the notes, assists users of financial statements in predicting the entity’s future cash flows and, in particular, their timing and certainty.

1.3 Complete set of financial statements [IAS 1: 10 & 11]

A complete set of financial statements comprises:

- a) a statement of financial position as at the end of the period;
- b) a statement of profit or loss and other comprehensive income for the period;
- c) a statement of changes in equity for the period;
- d) a statement of cash flows for the period;
- e) notes, comprising significant accounting policies and other explanatory information;

An entity may use titles for the statements other than those used in IAS 1. For example, an entity may use the title ‘statement of comprehensive income’ instead of ‘statement of profit or loss and other comprehensive income’.

An entity shall present with equal prominence all of the financial statements in a complete set of financial statements.

1.4 Comparative information [IAS 1: 10, 38, 38A & 40A]

Comparative information in respect of the preceding period is also required. An entity shall include comparative information for narrative and descriptive information if it is relevant to understanding the current period's financial statements.

An entity shall present, as a minimum, two statements of financial position, two statements of profit or loss and other comprehensive income, two separate statements of profit or loss (if presented), two statements of cash flows and two statements of changes in equity, and related notes.

An additional (third) statement of financial position as at the beginning of the preceding period is also required when an entity:

- a) applies an accounting policy retrospectively (IAS 8); or
- b) makes a retrospective restatement of items in its financial statements (IAS 8); or
- c) reclassifies items in its financial statements (IAS 1).

1.5 Identification of the financial statements [IAS 1: 49 to 51]

An entity shall clearly identify the financial statements and distinguish them from other information in the same published document.

IFRSs apply only to financial statements, and not necessarily to other information presented in an annual report, a regulatory filing, or another document. Therefore, it is important that users can distinguish information that is prepared using IFRSs from other information that may be useful to users but is not the subject of those requirements.

An entity shall clearly identify each financial statement and the notes. In addition, an entity shall display the following information prominently, and repeat it when necessary for the information presented to be understandable:

- a) the name of the reporting entity or other means of identification, and any change in that information from the end of the preceding reporting period;
- b) whether the financial statements are of an individual entity or a group of entities;
- c) the date of the end of the reporting period or the period covered by the set of financial statements or notes;
- d) the presentation currency, as defined in IAS 21; and
- e) the level of rounding used in presenting amounts in the financial statements.

2 GENERAL FEATURES

2.1 Fair presentation [IAS 1: 15 & 18]

Financial statements must present fairly the financial position, financial performance and cash flows of an entity. Fair presentation requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the Conceptual Framework.

The application of IFRSs, with additional disclosure when necessary, is presumed to result in financial statements that achieve a fair presentation.

An entity cannot rectify inappropriate accounting policies either by disclosure of the accounting policies used or by notes or explanatory material.

2.2 Compliance with IFRSs [IAS 1: 16]

An entity whose financial statements comply with IFRSs shall make an explicit and unreserved statement of such compliance in the notes. An entity shall not describe financial statements as complying with IFRSs unless they comply with all the requirements of IFRSs.

2.3 Departure from IFRSs [IAS 1: 19, 20 & 23]

In the extremely rare circumstances, management might conclude that compliance with a requirement in an IFRS would be so misleading that it would conflict with the objective of financial statements set out in the Conceptual Framework.

The entity shall depart from that requirement if the relevant regulatory framework requires, or otherwise does not prohibit, such a departure and the entity shall disclose:

- that management has concluded that the financial statements present fairly the entity's financial position, financial performance and cash flows;
- that it has complied with applicable IFRSs, except that it has departed from a particular requirement to achieve a fair presentation;
- the title of the IFRS from which the entity has departed, the nature of the departure, including the treatment that the IFRS would require, the reason why that treatment would be so misleading in the circumstances that it would conflict with the objective of financial statements set out in the Conceptual Framework, and the treatment adopted; and
- for each period presented, the financial effect of the departure on each item in the financial statements that would have been reported in complying with the requirement.

If the relevant regulatory framework prohibits departure from the requirement, the entity shall, to the maximum extent possible, reduce the perceived misleading aspects of compliance by disclosing:

- the title of the IFRS in question, the nature of the requirement, and the reason why management has concluded that complying with that requirement is so misleading in the circumstances that it conflicts with the objective of financial statements set out in the Conceptual Framework; and
- for each period presented, the adjustments to each item in the financial statements that management has concluded would be necessary to achieve a fair presentation.

2.4 Going concern [IAS 1: 25 & 26]

When preparing financial statements, management shall make an assessment of an entity's ability to continue as a going concern. An entity shall prepare financial statements on a going concern basis unless management either:

- intends to liquidate the entity or to cease trading; or
- has no realistic alternative but to do so.

In assessing whether the going concern assumption is appropriate, management takes into account all available information about the future, which is at least, but is not limited to, twelve months from the end of the reporting period.

Management's assessment	Impact
Entity is going concern	Prepare the financial statements on going concern basis.
Entity is going concern but there is significant doubt upon the entity's ability to continue as a going concern.	Prepare the financial statements on going concern basis. Disclose the uncertainties causing such significant doubt.
Entity is not a going concern.	Prepare the financial statements on alternative basis (e.g. liquidation accounting). Disclose: The fact that entity is not a going concern. The basis on which financial statements have been prepared. The reason why the entity is not regarded as going concern.

2.5 Other issues [IAS 1: 27, 29, 30 & 32]

Accrual basis	An entity shall prepare its financial statements, except for cash flow information, using the accrual basis of accounting.
Separate presentation due to materiality	An entity shall present separately each material class of similar items. An entity shall present separately items of a dissimilar nature or function unless they are immaterial.
Aggregation	If a line item is not individually material, it is aggregated with other items either in those statements or in the notes. An item that is not sufficiently material to warrant separate presentation in those statements may warrant separate presentation in the notes.
Offsetting	An entity shall not offset assets and liabilities or income and expenses, unless required or permitted by an IFRS.

The following table summarises examples on offsetting:

Offsetting of:	IFRSs	Example
Income and expenses	Required	IFRS 15 requires revenue (income) to be reflected net of the discount or rebate (expense).
	Permitted	Gain or loss on disposal of non-current assets may be presented on net basis reflecting the substance of transaction.
	Not permitted	Revenue from sale of inventory and related cost of sales must be presented separately.
Assets and liabilities	Permitted	Grant related to assets may be presented either separately or may be deducted from carrying amount of the related asset.
	Not permitted	Income tax payable to FBR and sales tax refundable from FBR cannot be offset as tax legislation does not allow payment of these on net basis and presentation on net basis would not reflect the substance of the transactions.

2.6 Frequency of reporting [IAS 1: 36 & 37]

An entity shall present a complete set of financial statements (including comparative information) at least annually. When an entity changes the end of its reporting period and presents financial statements for a period longer or shorter than one year, an entity shall disclose, in addition to the period covered by the financial statements:

- a) the reason for using a longer or shorter period, and
- b) the fact that amounts presented in the financial statements are not entirely comparable.

Normally, an entity consistently prepares financial statements for a one-year period. However, for practical reasons, some entities prefer to report, for example, for a 52-week period and such practice is not prohibited under IAS 1.

3 STATEMENT OF FINANCIAL POSITION

3.1 Presented in the statement [IAS 1: 54 & 55]

The statement of financial position shall include line items that present the following amounts:

- a) property, plant and equipment (IAS 16);
- b) investment property (IAS 40);
- c) intangible assets (IAS 38);
- d) financial assets excluding amounts shown under (e), (h) and (i) (IFRS 9);
- e) investments accounted for using the equity method (IAS 28);
- f) biological assets (IAS 41);
- g) inventories (IAS 2);
- h) trade and other receivables (IFRS 15/IFRS 9);
- i) cash and cash equivalents (IFRS 9);
- j) trade and other payables (IFRS 15/IFRS 9);
- k) provisions (IAS 37);
- l) financial liabilities excluding amounts shown under (j) and (k) (IFRS 9);
- m) liabilities and assets for current tax (IAS 12);
- n) deferred tax liabilities and deferred tax assets (IAS 12);
- o) issued capital and reserves attributable to owners.

Note: Some of above items will be covered at a later stage of your studies.

An entity shall present additional line items (including by disaggregating the line items listed above), headings and subtotals in the statement of financial position when such presentation is relevant to an understanding of the entity's financial position.

3.2 Presented either in the statement or in the notes [IAS 1: 77 & 78]

An entity shall disclose, either in the statement of financial position or in the notes, further subclassifications of the line items presented, classified in a manner appropriate to the entity's operations.

The detail provided in subclassifications depends on the requirements of IFRSs and on the size, nature and function of the amounts involved. The disclosures vary for each item, for example:

- a) items of property, plant and equipment are disaggregated into classes in accordance with IAS 16;
- b) receivables are disaggregated into amounts receivable from trade customers, receivables from related parties, prepayments and other amounts;
- c) inventories are disaggregated, in accordance with IAS 2 Inventories, into classifications such as merchandise, production supplies, materials, work in progress and finished goods;
- d) provisions are disaggregated into provisions for employee benefits and other items; and
- e) equity capital and reserves are disaggregated into various classes, such as paid-in capital, share premium and reserves.

3.3 Current/non-current distinction [IAS 1: 60 & 61]

An entity shall present current and non-current assets, and current and non-current liabilities, as separate classifications in its statement of financial position except when a presentation based on liquidity provides information that is reliable and more relevant. When that exception applies, an entity shall present all assets and liabilities in order of liquidity.

Whichever method of presentation is adopted, an entity shall disclose the amount expected to be recovered or settled after more than twelve months for each asset and liability line item that combines amounts expected to be recovered or settled:

- a) no more than twelve months after the reporting period, and
- b) more than twelve months after the reporting period.

3.3.1 Assets [IAS 1: 56 & 66]

An entity shall classify an asset as current when:

- a) it expects to realise the asset, or intends to sell or consume it, in its normal operating cycle;
- b) it holds the asset primarily for the purpose of trading;
- c) it expects to realise the asset within twelve months after the reporting period; or
- d) the asset is cash or a cash equivalent (as defined in IAS 7) unless the asset is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting period.

An entity shall classify all other assets as non-current.

► Example 01:

X Limited uses small amounts of platinum in its production process. It has the following two assets at its financial year ended 31 December 20X4.

Inventory: this is slow-moving and is expected to be sold during 20X6;

Fixed deposit: this matures on 30 June 20X6.

Required:

Explain whether these assets are current or non-current at year-end.

► ANSWER:

Both assets are expected to be realised in 20X6 which is well after the 12 months period from reporting date of 31 December 20X4:

- a) However, the inventory would be classified as current because inventory forms part of the operating cycle and thus it meets one of the criteria to be classified as current.
- b) The fixed deposit is cash but since it only matures in 20X6, it is restricted from being used within the 12 month after the reporting date. It is not expected to be realised within 12 months of reporting date, it is not held mainly for the purpose of being traded and it is not held within the normal operating cycle. Thus the fixed deposit fails to meet any of the four criteria to be classified as current and must thus be classified as non-current.

An entity shall not classify deferred tax assets (liabilities) as current assets (liabilities).

3.3.2 Liabilities [IAS 1: 69, 72 & 76]

An entity shall classify a liability as current when:

- a) it expects to settle the liability in its normal operating cycle;
- b) it holds the liability primarily for the purpose of trading;
- c) the liability is due to be settled within twelve months after the reporting period; or
- d) it does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification.

An entity shall classify all other liabilities as non-current.

► **Example 02:**

A company has a financial year end of 31 December. On 31 October Year 1, it took out a bank loan of Rs. 50 million. The loan principal is repayable as follows:

- Rs. 20 million on 31 October Year 3
- Rs. 30 million on 31 October Year 4

Required:

Briefly state the classification of above loan as current and non-current (with amounts) from 31 December Year 1 to 3.

► **ANSWER:****As at 31 December Year 1**

The full bank loan of Rs. 50 million will be a non-current liability

As at 31 December Year 2

A current liability of Rs. 20 million repayable on 31 October Year 3 and a non-current liability of Rs. 30 million repayable on 31 October Year 4.

As at 31 December Year 3

Current liability of Rs. 30 million

An entity classifies its financial liabilities as current when they are due to be settled within twelve months after the reporting period, even if:

- a) the original term was for a period longer than twelve months, and
- b) an agreement to refinance, or to reschedule payments, on a long-term basis is completed after the reporting period and before the financial statements are authorised for issue.

In respect of loans classified as current liabilities, the following events after the year-end would not affect the classification of liabilities:

- a) refinancing on a long-term basis;
- b) rectification of a breach of a long-term loan arrangement; and
- c) the granting by the lender of a period of grace to rectify a breach of a long-term loan arrangement ending at least twelve months after the reporting period.

3.4 Share capital [IAS 1: 79]

An entity shall disclose the following, either in the statement of financial position or the statement of changes in equity, or in the notes:

- a) for each class of share capital:
 - i. the number of shares authorised;
 - ii. the number of shares issued and fully paid, and issued but not fully paid;
 - iii. par value per share, or that the shares have no par value;
 - iv. a reconciliation of the number of shares outstanding at the beginning and at the end of the period;
 - v. the rights, preferences and restrictions attaching to that class including restrictions on the distribution of dividends and the repayment of capital;
 - vi. shares in the entity held by the entity or by its subsidiaries or associates; and
 - vii. shares reserved for issue under options and contracts for the sale of shares, including terms and amounts; and
- b) a description of the nature and purpose of each reserve within equity.

3.5 Format

IAS 1 does not specify a format for a statement of financial position that must be used. However, the implementation guidance includes an illustrative statement of financial position. The illustration below is based on that illustrative statement of financial position.

Statement of financial position of ABCD Entity (an individual entity)

As at 31 December 20XX	
	Rs. million
Non-current assets	
Property, plant and equipment	205
Investment property	10
Intangible assets	7
Investments / financial assets	6
	228
Current assets	
Inventories	18
Trade and other receivables	16
Other current assets	3
Cash and cash equivalents	4
	41
	269
Equity	
Share capital	50
Other components of equity	32
Retained earnings	61
	143
Non-current liabilities	
Long term borrowings / financial liabilities	30
Deferred tax liability	8
Long term provisions	27
	65
Current liabilities	
Trade and other payables	13
Short term borrowings / bank overdraft	20
Current portion of long term borrowings	10
Current tax payable	11
Short term provisions	7
	61
	269

► **Example 03:**

The following information has been extracted from the draft financial statements of Shaheen Limited (SL) for the year ended 31 December 2014:

Statement of Financial Position as at 31 December 2014

Equity and Liabilities	Rs. million	Assets	Rs. million
Share capital (Rs. 100 each)	1,200	Property, plant and equipment	1,876
Retained earnings	618	Patents	28
Trade payables	645	Trade receivables (net)	630
Accruals	395	Inventory	503
Tax payable	215	Prepayments & other receivables	23
		Cash and bank balances	13
	3,073		3,073

Additional information:

- Closing inventory includes damaged goods costing Rs. 3 million which can be sold for Rs. 2.5 million after repair and repacking at a cost of Rs. 0.4 million.
- In December 2014, SL settled an old outstanding liability of Rs. 6 million by paying Rs. 4.5 million. The payment was debited to trade payables. The said liability had been written back prior to 2014.
- Fair value and value in use of patents as at 31 December 2014 amounted to Rs. 25 million and Rs. 27 million respectively.
- Due to increasing bad debts, the management is of the view that allowance for doubtful debts need to be increased from 3% to 5% of trade receivables.

Required:

Prepare a Statement of Financial Position as at 31 December 2014 in accordance with the International Financial Reporting.

► **ANSWER:****Shaheen Limited****Statement of financial Position****As on 31 December 2014**

	Rs. m
Non-current assets	
Property, plant and equipment	1,876.00
Patents [28 - 1]	27.00
	1,903.00
Current assets	
Stock-in-trade [503 - 0.90]	502.10
Trade receivables [630 - 12.99]	617.01
Prepayments & other receivables	23.00
Cash and bank balances	13.00
	1,155.11
	3,058.11

	Rs. m
Share capital and reserves	
Share Capital	1,200.00
Retained earnings [618 – 19.39 W1]	598.61
	1,798.61
Current liabilities	
Trade and other payables [645 + 395 + 4.5]	1,044.50
Current tax payable	215.00
	1,259.50
	3,058.11

W1: Impacts of Adjustments on profit / retained earnings	Rs. m
Write down to NRV [3 - (2.5 - 0.4)]	(0.90)
Payment of written back liability	(4.50)
Impairment of patents [28 - 27]	(1.00)
Increase in doubtful debts [630 / 97% x 2%]	(12.99)
	(19.39)

4 STATEMENT OF COMPREHENSIVE INCOME

4.1 Definitions [IAS 1: 7]

“Profit or loss” is the total of income less expenses, excluding the components of other comprehensive income.

“Other comprehensive income” comprises items of income and expense (including reclassification adjustments) that are not recognised in profit or loss as required or permitted by other IFRSs.

“Total comprehensive income” is the change in equity during a period resulting from transactions and other events, other than those changes resulting from transactions with owners in their capacity as owners.

4.2 Single statement versus two statements [IAS 1: 10A, 88 & 91]

An entity may present a single statement of profit or loss and other comprehensive income, with profit or loss and other comprehensive income presented in two sections. The sections shall be presented together, with the profit or loss section presented first followed directly by the other comprehensive income section.

An entity may present the profit or loss section in a separate statement of profit or loss. If so, the separate statement of profit or loss shall immediately precede the statement presenting comprehensive income, which shall begin with profit or loss.

An entity shall recognise all items of income and expense in a period in profit or loss unless an IFRS requires or permits otherwise.

4.3 Presentation in the statement [IAS 1: 81A]

The statement of profit or loss and other comprehensive income (statement of comprehensive income) shall present, in addition to the profit or loss and other comprehensive income sections:

- profit or loss;
- total other comprehensive income;
- comprehensive income for the period, being the total of profit or loss and other comprehensive income.

If an entity presents a separate statement of profit or loss it does not present the profit or loss section in the statement presenting comprehensive income.

4.4 Presentation either in the statement or in the notes [IAS 1: 82 & 85]

In addition to items required by other IFRSs, the profit or loss section or the statement of profit or loss shall include line items that present the following amounts for the period:

- revenue, presenting separately interest revenue and other revenue;
- finance costs;
- tax expense;

An entity shall present additional line items (including by disaggregating the line items listed above), headings and subtotals in the statement(s) presenting profit or loss and other comprehensive income when such presentation is relevant to an understanding of the entity's financial performance.

4.5 Analysis of expenses [IAS 1: 99 to 104]

Expenses should be analysed. Either of two methods of analysis may be used:

- according to the function of the expense; or
- according to the nature of expenses.

IAS 1 states that entities should choose the method that provides the more relevant or reliable information.

IAS 1 encourages entities to show this analysis of expenses on the face of the statement of comprehensive income rather than in a note to the accounts.

4.5.1 Analysis of expenses by their function

When expenses are analysed according to their function, the functions are commonly 'cost of sales', 'distribution costs', 'administrative expenses' and 'other expenses'. This method of analysis is also called the 'cost of sales method'.

Statement of comprehensive income – Expenses analysed by function	Rs. m
Revenue	7,200
Cost of sales	(2,700)
Gross profit	4,500
Other income	300
Distribution costs	(2,100)
Administrative expenses	(1,400)
Other expenses	(390)
Profit before tax	910

IAS 1 also requires that if the analysis by function method is used, additional information about expenses must be disclosed including:

- depreciation and amortisation expense; and
- employee benefits expense (staff costs).

4.5.2 Analysis of expenses by their nature

When expenses are analysed according to their nature, the categories of expenses will vary according to the nature of the business.

In a manufacturing business, expenses would probably be classified as:

- raw materials and consumables used;
- staff costs ('employee benefits costs');
- depreciation.

Items of expense that on their own are immaterial are presented as 'other expenses'.

There will also be an adjustment for the increase or decrease in inventories of finished goods and work-in-progress during the period.

Other entities (non-manufacturing entities) may present other expenses that are material to their business.

Statement of comprehensive income – Expenses analysed by nature	Rs. m
Revenue	7,200
Other income	300
	7,500
Changes in inventories of finished goods and work-in-progress (reduction = expense, increase = negative expense)	90
Raw materials and consumables used	1,200
Staff costs (employee benefits expense)	2,000
Depreciation and amortisation expense	1,000
Other expenses	2,300
	6,590
Profit before tax	910

4.6 Material items [IAS 1: 97 & 98]

When items of income or expense are material, an entity shall disclose their nature and amount separately.

Circumstances that would give rise to the separate disclosure of items of income and expense include:

- write-downs of inventories to net realisable value or of property, plant and equipment to recoverable amount, as well as reversals of such write-downs;
- restructurings of the activities of an entity and reversals of any provisions for the costs of restructuring;
- disposals of items of property, plant and equipment;
- disposals of investments;
- discontinued operations;
- litigation settlements; and
- other reversals of provisions.

4.7 Format

IAS 1 does not specify an exact format for the statement of comprehensive income but the example below is based on a suggested presentation included in the implementation guidance. (In this example, expenses are classified by function).

XYZ Entity: Statement of comprehensive income (single statement)

For the year ended 31 December 20XX	Rs. million
Revenue	678
Cost of sales	(250)
Gross profit	428
Other income	12
Distribution costs	(66)
Administrative expenses	(61)
Other expenses	(18)
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

► *Example 04:*

The trial balance of Larry Limited as at 31 December 2015 is as follows:

	Rupees in million	
	Dr	Cr
Administration charges	342	
Bank account	89	
Cash	2	
Payables' ledger		86
Accumulated amortisation on patents at 31 December 2015		5
Accumulated depreciation at 31 December 2015		918
Receivables' ledger	189	
Distribution expenses	175	
Property, plant and equipment at cost	2,830	
Interest received		20
Issued share capital		400
Loan		18
Patents at cost	26	
Accumulated profits		1,562
Purchases	2,542	
Sales		3,304
Inventories at 31 December 2014	118	
	<u>6,313</u>	<u>6,313</u>

The following information is also relevant.

- Inventories on 31 December 2015 amounted to Rs. 127 million.
- Current tax of Rs. 75 million is to be accrued.
- The loan is repayable by equal annual instalments over three years.

Required:

Prepare a statement of profit or loss (analysing expenses by function) for the year ended 31 December 2015 and a statement of financial position as at that date.

► ANSWER:

Larry Limited**Statement of profit or loss for the year ended 31 December 2015**

	Rs. in million
Revenue	3,304
Cost of sales (2,542 + 118 – 127 closing inventory)	(2,533)
Gross profit	771
Other income	20
Distribution costs	(175)
Administrative expenses	(342)
Profit before tax	274
Income tax expense	(75)
Profit for the period	199

Larry Limited**Statement of financial position****As at 31 December 2015**

Assets	Rs. in million
Non-current assets	
Property, plant and equipment (2,830 – 918)	1,912
Intangible assets (26 – 5)	21
	1,933
Current assets	
Inventories	127
Trade and other receivables	189
Cash (89 + 2)	91
	407
Total assets	2,340
Equity and liabilities	
Equity	
Share capital	400
Retained earnings (1,562 + 199)	1,761
	2,161
Non-current liabilities	
Long-term borrowings (18 – 6 current portion)	12
Current liabilities	
Trade and other payables	86
Current portion of long-term borrowing (18 / 3 years)	6
Current tax payable	75
	167
Total equity and liabilities	2,340

► *Example 05:*

Barry Limited has prepared the following draft financial statements for your review:

Statement of profit or loss for year to 31st August 2015

	Rs. 000
Sales revenue	30,000
Raw materials consumed	(9,500)
Manufacturing overheads	(5,000)
Increase in inventories of work in progress and finished goods	1,400
Staff costs	(4,700)
Distribution costs	(900)
Depreciation	(4,250)
Interest expense	(350)
	6,700

Statement of financial position as at 31st August 2015

	Rs. 000
Assets	
Non-current	
Freehold land and buildings	20,000
Plant and machinery	14,000
Fixtures and fittings	5,600
	39,600
Current assets	
Prepayments	200
Trade receivables	7,400
Cash at bank	700
Inventories	4,600
	12,900
Total assets	52,500

	Rs. 000
Equity and liabilities	
Equity shares of Rs. 1 each	21,000
Share premium	2,000
Revaluation surplus	5,000
Accumulated profit	14,000
	42,000
Current liabilities	5,300
Non-current liabilities	
8% Debentures 2019	5,200
Total equity and liabilities	52,500

Additional information

- i. There have been no additions to, or disposals of, non-current assets in the year but the assets under construction have been completed in the year at an additional cost of Rs. 50,000. These related to plant and machinery.

The cost and accumulated depreciation of non-current assets as at 1st September 2014 were as follows:

	Cost	Depreciation
	Rs. in '000	Rs. in '000
Freehold land and buildings	19,000	3,000
(land element Rs. 10 million)		
Plant and machinery	20,100	4,000
Fixtures and fittings	10,000	3,700
Assets under construction	400	-

- ii. There was a revaluation of land and buildings during the year, creating the revaluation surplus of Rs. 5 million (land element Rs. 1 million). The effect on depreciation for the buildings have increased by Rs. 300,000. Barry Limited adopts a policy of transferring the revaluation surplus included in equity to retained earnings as it is realised.
- iii. Staff costs comprise 70% factory staff, 20% general office staff and 10% goods delivery staff
- iv. An analysis of depreciation charge shows the following:

	Rs. in '000
Buildings (50% production, 50% administration)	1,000
Plant and machinery	2,550
Fixtures and fittings (30% production, 70% administration)	700

Required:

Prepare the following information in a form suitable for publication for Barry Limited's financial statements for the year ended 31st August 2015:

- Statement of comprehensive income
- Statement of financial position

► ANSWER:

Barry Limited**Statement of comprehensive income****For the year ended 31st August 2015**

	Rs. in '000
Revenue	30,000
Cost of sales (W1)	(19,650)
Gross profit	10,350
Distribution costs (W1)	(1,370)
Administrative expenses (W1)	(1,930)
Profit from operations	7,050
Finance costs	(350)
Profit before tax	6,700
Tax	-
Profit after tax	6,700
Other comprehensive income	
Gain on revaluation	5,000
Total comprehensive income	11,700

Barry Limited**Statement of financial position****As at 31st August 2015**

ASSETS	Rs. in 000
Non-current assets	
Property, plant and equipment (W2)	39,600
Current assets	
Inventory	4,600
Trade and other receivables (7,400 + 200)	7,600
Cash and cash equivalents	700
	12,900
Total assets	52,500
EQUITY AND LIABILITIES	
Capital and reserves	
Equity shares	21,000
Share premium	2,000
Retained earnings 14,000 + 300	14,300
Revaluation surplus 5,000 – 300	4,700
	42,000
Non-current liabilities	
Borrowings	5,200
	5,200
Current liabilities	
Trade and other payables	5,300
	5,300
	52,500

W1: Allocation of expenses	Cost of sales	Admin	Distribution
	Rs. 000		
Raw materials consumed	9,500		
Manufacturing overheads	5,000		
Increase in inventories	(1,400)		
Staff costs (70%/20%/10%)	3,290	940	470
Distribution costs			900
Depreciation			
Building (50%/50%)	500	500	
Plant and machinery	2,550		
Fixtures and fittings (30%/70%)	210	490	
	19,650	1,930	1,370

W2: Property, plant and equipment including CWIP

	Land	Buildings	Plant & machinery	Fixtures & fittings	CWIP	Total
Cost/ Valuation	Rs. 000					
At 1 Sept 2014	10,000	9,000	20,100	10,000	400	49,500
Additions	-	-	-	-	50	50
Transfer from CWIP	-	-	450	-	(450)	-
Revaluation-cancel	-	(3,000)	-	-	-	(3,000)
Revaluation (gain)	1,000	4,000				5,000
At 31 Aug 2015 (A)	11,000	10,000	20,550	10,000	-	51,550
Depreciation						
At 1 Sept 2014	-	3,000	4,000	3,700	-	10,700
Revaluation	-	(3,000)	-	-	-	(3,000)
Charge for year	-	1,000	2,550	700	-	4,250
At 31 Aug 2015 (B)	-	1,000	6,550	4,400	-	11,950
Net book value						
At 31 Aug 2015 (A-B)	11,000	9,000	14,000	5,600	-	39,600

► *Example 06:*

The following trial balance has been extracted from the books of accounts of Oscar Limited as at 31 March 2015.

	Rs. in '000	
	Dr	Cr
Administrative expenses	210	
Share capital		600
Receivables	470	
Bank overdraft		80
Loan		180
Distribution costs	420	
Non-current investments	560	
Investment income		100
Plant and machinery		
At cost	750	
Accumulated depreciation (at 31 March 2015)		220
Retained earnings (at 1 April 2014)		180
Purchases	960	
Inventory (at 1 April 2014)	140	
Trade payables		260
Sales revenue		2,010
Interim dividend paid	120	
	3,630	3,630

Additional information

- Inventory at 31 March 2015 was valued at Rs. 150,000.
- The income tax charge based on the profits on ordinary activities is estimated to be Rs. 74,000.
- The loan is of short term nature and interest of Rs. 16,000 needs to be accrued which shall be paid along with repayment of loan.
- There were no purchases or disposals of fixed assets during the year.

Required:

Prepare Oscar Limited's statement of profit or loss for the year to 31 March 2015 and a statement of financial position as at that date in accordance with IAS 1.

► ANSWER:

Oscar Limited**Statement of profit or loss for the year ended 31 March 2015**

	Rs. in '000
Sales	2,010
Cost of sales (140 + 960 – 150)	(950)
Gross profit	1,060
Distribution costs	(420)
Administrative expenses	(210)
Operating profit	430
Finance cost	(16)
Investment income	100
Profit before tax	514
Income tax	(74)
Profit after tax	440

Oscar Limited**Statement of financial position as at 31 March 2015**

Assets	
Non-current assets	
Property, plant and equipment 750 – 220	530
Investments	560
	1,090
Current assets	
Inventory	150
Receivables	470
	620
	1,710
Equity and liabilities	
Share capital	600
Retained earnings 180 + 440 profit – 120 dividend	500
	1,100
Current liabilities	
Trade payables	260
Current tax payable	74
Bank overdraft	80
Short term loan 180 + 16	196
	610
	1,710

► *Example 07:*

The following trial balance relates to Clifton Pharma Limited, a public listed company, at 30 September 2015.

	Rs. in '000	
	Dr	Cr
Cost of sales	134,000	
Operating expenses	42,000	
Loan interest paid	1,500	
Revenue		338,300
Investment income		2,000
Leasehold property at cost	250,000	
Plant and equipment at cost	197,000	
Accumulated depreciation at 1 October 2014:		
- leasehold property		40,000
- plant and equipment		47,000
Investments	94,000	
Share capital		280,000
Share premium		20,000
Retained earnings at 1 October 2014		19,300
6% Loan notes (issued on 1 Oct 2014)		50,000
Inventory at 30 September 2015	23,700	
Trade receivables	76,400	
Trade payables		34,100
Bank	12,100	
	830,700	830,700

The following notes are relevant

- Other plant and equipment is depreciated at 20% per year by the reducing balance method. The leasehold property has a 25-year life and is amortised at a straight-line rate. All depreciation of property, plant and equipment should be charged to cost of sales.
- The accrual for income tax for the year ended 30 September 2015 has been estimated at Rs. 18 million.

Required:

Prepare a statement of profit or loss for Clifton Pharma Limited for the year to 30 September 2015 and a statement of financial position (balance sheet) for Clifton Pharma Limited as at 30 September 2015.

► ANSWER:

CLIFTON PHARMA LIMITED**Statement of profit or loss****For the year ended 30 September 2015**

	Rs. 000
Sales	338,300
Cost of sales W1	(174,000)
Gross profit	164,300
Other income (investment income)	2,000
Operating expenses	(42,000)
Finance cost 50,000 x 6%	(3,000)
Profit before tax	121,300
Taxation	(18,000)
Profit after tax	103,300

CLIFTON PHARMA LIMITED**Statement of Financial Position****As at 30 September 2015**

Assets	Rs. 000
<i>Non-current assets</i>	
PPE [250,000 – 40,000 – 10,000 W1] + (197,000 – 47,000 – 30,000 W1)	320,000
Investments	94,000
	414,000
<i>Current assets</i>	
Inventory	23,700
Receivables	76,400
Bank	12,100
	112,200
	526,200
<i>Equity & Liabilities</i>	
<i>Capital & Reserves</i>	
Share Capital	280,000
Share premium	20,000
Retained Earnings (19,300 + 103,300)	122,600
	422,600
<i>Non-Current liabilities</i>	
6% loan notes	50,000
	50,000
<i>Current liabilities</i>	
Trade payables	34,100
Interest payable 50,000 x 6% = 3,000 – 1,500	1,500
Income tax payable	18,000
	53,600
	526,200

W1: Cost of sales	Rs. 000
As given in the trial balance	134,000
Depreciation of plant and equipment: $20\% \times (197,000 - 47,000)$	30,000
Amortisation of leasehold property: $250,000/25$ years	10,000
	174,000

► **Example 08:**

The following trial balance relates to Sarhad Sugar Limited at 30 September 2015:

	Dr	Cr
	Rs. 000	
Leasehold property – at valuation 1 Oct 2014 (note (i))	50,000	
Plant and equipment – at cost (note (i))	76,600	
Plant and equipment – accumulated depreciation at 1 Oct 2014		24,600
Capitalised development expenditure – at 1 Oct 2014 (note (ii))	20,000	
Development – accumulated amortisation at 1 Oct 2014		6,000
Closing inventory at 30 September 2015	20,000	
Trade receivables	43,100	
Bank		1,300
Trade payables		29,300
Revenue (note (i))		300,000
Cost of sales	204,000	
Distribution costs	14,500	
Administrative expenses	21,900	
Interest on bank borrowings	1,000	
Equity dividend paid	6,000	
Research and development costs (note (ii))	8,600	
Share capital		70,000
Retained earnings at 1 October 2014		24,500
Revaluation surplus (Leasehold property)		10,000
	465,700	465,700

The following notes are relevant:

i. Non-current assets – tangible:

The leasehold property had a remaining life of 20 years at 1 October 2014. The company's policy is to revalue its property at each year end and at 30 September 2015 it was valued at Rs. 43 million.

On 1 October 2014 an item of plant was disposed of for Rs. 2.5 million cash. The proceeds have been treated as sales revenue by Sarhad Sugar Limited. The plant is still included in the above trial balance figures at its cost of Rs. 8 million and accumulated depreciation of Rs. 4 million (to the date of disposal).

All plant is depreciated at 20% per annum using the reducing balance method.

Depreciation and amortisation (and any losses) of all non-current assets is charged to cost of sales.

ii. Non-current assets – intangible:

In addition to the capitalised development expenditure (of Rs. 20 million), further research and development costs were incurred on a new project which commenced on 1 October 2014. The research stage of the new project lasted until 31 December 2014 and incurred Rs. 1.4 million of costs. From that date the project incurred development costs of Rs. 800,000 per month. On 1 April 2015 the directors became confident that the project would be successful and yield a profit well in excess of its costs. The project is still in development at 30 September 2015.

Capitalised development expenditure is amortised at 20% per annum using the straight-line method. All expensed research and development is charged to cost of sales.

iii. The directors have estimated the accrual for income tax for the year ended 30 September 2015 at Rs. 11.6 million.

Required:

Prepare the statement of profit or loss for the year ended 30 September 2015 and the statement of financial position as at 30 September 2015. (notes to the financial statements are not required).

► **ANSWER:****SARHAD SUGAR LIMITED****Statement of profit or loss****For the year ended 30 September 2015**

	Rs. 000
Sales 300,000 – 2,500 disposal correction	297,500
Cost of sales W1	(225,400)
Gross profit	72,100
Distribution cost	(14,500)
Admin expenses	(21,900)
Finance cost	(1,000)
Profit before tax	34,700
Taxation	(11,600)
Profit after tax	23,100

SARHAD SUGAR LIMITED**Statement of Financial Position****As at 30 September 2015**

Assets	Rs. 000
<i>Non-current assets</i>	
Property, plant and equipment W2	81,400
Intangible Asset W3	14,800
	96,200
<i>Current assets</i>	
Inventory	20,000
Receivables	43,100
	63,100
	159,300

	Rs. 000
Equity & Liabilities	
Capital & Reserves	
Share Capital	70,000
Revaluation reserve 10,000 – 4,500 W2	5,500
Retained Earnings (24,500 + profit 23,100 – dividend 6,000)	41,600
	117,100
Current liabilities	
Trade payables	29,300
Bank overdraft	1,300
Income tax payable	11,600
	42,200
	159,300

W1: Cost of sales	Rs. 000
Per trial balance	204,000
Depreciation leasehold property 50,000 / 20 years	2,500
Depreciation plant and equipment $[(76,600 - 8,000) - (24,600 - 4,000)] \times 20\%$	9,600
Research & Development expensed 1,400 + 800 x 3 months (Note 2)	3,800
Amortisation of development costs 20,000 x 20%	4,000
Loss on disposal of plant $(8,000 - 4,000) - 2,500$	1,500
	225,400

W2: Property plant and equipment	Rs. 000
Leasehold property	50,000
Depreciation 50,000 / 20 years	(2,500)
Revaluation loss	(4,500)
	43,000
Plant and equipment 76,600 – 24,600	52,000
Disposal 8,000 – 4,000	(4,000)
Depreciation $(52,000 - 4,000) \times 20\%$	(9,600)
	38,400
	81,400

W3: Intangible asset (development)	Rs. 000
As per trial balance 20,000 – 6,000	14,000
Amortisation during the year 20,000 x 20%	(4,000)
Further capitalisation 800 x 6 months (Note 2)	4,800
	14,800

Tutorial Note: Development costs can only be treated as an asset from the point where they meet the recognition criteria in IAS 38 Intangible assets. Thus development costs from 1 April to 30 September 2015 of Rs.4.8 million (800 x 6 months) can be capitalised. These will not be amortised as the project is still in development.

The research costs of Rs.1.4 million plus three months' development costs of Rs. 2.4 million (800 x 3 months) (i.e. those incurred before 1 April 2015) are treated as an expense.

► **Example 09:**

Following is the summarised trial balance of Moonlight Pakistan Limited (MPL), a listed company, for the year ended December 31, 2017:

	Rs. in million	
	Debit	Credit
Land and buildings - at cost	2,600	-
Plants - at cost	2,104	-
Trade receivables	702	-
Stock in trade at December 31, 2017	758	-
Cash and bank	354	-
Cost of sales	1,784	-
Selling expenses	220	-
Administrative expenses	250	-
Financial charges	210	-
Accumulated depreciation: Building (January 1, 2017)	-	400
Accumulated depreciation: Plants (January 1, 2017)	-	670
Ordinary shares of Rs. 10 each fully paid	-	1,200
Retained earnings as at January 1, 2017	-	510
12% Long term loan	-	1,600
Salaries payable	-	8
Trade payables	-	566
Right subscription received	-	420
Revenue	-	3,608
	8,982	8,982

Additional Information

- The land and buildings were acquired on January 1, 2013. The cost of land was Rs. 600 million. On January 1, 2017 a professional valuation firm valued the buildings at Rs. 1,840 million with no change in the value of land. The estimated life at acquisition was 20 years and the remaining life has not changed as a result of the valuation. 60% of depreciation on buildings is allocated to manufacturing, 25% to selling and 15% to administration. MPL does not transfer effect of incremental depreciation within the equity on annual basis.
- Plant is depreciated at 20% per annum using the reducing balance method.
- On March 31, 2017 MPL made a bonus issue of one share for every six held. The issue has not been recorded in the books of account yet. Right shares were issued on September 1, 2017 at Rs. 12 per share. The proceeds of right issue were credited to 'right subscription received account'.

- iv. The interest on long term loan is payable on the first day of July and January. No accrual has been made for the interest payable on January 1, 2015.
- v. Some of the salary sheets were omitted from calculation and now salaries payable is to be increased from Rs. 8 million to Rs. 23 million. Salaries expense is allocated to production, selling and administration expenses in the ratio of 60%: 20% : 20%.
- vi. The tax charge for the current year after making all related adjustments is estimated at Rs. 65 million.

Required:

In accordance with the IFRS, prepare the statement of Financial Position as of December 31, 2017 and statement of profit or loss for the year then ended.

► **ANSWER:****Moonlight Pakistan Limited****Statement of Financial Position****As at December 31, 2017**

Non-current assets	Rs. in million
Property, plant and equipment W2	3,472
Current assets	
Stocks in trade	758
Trade receivables	702
Cash and bank	354
	1,814
	5,286
EQUITY	
Share Capital $1,200 + 1200 \times \frac{1}{6} + 420 \times \frac{10}{12}$	1,750
Share premium $(420 \times \frac{2}{12})$	70
Retained earnings $510 - 200 \text{ bonus issue} + 566 \text{ profit}$	876
Revaluation surplus	240
	2,936
LIABILITIES	
Non-current liabilities	
Long term loan	1,600
	1,600
Current liabilities	
Trade and other payables $(566 + 8 + 96 + 15)$	685
Income tax payable	65
	750
	5,286

Moonlight Pakistan Limited

Statement of profit or loss

For the year ended December 31, 2017	Rs. million
Sales	3,608
Cost of sales W1	(2,149)
Gross profit	1,459
Selling expenses W1	(252)
Administrative expenses W1	(270)
Financial charges $(210 + 1,600 \times 12\% \times 6/12)$	(306)
Profit before taxation	631
Taxation $(37 + 80 \times 35\%)$	(65)
Profit after taxation	566

W1: Cost of sales/selling expenses/admin expenses

	Cost of sales	Selling expenses	Admin. expenses
	Rs. in million		
As per trial balance	1,784	220	250
Depreciation – building $(60\%:25\%:15\%)$ W2	69	29	17
Depreciation – plant W2	287	-	-
Additional salaries $(23-8) \times 60\%:20\%:20\%$	9	3	3
	2,149	252	270

W2: Property, plant and equipment

	Land	Building	Plant	Total
	Rs. in million			
Cost as at January 1, 2017	600	2,000	2,104	4,704
Accumulated depreciation	-	(400)	(670)	(1,070)
	600	1,600	1,434	3,634
Revaluation $(1,840 - (2,000 - 400))$	-	240	-	240
Depreciation $(1,840/16); 1,434 \times 20\%$	-	(115)	(287)	(402)
	600	1,725	1,147	3,472

5 STATEMENT OF CHANGES IN EQUITY

5.1 Presented in the statement [IAS 1: 106]

The statement of changes in equity includes the following information:

- a) total comprehensive income for the period;
- b) for each component of equity, the effects of retrospective application or retrospective restatement recognised in accordance with IAS 8; and
- c) for each component of equity, a reconciliation between the carrying amount at the beginning and the end of the period, separately (as a minimum) disclosing changes resulting from:
 - i. profit or loss;
 - ii. other comprehensive income; and
 - iii. transactions with owners in their capacity as owners, showing separately contributions by and distributions to owners.

5.2 Presented either in the statement or in the notes [IAS 1: 106A & 107]

For each component of equity an entity shall present, either in the statement of changes in equity or in the notes, an analysis of other comprehensive income by item.

An entity shall present, either in the statement of changes in equity or in the notes, the amount of dividends recognised as distributions to owners during the period, and the related amount of dividends per share.

5.3 Format

An illustrative format is given below:

PQR Entity: Statement of changes in equity

For the year ended 31 December 20X9

Share capital	Share premium	Revaluation surplus	Retained earnings	Total
	Rs. m	Rs. m	Rs. m	Rs. m
Balance at 1 Jan 20X9 (reported)	200	70	80	510
Change in accounting policy	-	-	-	(60)
Balance at 1 Jan 20X9 (restated)	200	70	80	450
Issue of share capital	80	100		180
Dividend payments			(90)	(90)
Total comprehensive income			12	155
Transfer (incremental depreciation)			(8)	8
Balance at 31 December 20X9	280	170	84	523
				1,057

► **Example 10:**

The trial balance of Mingora Imports Limited at 31 December 2015 is as follows:

	Dr	Cr
	Rupees in million	
Patent rights	60	
Work-in-progress inventory, 1 January 2015	125	
Leasehold buildings at cost	300	
Ordinary share capital		600
Sales		1,740
Staff costs	260	
Accumulated depreciation on buildings, 1 January 2015		60
Inventories of finished games, 1 January 2015	155	
Consultancy fees	44	
Directors' salaries	360	
Computers at cost	50	
Accumulated depreciation on computers, 1 January 2015		20
Dividends paid	125	
Cash	340	
Receivables	420	
Trade payables		92
Sundry expenses	294	
Accumulated profits, 1 January 2015		121
Investments	100	
	2,633	2,633

The following information is also relevant.

- Closing inventories of finished goods are valued at Rs. 180 million. Work-in-progress inventory has increased to Rs. 140 million.
- The patent rights relate to a computer program with a three year lifespan.
- On 1 January 2015 buildings were revalued to Rs. 360 million. This has not yet been reflected in the accounts. Computers are depreciated over five years. Buildings are now to be depreciated over 30 years.
- An allowance for bad debts (irrecoverable debts) of 5% is to be created.
- The computed current tax of Rs. 120 million has not yet been recognised yet.

Required:

Prepare a statement of Comprehensive Income (analysing expenses by nature) for the year ended 31 December 2015, Statement of Changes in Equity and a statement of financial position as at that date.

► ANSWER:

MINGORA IMPORTS**Statement of profit or loss for the year ended 31 December 2015**

	Rs. m
Sales	1,740
Change in inventories of WIP & FG (140 - 125) + (180 - 155)	40
Staff cost (260 + 360)	(620)
Depreciation & Amortization W1	(42)
Other expenses (44 + 294 + (420 x 5%))	(359)
Profit before tax	759
Taxation	(120)
Profit after tax	639
Other comprehensive income	
Gain on revaluation of buildings [360 - (300-60)]	120
	120
Total comprehensive income	759

MINGORA IMPORTS**Statement of changes in equity for the year ended 31 December 2015**

	Share Capital	Revaluation surplus	Retained Earnings	Total
	Rs. million			
At 31 December 2014	600		121	721
Total comprehensive income		120	639	759
Dividends paid			(125)	(125)
Transfer [120 / 30 years]		(4)	4	-
At 31 December 2015	600	116	639	1,355

MINGORA IMPORTS**Statement of Financial Position as at 31 December 2015**

Assets	Rs. m
<i>Non-current assets</i>	
PPE (300 – 60 + 120 – 12 W1) + (50 – 20 – 10 W1)	368
Intangible assets (60 – 20 W1)	40
Investments 100	100
	508
<i>Current assets</i>	
Inventory (180 + 140)	320
Trade receivables (420 – 21)	399
Cash	340
	1,059
	1,567
<i>Equity & Liabilities</i>	
Capital & Reserves	
Share Capital	600
Revaluation reserves	116
Retained Earnings	639
	1,355
<i>Current liabilities</i>	
Trade & other payables	92
Income tax payable	120
	212
	1,567

W1: Depreciation and amortisation	Rs. m
Buildings 360 / 30 years	12
Computers 50 / 5 years	10
Patents 60 / 3 years	20
	42

► *Example 11:*

The following trial balance related to Yasir Industries Limited (YIL) for the year ended June 30, 2017:

	Dr	Cr
	Rs. in million	
Ordinary share capital (Rs. 10 each)	-	120.00
Retained earnings	-	10.20
Sales	-	472.40
Purchases	175.70	-
Production labour	61.00	
Manufacturing overheads	39.00	
Inventories (July 1, 2016)	38.90	
Administrative expenses	40.00	-
Distribution expenses	19.80	-
Financial charges	0.30	-
Cash and bank	-	13.25
Trade creditors	-	30.40
Accrued expenses	-	22.20
10% redeemable preference shares	-	40.00
Debentures	-	80.00
Suspense account	30.00	-
Leasehold property - at cost	230.00	-
Machines - at cost	168.60	-
Software - at cost	20.00	-
Acc. depreciation - Leasehold property (June 30, 2017)	-	40.25
Acc. depreciation - Machines (June 30, 2017)	-	48.60
Acc. amortization - Software (June 30, 2017)	-	12.00
Trade receivables	66.00	-
	889.30	889.30

Additional Information

- On June 30, 2017 a customer returned goods sold earlier invoiced at Rs. 27 million. Neither the return nor the inventory received has been accounted for yet. The sale has been made at cost plus 20%. The value of inventories at June 30, 2017 was Rs. 42 million other than the goods returned as afore-mentioned.
- A fraud of Rs. 30 million was discovered in October 2016. A senior employee of the company, who left earlier, had embezzled the funds from YIL's bank account. The chances of recovery are remote. The amount is presently appearing in the suspense account.
- On January 1, 2017 YIL issued debenture certificates which are repayable in 2020. Interest is paid on these at 12% per annum. Financial charges comprise bank charges and bank commission.

- iv. On July 1, 2016, the leasehold property having a useful life of 40 years was revalued at Rs. 238 million. Neither revaluation nor tax adjustment in this regard has been made in the books. Depreciation of leasehold property is charged using the straight line method. 50% of depreciation is allocated to manufacturing, 30% to administration and 20% to selling and distribution.
- v. The accrual for current taxation for the year ended June 30, 2017 after making all the above adjustments is estimated at Rs. 16.5 million.

Required:

Prepare the statement of financial position as of June 30, 2017, statement of profit or loss for the year ended June 30, 2017, and statement of changes in equity for the year then ended.

► **ANSWER:****Yasir Industries Limited****Statement of Comprehensive Income****For the year ended 30 June 2017**

	Rs m
Revenue 472.40 – 27	445.4
Cost of sales W1	(250.72)
Gross profit	194.68
Selling expense (19.80 + 1.25 W3 x 20%)	(20.05)
Administrative expenses (40 + 1.25 W3 x 30%)	(40.38)
Operating profit	134.25
Loss due to fraud	(30)
Finance costs W2	(9.10)
Profit before tax	95.15
Income tax expense	(16.5)
PROFIT FOR THE YEAR	78.65
Other Comprehensive Income	
Gain on revaluation of fixed assets W4	42.5
TOTAL COMPREHENSIVE INCOME	121.15

Yasir Industries Limited**Statement of Changes in Equity****For the year ended 30 June 2017**

	Share Capital	Retained earnings	Revaluation surplus	Total
	Rs. m	Rs. m	Rs. m	Rs. m
At July 01, 2016	120	10.20	-	130.20
Total comprehensive income		78.65	42.5	121.15
Transfer		1.25	(1.25)	-
At June 30, 2017	120	90.1	41.25	251.35

Yasir Industries Limited**Statement of Financial Position****As at 30 June 2017**

EQUITY AND LIABILITIES	Rs. m
Share capital and reserves	
Share capital	120
Revaluation Surplus	41.25
Retained earnings	90.1
	251.35
Non-current liabilities	
10% redeemable preference shares	40
Debentures	80
	120
Current liabilities	
Trade and other payables (30.40+22.20)	52.6
Interest accrued W2	4.8
Preference dividend payable W2	4
Bank overdraft	13.25
Current tax payable	16.5
	91.15
Total equity and liabilities	462.5
ASSETS	
Non-current assets	
Property, plant and equipment 231 W4 + (168.6 - 48.60)	351
Intangible assets (Software) 20-12	8
	359
Current assets	
Stock-in-trade 42 + (27 x 100/120)	64.5
Trade debts 66 - 27	39
	103.5
Total assets	462.5

W1: Cost of sales	Rs. m
Opening inventory	38.9
Purchases	175.7
Less: closing inventory $42 + (27 \times 100/120)$	(64.5)
Direct labour	61
Manufacturing overheads (as given)	39
Additional depreciation due to revaluation $[1.25 \text{ W3} \times 50\%]$	0.62
	250.72

W2: Finance costs	Rs. m
As given	0.30
Interest on debentures $\text{Rs. } 80 \times 12\% \times 6/12$	4.8
Dividend on redeemable Preference shares $\text{Rs. } 40 \times 10\%$	4
	9.1

W3: Leasehold property	Rs. m
As given $[230 - 40.25]$	189.75
Add back: Annual depreciation charged on cost $[230 / 40 \text{ years}]$	5.75
	195.5
Revaluation gain (balancing)	42.5
Revalued amount as at 1 July 2016	238
Depreciation $238 / 34 \text{ years}$	(7)
Carrying amount on 30 June 2017	231
Remaining useful life $40 \text{ years} - [(Rs. 40.25 - 5.75) / 5.75]$	34 years
Additional (incremental) depreciation $7 - 5.75$	1.25

6 NOTES

6.1 Definitions & structure [IAS 1: 7, 112 & 113]

“Notes” contain information in addition to that presented in the statement of financial position, statement(s) of profit or loss and other comprehensive income, statement of changes in equity and statement of cash flows. Notes provide narrative descriptions or disaggregation of items presented in those statements and information about items that do not qualify for recognition in those statements.

The notes shall:

- a) present information about the basis of preparation of the financial statements and the specific accounting policies used;
- b) disclose the information required by IFRSs that is not presented elsewhere in the financial statements; and
- c) provide information that is not presented elsewhere in the financial statements, but is relevant to an understanding of any of them.

An entity shall, as far as practicable, present notes in a systematic manner. In determining a systematic manner, the entity shall consider the effect on the understandability and comparability of its financial statements. An entity shall cross-reference each item in the statements of financial position and in the statement(s) of profit or loss and other comprehensive income, and in the statements of changes in equity and of cash flows to any related information in the notes.

6.2 Disclosure of accounting policies [IAS 1: 117]

An entity shall disclose its significant accounting policies comprising:

- a) the measurement basis (or bases) used in preparing the financial statements; and
- b) the other accounting policies used that are relevant to an understanding of the financial statements.

6.3 Other disclosures [IAS 1: 137 & 138]

An entity shall disclose in the notes:

- a) the amount of dividends proposed or declared before the financial statements were authorised for issue but not recognised as a distribution to owners during the period, and the related amount per share; and
- b) the amount of any cumulative preference dividends not recognised.

An entity shall disclose the following, if not disclosed elsewhere in information published with the financial statements:

- a) the domicile and legal form of the entity, its country of incorporation and the address of its registered office (or principal place of business, if different from the registered office);
- b) a description of the nature of the entity’s operations and its principal activities;
- c) the name of the parent and the ultimate parent of the group; and
- d) if it is a limited life entity, information regarding the length of its life.

6.4 Regulatory framework for accounting in Pakistan

In Pakistan, companies are required to follow the requirements of Companies Act, 2017 (specifically, fourth and fifth schedule), when preparing and presenting their financial statements.

In case of conflict between requirements of law and requirements of IFRSs, the requirements of law shall prevail.

The requirements of regulatory framework for accounting in Pakistan shall be covered at a later stage of your studies.

7 COMPREHENSIVE EXAMPLES

► Example 12:

The following balances have been extracted from the trial balance as at 30 June 2014 of Zee Trading Limited (ZTL):

Description	Debit	Credit
	----- Rs. in 000 -----	
Sales		80,000
Other income		5,300
Opening inventory	4,000	
Purchases	33,400	
Selling and distribution expenses	15,000	
Administrative expenses	9,700	
Financial charges	8,698	
Investment at cost	6,800	
Trade receivables	10,000	
Allowance for doubtful debts		380

The following matters need to be considered in finalizing the financial statements of ZTL:

- As per store records, closing inventory as at 30 June 2014 amounted to Rs. 8,500,000.
Physical inventory taken on 1 July 2014 revealed the following information:
 - Value of goods found short by Rs. 1,500,000 (abnormal loss).
 - Goods costing Rs. 860,000 are obsolete. Their estimated net realizable value is Rs. 600,000.
- Selling and distribution expenses include trade discounts allowed to customers amounting to Rs. 4,000,000.
- In June 2014, ZTL received Rs. 810 million, net of 10% tax, cash dividend on its investments and the amount received was credited to other income.
- ZTL maintains an allowance for doubtful debts at 5% of trade receivables.
- Accrual for tax expense of Rs. 6,452 is to be recorded.

Required:

Prepare ZTL's statement of comprehensive income for the year ended 30 June 2014 in accordance with IFRSs.

► ANSWER:

Zee Trading Limited**Statement of comprehensive income****For the year ended 30 June 2014**

			Rs. 000
Sales	[80,000 - 4,000]		76,000
Cost of sales		W1	(29,160)
Gross profit			46,840
Selling and distribution expenses	[15,000 - 4,000 + 120*]		(11,120)
Administrative expenses	[9,700 + 1,500]		(11,200)
Operating profit			24,520
Finance cost			(8,698)
Other income	[5,300 + (810 / 90 x 10)]		5,390
Profit before tax			21,212
Taxation			(6,452)
Profit for the year			14,760
Other comprehensive income			0
Total comprehensive income			14,760

W1: Cost of Sales	Rs. 000
Opening Inventory	4,000
Purchases	[33,400 - 1,500]
Less: Closing inventory	[8,500 - 260 - 1,500]
	29,160

*10,000 x 5% = 500 - 380 = 120

► **Example 13:**

The following trial balance pertains to Hadi Limited (HL) for the year ended 31 December 2016:

Description	Debit	Credit
	----- Rs. in '000 -----	
Capital work-in-progress	145,000	
Plant and machinery – at cost	305,000	
Trade receivables	61,400	
Stock-in-trade	79,600	
Cash and bank	33,444	
Cost of sales	78,664	
Administrative expenses	37,636	
Ordinary share capital (Rs. 10 each)		241,000
Retained earnings		104,175
Accumulated depreciation – Plant and machinery		53,250
Trade payables		60,912
10% long term loan		75,000
Allowance for bad debts		5,000
Sales		201,407
	740,744	740,744

While finalizing the financial statements of HL from the above trial balance, the following issues have been noted:

- No depreciation has been charged in the current year. Depreciation is provided at 10% per annum using the straight line method.
- A machine which was purchased on 1 January 2015 for Rs. 25 million was traded-in, on 1 July 2016 for a new and more sophisticated machine. The disposal was not recorded and the new machine was capitalised at Rs. 15 million being the net amount paid to supplier. The trade-in allowance amounted to Rs. 20 million.
- HL maintains an allowance for doubtful debts at 6% of trade receivables. On 1 February 2017, a customer owing Rs. 10 million at year-end was declared bankrupt. HL estimates that 20% of the amount would be received on liquidation.
- The long term loan of Rs. 75 million was obtained on 1 January 2016, to finance the capital work-in-progress. HL correctly capitalised the finance cost on such loan in accordance with IAS-23 'Borrowing cost'.
- On 1 January 2016, HL started research and development work for a new product. On 1 May 2016, the recognition criteria for capitalization of internally generated asset was met. The product was launched on 1 November 2016.

HL incurred Rs. 20 million from commencement of research and development work till launching of the product and charged it to cost of goods sold. It is estimated that the useful life of this new product will be 20 years. It may be assumed that all costs accrued evenly over the period.

On 31 December 2016, the recoverable amount of the development expenditure was Rs. 10 million. For tax purposes, research and development costs are allowed to be amortized over 10 years.

- The accrual of income tax has been estimated at Rs. 8,153,000.

Required:

Prepare statement of comprehensive income for the year ended 31 December 2016 in accordance with the requirements of International Financial Reporting Standards.

► ANSWER:

Hadi Limited**Statement of comprehensive income****For the year ended 31 December 2016**

	Rs. 000
Sales	201,407
Cost of sales [78,664 + 29,500 - 20,000]	(88,164)
Gross profit	113,243
Administrative expenses W1	(55,090)
Profit before tax	58,153
Taxation	(8,153)
Profit for the year	50,000
Other comprehensive income	0
Total comprehensive income	50,000

W1: Administrative expenses	Rs. 000
As given	37,636
Loss on disposal W2	1,250
Bad debts W3	8,000
Reversal of doubtful debts W3	(1,796)
Research expense W4	8,000
Amortisation of development costs W4	100
Impairment of development costs W4	1,900
	55,090

W2: Plant & Machinery	10% Straight line basis	Rs. 000
Cost	[305,000 - 15,000]	290,000
Less: Accumulated dep.		(53,250)
WDV on 1 January 2016		236,750
Addition	[15,000 + 20,000]	35,000
Disposal		(21,250)
Depreciation (disposed)	[25,000 x 10% x 6/12]	1,250
Depreciation (addition)	[35,000 x 10% x 6/12]	1,750
Depreciation (other)	[(290,000 - 25,000) x 10%]	26,500
		(29,500)
WDV on 31 December 2016		221,000

Asset Disposal	Rs. 000
Cost 1 January 2015	25,000
Depreciation 2015 [25,000 x 10%]	(2,500)
WDV on 1 January 2016	22,500
Depreciation upto June [25,000 x 10% x 6/12]	(1,250)
WDV on disposal	21,250
Disposal proceeds Trade-in-allowance	(20,000)
Loss (gain) on disposal	1,250

W3: Bad and doubtful debts	Rs. 000
Bad debts written off [10,000 x 80%]	8,000
Closing allowance [(61,400 – 8,000) x 6%]	3,204
Less: Opening balance	(5,000)
Reversal	(1,796)

W4: Research and development	Rs. 000
Incorrect charge in cost of sales	20,000
Less: research expense (administrative expenses) [20,000 x 4/10]	(8,000)
Development costs	12,000
Less: Amortisation (administrative expenses) [12,000 / 20 x 2/12]	(100)
Carrying amount	11,900
Less: recoverable amount	10,000
Impairment loss (administrative expenses)	1,900

► **Example 14:**

The following balances have been extracted from the trial balance of Mint Lemonade Limited (MLL) as at 31 December 2019:

	Rs. in million
Trade receivables	1,200
Capital work in progress	910
Allowance for bad debts as on 1 January 2019	44
Sales	2,500
Cost of goods sold	1,320
Research and development	180
Dividend receivable	10
Administrative expenses	302
Selling and distribution expenses	200
Finance cost	48
Dividend income	30
Other income	86

While finalizing the financial statements of MLL, the following issues have been noted:

- i. Trade receivables include a balance of Rs. 40 million which needs to be written off. MLL maintains an allowance for doubtful debts at 5% of trade receivables.
- ii. Capital work in progress includes interest cost of Rs. 84 million on specifically acquired bank loan during the year. However, interest of Rs. 16 million earned by investing surplus funds available from the bank loan has been included in other income.
- iii. Research and development represents cost incurred for a new product started on 1 February 2019. The recognition criteria for capitalization of internally generated intangible asset was met on 1 May 2019. The product was launched on 31 October 2019. It is estimated that the useful life of this new product will be 5 years. It may be assumed that all costs were incurred evenly over the period.
- iv. Office building of ML had net book value of Rs. 900 million on 31 December 2018 with remaining useful life of 12 years. During 2019, MLL decided to opt revaluation model for its building. Consequently, fair value of building at start of 2019 was determined at Rs. 1,200 million. Such revaluation has not yet been accounted for. Depreciation on office building under cost model has already been recorded in the books.
- v. The estimate for accrual of income tax is Rs. 167.24 million.

Required:

Prepare MLL's statement of profit or loss and other comprehensive income for the year ended 31 December 2019.

► **ANSWER:**

Mint Lemonade Limited

Statement of comprehensive income

For the year ended 31 December 2019

		Rs. m
Sales		2,500
Cost of sales		(1,320)
Gross profit		1,180
Administrative expenses	W1	(391)
Selling and distribution expenses	W2	(254)
Operating profit		535
Finance cost		(48)
Other income	[30 + 86 - 16 (ii)]	100
Profit before tax		587
Taxation		(167.24)
Profit for the year		419.76
Other comprehensive income:		
Gain on revaluation		300
		300
Total comprehensive income		719.76

W1: Administrative expense		Rs. m
Trial balance		302
R&D Expense	[180 x 3/9 months]	60
Amortisation of Development costs	[180 x 6/9 = 120 / 5 x 2/12]	4
Additional depreciation on building	[300 / 12 years]	25
		391

W2: Selling & Distribution Expense		Rs. m
Trial balance		200
Bad debts		40
Doubtful debts	[(1,200 - 40) x 5% - 44]	14
		254

► **Example 15:**

Following is the summarised trial balance of ABC Limited as at 30 June 2014:

	Rs. in million	
Sales		737
Stock at 1 July 2013	75	
Purchases	301	
Manufacturing expenses	240	
Selling and marketing expenses	28	
Administrative expenses	51	
Factory building – cost at 1 July 2013	200	
Machines – cost at 1 July 2013	280	
Factory building – accumulated depreciation at 1 July 2013		50
Machines – accumulated depreciation at 1 July 2013		87
Advance income tax	4	
Debtors	117	
Cash and bank	51	
Creditors		83
Share capital		300
Unappropriated profit at 1 July 2013		90
	1,347	1,347

Additional information:

- Depreciation on factory building and machines are provided on reducing balance method @ 10% and 15% per annum respectively. 60% depreciation on factory building and 100% depreciation on machines are charged to cost of sales. The balance depreciation is charged to administrative expenses
- On 31 May 2014, a fully depreciated machine was sold for Rs. 3 million. The sale proceeds were received on 5 July 2014. No entries have been made in respect of these transactions.

- iii. Debtors include an amount of Rs. 28 million owed by a customer who experienced cash flow problems prior to the year-end. The company has agreed to accept Rs. 18 million in full and final settlement of the debt. Four other debtors aggregating Rs. 5 million are required to be written off.
- iv. Income tax liability for the year ended 30 June 2014 is estimated at Rs. 25 million.
- v. On 20 June 2014 an advance of Rs. 12 million was received under a contract for supply of goods in August 2014. The advance was credited to sales.
- vi. Closing stock at 30 June 2014 amounted to Rs. 114 million. It included stock costing Rs. 20 million whereas the related invoice was booked on 4 July 2014.
- vii. In June 2014, a competitor developed a new product which has affected ABC's ability to sell one of its products at its normal price of Rs. 160. It is estimated that to sell the product, the company needs to offer a discount of 25%. 150,000 units of that product were in hand as on 30 June 2014 at a cost of Rs. 120 per unit. Its selling costs are estimated at Rs. 20 per unit.

Required:

Prepare the statement of comprehensive income for the year ended 30 June 2014 and the statement of financial position as at that date in accordance with International Financial Reporting Standards.

► **ANSWER:****ABC Limited****Statement of comprehensive income for the year ended 30 June 2014**

	Rs. in million
Sales 737 – 12 advance	725
Cost of sales 75 + 301 + 240 + (9+29 Dep) – 114 closing + 20 purchases + 3 write down	(563)
Gross profit	162
Selling and marketing expense	(28)
Administrative expenses 51 + 6 depreciation + 15 bad debts	(72)
Other income (gain on disposal)	3
Profit before tax	65
Income tax expense	(25)
Profit for the year	40

Statement of financial position as at 30 June 2014

ASSETS	Rs. in million
Non-current assets	
Property, plant and equipment 343 – 44 Depreciation	299
Current assets	
Stock 114 – 3 write down	111
Debtors 117 – 15	102
Other receivable (disposed asset)	3
Cash and bank	51
	267
	566

EQUITY AND LIABILITIES	Rs. in million
Owner's equity	
Share capital	300
Un-appropriated profit (90+40)	130
Total equity	430
Current liabilities	
Creditors 83 + 20 unrecorded invoice	103
Income tax payable 25 – 4 advance	21
Advance from customer	12
	136
Total equity and liabilities	566

W1: Depreciation on factory building $[200 - 50] \times 10\% = 15$ [9 Cost of sales and 6 in Admin expenses]

W2: Depreciation on machinery $[280-87] \times 15\% = 29$

W3: Bad debts $28 - 18 = 10 + 5 = 15$

W4: Write down of inventory

Cost of product $(150,000 \times \text{Rs. } 120) = 18$

NRV of product $(150,000 \times [(\text{Rs. } 160 \times 75\%) - \text{Rs. } 20]) = 15$

Write down = 3

► **Example 16:**

Following is the summarised trial balance of Eagles Limited (EL) as at 30 June 2015:

	Debit Rs. in '000'		Credit Rs. in '000'
Plant	2,500	Acc. depreciation at 1 July 2014	
Equipment	700	– Plant	1,000
Stock as on 1 July 2014	1,500	– Equipment	270
Trade debtors	1,300	Provision for obsolete stock at 1 July 2014	45
Cash and bank	1,759	Provision for bad debts at 1 July 2014	48
Purchases	6,987	Capital	2,500
Salaries & wages	843	Accumulated profits	960
Warehouse rent	740	Trade creditors	1,545
Repair and maintenance	500	Revenue	10,706
Utilities expenses	400	Other income	425
Insurance expenses	300	Accruals at 1 July 2014	
Bad debt written off	30	– Repairs & maintenance	45
Obsolete inventory written off	40	– Utilities expenses	55
	17,599		17,599

Additional Information:

- i. The sales return of Rs. 390,000 has not been recorded yet. The goods returned have been received but not included in physical count of inventory at year-end. EL sells such goods at a mark-up of 30% on cost.
- ii. Other income includes proceed from sale of an equipment amounting to Rs. 100,000 received on 31 December 2014. The cost and written down value of the equipment at 1 July 2014 were Rs. 200,000 and Rs. 70,000 respectively.
- iii. Plant and equipment are depreciated at the rate of 10% and 15% respectively on straight line basis.
- iv. Cost of stock on 30 June 2015 was Rs. 1,400,000, having net realizable value of Rs. 1,450,000. This does not include inventory given in (i) above.
- v. The management estimates that:
 - 5% of trade debts would not be recovered.
 - 3% of the stock is obsolete.
- vi. Current warehouse rent is Rs. 600,000 per annum which was paid in advance on 1 October 2014.
- vii. Following bills for expenses were received but not entered in books:

	Rs. in '000'
Repair and maintenance	56
Utilities expenses	67

- viii. The company revalued its non-current assets on 31 December 2014. Valuer has suggested following fair values:

	Rs. in '000'
Plant	1,650
Equipment	175

- ix. The tax charge for the current year after making all related adjustments is estimated at Rs. 200,000.
- x. No entry has been made in respect of disposal, revaluation and depreciation of fixed assets. *[Transfer for incremental depreciation is to be ignored]*

Required:

Prepare statement of financial position as at 30 June 2015 and statement of comprehensive income for the year ended 30 June 2015.

► **ANSWER:****Eagles Limited****Statement of comprehensive income for the year ended 30 June 2015**

	Rs. 000
Sales 10,706 – 390 return	10,316
Cost of goods sold 1,500 + 6,987 – 45 – 300 W1 – 1,400 + 51 W6 + 348 W8	(7,141)
Gross profit	3,175
Other income 425 – 55 correction	370
	3,545

	Rs. 000
Operating expenses 843 + 740 + 500 + 400 + 300 + 30 + 40 – 2.5 W5 – 150 W7 + 23 increase in accrual	(2,723.5)
Loss on revaluation W8	(147)
Profit before tax	674.5
Taxation	(200)
Profit after tax	474.5
<u>Other comprehensive Income</u>	
Gain on revaluation W8	275
Total comprehensive income	749.5

Eagles Limited

Statement of Financial Position as at 30 June 2015

Non-current assets	Rs. 000
Property, plant and equipment 2,500 + 700 – 1,000 – 270 – (200 – 145) – 348 W8 + 275 W8 – 147 W8	1,655
Current assets	
Inventory 300 W1 + 1,400 – 51 W6	1,649
Trade Receivables [1,300 – 390 return] less 45.5	864.5
Prepaid rent W7	150
Cash & Bank	1,759
	4,422.5
	6,077.5
Equity & Liabilities	
Capital and reserves	
Share Capital	2,500
Revaluation reserve	275
Accumulated profit 960 + 474.5 SPL	1434.5
	4,209.5
Current liabilities	
Trade payables	1,545
Accrued Expenses 56 + 67	123
Income tax payable	200
	1,868
	6,077.5

W1: Cost of goods returned $390 \times 100/130 = 300$

W2: Accumulated depreciation [01 July 2014 $200 - 70$ WDV = Rs. 130 + for six months $200 \times 15\% \times 6/12$ = Rs. 145

W3: Correction in other income Rs. 100 recorded already – correct gain 45 = Rs. 55

W4: Trade debtors: $1,300 - 390 = 910$; Closing Allowance @ 5% = $910 @ 5\% = 45.5$

W5: Decrease in provision = $48 - 45.5 = 2.5$

W6: Obsolete inventory $1,400 + 300$ W1 = 1,700; Closing Allowance @ 3% = $1,700 @ 3\% = 51$

W7: Prepaid rent $(600/12 \times 3 \text{ months}) = 150$

W8 – Depreciation, Disposal & Revaluation	Plant	Disp. Equip.	Other Equip.	TOTAL
Cost 1 July 2014	2,500	200	500	3,200
Accumulated depreciation 1 July 2014	(1,000)	(130)	(140)	(1,270)
	1,500	70	360	1,930
Depreciation up to 31 December 2014 10%, 15%	(125)	(15)	(38)	(178)
Disposal of equipment 200 – 145		(55)		(55)
	1,375	0	322	1,697
Revaluation gain / (loss) balancing	275		(147)	128
Revalued value on 31 December 2014	1,650		175	1,825
Depreciation up to 30 June 2015 (See life below)	(150)		(20)	(170)
Carrying amount	1,500	0	155	1,655
Total useful life [1/10%] ; [1/15%]	10 years		6.7 years	
Remaining life on 31.12. 2014 [CA/Cost x total life]	5.5 years		4.3 years	

► **Example 17:**

Following is the trial balance of Mateen Limited as at 30 June 2016 :

	Debit	Credit
	----- Rupees -----	
Sales		6,892,000
Purchases	4,124,000	
Administrative expenses	1,855,000	
Distribution costs	549,000	
Property, plant and equipment		
Cost	1,750,000	
Accumulated depreciation at 30 June 2015		350,000
Inventories at 30 June 2015	344,000	
Un-appropriated profit at 30 June 2015		330,000
Share capital		2,000,000
Cash in hand	22,000	
Cash at bank	14,000	
Bank loan		500,000
Trade receivables	2,255,000	
Trade and other payables		826,000
Provision for bad debts at 30 June 2015		15,000
	10,913,000	10,913,000

The following additional information is available:

- i. Sales return of Rs. 70,000 has not been recorded yet. The goods had a cost of Rs. 47,000. The goods are not included in cost and net realisable value of inventories given below.
- ii. Cost of inventories at 30 June 2016 amounted to Rs. 365,000. The net realizable value of the inventories was Rs. 350,000.
- iii. Administrative expenses include rent of office building amounting to Rs. 700,000. 70% of the rental amount should be allocated to cost of sales and 30% to administrative expenses.
- iv. Prepaid administrative expenses and accrued distribution costs at 30 June 2016 amounted to Rs. 131,000 and Rs. 176,000 respectively.
- v. Property, plant and equipment are depreciated at 10% per annum using reducing balance method. Depreciation on addition is provided from the month in which the asset is acquired while no depreciation is charged in the month in which the asset is disposed of. Depreciation should be allocated between cost of sales and administrative expenses in the ratio of 80:20 respectively. On 10 January 2016, a generator which was purchased on 1 July 2012 for Rs. 100,000 was traded-in for a new generator. The disposal was not recorded and the generator was capitalized at Rs. 500,000 being the net amount paid to supplier after adjusting trade-in allowance of Rs. 35,000. The cost of installation of the generator amounting to Rs. 30,000 was debited to administrative expenses.
- vi. Bank loan was taken on 1 October 2015 and carries interest at 8% per annum. The loan is repayable on 30 September 2016.
- vii. Trade receivables amounting to Rs. 5,000 are required to be written off. Bad debts are estimated at 4% of the trade receivables.
- viii. Income tax liability for the year ended 30 June 2016 is estimated at Rs. 40,000.

Required:

Prepare the following:

- a) Statement of comprehensive income for the year ended 30 June 2016; and
- b) Statement of financial position as at 30 June 2016.

► **ANSWER:**

Statement of comprehensive income for the year ended 30 June 2016

	Rupees
Revenue 6,892,000 – 70,000	6,822,000
COS 4,124,000 + 344,000 – 47,000 – 350,000 + 490,000 + 91,684	(4,652,684)
Gross profit	2,169,316
Admin exp. 1,855,000 – 490,000 – 131,000 + 34,255 – 30,000 + 22,921 + 5,000 + 72,200	(1,338,376)
Distribution costs 549,000 + 176,000	(725,000)
Profit from operations	105,940
Finance cost	(30,000)
Profit before tax	75,940
Income tax expense	(40,000)
Profit for the period	35,940

Statement of financial position

As at 30 June 2016

	Rupees
Assets	
Non-current assets	
PPE $1,750,000 - 350,000 - 34,255 + 30,000 - 114,605$ [see working 4]	1,281,140
Current assets	
Inventories $47,000 + 350,000$	397,000
Trade receivables $[2,250,000 - 70,000 - 5,000] - [15,000 + 72,200 \text{ W3}]$	2,092,800
Prepaid admin expenses	131,000
Cash and bank $22,000 + 14,000$	36,000
	3,937,940
Equity and liabilities	
Share Capital	2,000,000
Retained earnings $(330,000 + 35,940)$	365,940
	2,365,940
Current liabilities	
Bank loan	500,000
Trade and other payables $826,000 + 176,000$	1,002,000
Taxation	40,000
Bank interest payable W2	30,000
	3,937,940

W1: To be allocated to COS from AE $\text{Rs. } 700,000 \times 70\% = \text{Rs. } 490,000$

W2: Accrual of interest $(500,000 \times 8\% \times 9 \div 12) = \text{Rs. } 30,000$

W3: Doubtful debts $[2,255,000 - 70,000 - 5,000] \times 4\% = 87,200 - 15,000 \text{ opening} = 72,200$

W3: Depreciation and loss on disposal	Rupees	Dep. for the year
Property, plant & equipment as per trial balance	1,750,000	
Less: Cost of generator disposed of (A)	(100,000)	
Less: Cost of generator purchased during the year	(500,000)	
Cost of PPE used throughout the year	1,150,000	
Less: Opening balance of Acc. Dep.	(350,000)	
Add: Opening balance of Acc. Dep. relating to disposed of generator [100,000 – (100,000 × 0.9 × 0.9 × 0.9)] (B)	27,100	
WDV of PPE used throughout the year	827,100	
Depreciation for the year (827,100 × 10%)	(82,710)	82,710
Addition:		
New generator	500,000	
Old generator – trade-in-allowance	35,000	
Installation charges	30,000	
	565,000	
Depreciation on additions (565,000 × 10% × 6/12)	(28,250)	28,250
	536,750	
Depreciation on disposed of generator [(100,000 – 27,100) × 10% × 6/12] (C)	-	3,645
	1,281,140	114,605
Loss on disposal [(A – B – C) – 35,000]	34,255	

► **Example 17:**

Following is the trial balance of Younus Limited (YL) as on 30 June 2017:

Particular	Debit	Particular	Credit
	Rs. in '000		Rs. in '000
PPE	200,000	Share capital (Rs. 10 each)	35,000
Receivables and advances	13,000	Un-appropriated profit	66,820
Office rent	1,120	5% Bank loan	52,000
Opening stock	54,000	Trade payables	10,000
Taxation (advance tax)	6,000	Acc. dep. – 30 June 2017	120,000
Cash and bank	40,000	Sales	240,000
Purchases	170,000		
Selling expenses	20,000		
Administrative expenses	17,000		
Financial charges	2,700		
	523,820		523,820

The following additional information is available:

- i. On 1 July 2016 engine of a delivery truck seized and was replaced at a cost of Rs. 2 million on the next day. Rs. 1.2 million was paid in cash whereas the remaining amount was adjusted against the trade in value of the seized engine. The payment was charged to selling expenses.

The delivery truck was purchased on 1 July 2010. The cost of the delivery truck is Rs. 5 million of which approximately Rs. 1 million is attributable to the seized engine. Delivery trucks are depreciated over their useful life of 10 years.

- ii. Certain goods despatched on 28 June 2017 reached YL's warehouse on 2 July 2017.

Break-up of the amount paid against these goods is as follows:

	Rs. in '000
20% advance to supplier	500
Insurance in transit	50
Delivery charges	100

The above amounts are appearing under the head 'Receivables and advances'.

- iii. Cost of stock in hand as on 30 June 2017 is Rs. 50 million.
- iv. During the year, YL gave free samples to certain customers. The selling price and gross profit on these goods was Rs. 5.4 million and 20% of cost respectively. No adjustment has been made in the books in this regard.
- v. Office rent pertains to the period from July 2016 to December 2017 and is inclusive of an upward revision of 10% with effect from 1 January 2017.
- vi. Bank loan was obtained on 1 July 2015. The principal is repayable in 20 equal quarterly instalments. The principal along with interest is paid on the first day of the next quarter.
- vii. Tax expense for the year is Rs. 7.7 million.

Required:

Prepare statement of financial position as at 30 June 2017 and statement of profit or loss for the year ended 30 June 2017 in accordance with International Financial Reporting Standards.

► ANSWER:

Younus Limited

Statement of Profit or Loss

For The Year Ended June 30, 2017

	Rs. 000
Sales	240,000
Cost of sales $54,000 + 170,000 - 50,000 - 4,500$	(169,500)
Gross profit	70,500
Other income (Gain on disposal)	400
	70,900
Administration cost $17,000 + 1,120 - 385$	(17,735)
Selling & distribution expense $20,000 - 1,200 + 400 + 4,500$	(23,700)
Financial charges $2,700 + 650$	(3,350)
Profit before tax	26,115
Income tax expense	(7,700)
Profit for the year	18,415

Younus Limited**Statement of Financial Position****As at June 30, 2017**

	Rs. 000
Non – current assets	
PPE 200,000 – 120,000 + 1,600 – 400	81,200
Current assets	
Inventory 50,000 + 2,650	52,650
Receivable and advances 13,000 – 650	12,350
Prepaid rent	385
Cash and bank	40,000
	105,385
	186,585
Capital and Liabilities	
Share capital	35,000
Un- appropriated profit (66,820 + 18,415)	85,235
	120,235
Non – current liabilities	
Bank loan [52,000-16,000]	36,000
Current liabilities	
Trade payables 10,000 + 2,000	12,000
Current portion of bank loan 52,000 x 4 Quarters / 13 remaining Quarters	16,000
Income tax payable 7,700 – 6,000 advance	1,700
Interest payable	650
	30,350
	186,585

W1: NBV of old PPE given in exchange $1,000 - (1,000 \times 10\% \times 6 \text{ years}) = 400$

W2: Depreciation impact of correction of error $2,000 - 400 = 1,600 / 4 \text{ years remaining life} = \text{Rs. } 400$

W3: Payable for inventory in transit $500 / 20\%] - 500 \text{ advance} = \text{Rs. } 2,000$

W4: Inventory in transit $2,000 + 650 = \text{Rs. } 2,650$

W5: Cost of free samples $5,400 \times 100 / 120 = \text{Rs. } 4,500$

W6: Prepaid rent $1,120 / [0.5 \text{ year} + (1 + 10\% \text{ year})] = 700 \text{ per year} \times 6/12 = 350 + 10\% = 385$

W7: Accrued interest $52,000 \times 5\% \times 3/12 = \text{Rs. } 650$

8 OBJECTIVE BASED Q&A

1. Which one of the following would not necessarily lead to a liability being classified as a current liability?
 - a) The liability is expected to be settled in the course of the entity's normal operating cycle
 - b) The liability has arisen during the current accounting period
 - c) The liability is held primarily for the purpose of trading
 - d) The liability is due to be settled within 12 months after the end of the reporting period
2. Which one of the following would be shown in the 'other comprehensive income' section of the statement of profit or loss and other comprehensive income?
 - a) A revaluation gain on an investment property
 - b) Profit on sale of an investment
 - c) Receipt of a government grant
 - d) Gain on revaluation of a factory building
3. Which of the following are not items required by IAS 1 Presentation of Financial Statements to be shown on the face of the statement of financial position?
 - a) Inventories
 - b) Provisions
 - c) Government grants
 - d) Intangible assets
4. How does IAS 1 define the 'operating cycle' of an entity?
 - a) The time between acquisition of assets for processing and delivery of finished goods to customers
 - b) The time between delivery of finished goods and receipt of cash from customers
 - c) The time between acquisition of assets for processing and payment of cash to suppliers
 - d) The time between acquisition of assets for processing and receipt of cash from customers
5. Where are equity dividends paid presented in the financial statements?
 - a) As a deduction from retained earnings in the statement of changes in equity
 - b) As a liability in the statement of financial position
 - c) As an expense in profit or loss
 - d) As a loss in 'other comprehensive income'
6. Inappropriate accounting policies are rectified by:
 - a) Disclosure of the accounting policies used
 - b) Notes
 - c) Explanatory material
 - d) None of above
7. Each component of the financial statements shall be identified clearly. In addition, the following information shall be displayed prominently:
 - i. The name of the reporting undertaking
 - ii. The name of chief accountant
 - iii. Whether the financial statements cover the individual undertaking, or a group

- iv. The SFP date, or the period covered by the financial statements, whichever is appropriate to that component of the financial statements
 - v. the presentation currency
 - vi. the level of rounding used in presenting amounts in the financial statements
 - a) All of above
 - b) All of above except (iii)
 - c) All of above except (ii)
 - d) All of above except (v)
8. Which of the following is appropriate statement regarding compliance with IFRSs?
- a) These financial statements have been prepared in accordance with most of IFRSs
 - b) These financial statements have been prepared in accordance with all the IFRSs except IAS 8 and IAS 2
 - c) These financial statements have been prepared in accordance with IFRSs
 - d) These financial statements have been prepared in accordance with selected IFRSs
9. An entity's year end is June 30, 2019 when it has a long-term loan due on February 29, 2020. The loan is refinanced on July 20, 2019 and now it will be repaid on April 30, 2025.
- This loan shall be presented as:
- a) Current liability
 - b) Non-current liability
 - c) Equity
 - d) Contingent liability
10. An entity's year end is June 30, 2019. It breached a condition of loan and it is now payable on demand. However, on June 30, 2019, the lender agrees not to demand payment as a consequence of the breach prior to June 30, 2020 giving at least 12 months grace to rectify the breach.
- This loan shall be presented as:
- a) Current liability
 - b) Non-current liability
 - c) Equity
 - d) Contingent liability
11. The judgement on whether additional items are presented separately is based on an assessment of:
- i. The nature and liquidity of assets
 - ii. The function of assets
 - iii. The amounts, nature and timing of liabilities
 - iv. The space available in the financial statements
 - a) (i) and (ii)
 - b) (i) and (iv)
 - c) (ii) and (iii)
 - d) (i), (ii) and (iii)

12. Which of the following statements are correct according to IAS 1?
- i. Profit or loss is the total of income less expenses, including the components of other comprehensive income.
 - ii. An entity shall present with equal prominence all of the financial statements in a complete set of financial statements.
- a) (i) only
 - b) (ii) only
 - c) (i) and (ii) both
 - d) Neither (i) nor (ii)
13. Which of the following statements are correct according to IAS 1?
- i. All financial statements are prepared using the accrual basis of accounting.
 - ii. The entity shall reclassify comparative amounts unless reclassification is impracticable.
- a) (i) only
 - b) (ii) only
 - c) (i) and (ii) both
 - d) Neither (i) nor (ii)
14. Which of the following statements are correct according to IAS 1?
- i. An entity need not provide a specific disclosure required by an IFRS if the information is not material.
 - ii. Measuring assets net of valuation allowance is not offsetting.
- a) (i) only
 - b) (ii) only
 - c) (i) and (ii) both
 - d) Neither (i) nor (ii)
15. Which of the following statements are correct according to IAS 1?
- i. Statement of comprehensive income may be presented as a single statement or in two statements, displaying profit or loss and other comprehensive income separately.
 - ii. Analysis of expense in profit or loss may be presented using a classification based on their nature or their function.
- a) (i) only
 - b) (ii) only
 - c) (i) and (ii) both
 - d) Neither (i) nor (ii)
16. On January 1, 2015 Yasir Limited issued debenture certificates of Rs. 80 million which are repayable along with interest in 2020. The interest rate is 10% per annum and is payable at redemption.
- At which amount these debentures should be presented in statement of financial position as at June 30, 2015 under the heading non-current liabilities?
- a) Rs. 80 million
 - b) Rs. 84 million
 - c) Rs. 88 million
 - d) None of above

17. On January 1, 2015 Yasir Limited issued debenture certificates of Rs. 80 million which are repayable at par in 2020. The interest rate is 10% per annum. The interest is payable half yearly on July 1 and January 1 each year until redemption.

At which amount these debentures should be presented in statement of financial position as at June 30, 2015 under the heading non-current liabilities?

- Rs. 80 million
 - Rs. 84 million
 - Rs. 88 million
 - None of above
18. On 1 January 2016, Hadi Limited (HL) started research and development work for a new product. On 1 May 2016, the recognition criteria for capitalization of internally generated asset was met. The product was launched on 1 November 2016.

HL incurred Rs. 20 million from commencement of research and development work till launching of the product and charged it to cost of goods sold. It is estimated that the useful life of this new product will be 20 years. It may be assumed that all costs accrued evenly over the period.

On 31 December 2016, the recoverable amount of the development expenditure was Rs. 10 million.

For the year ended 31 December 2016, what amount should be transferred from cost of goods sold to administrative expenses?

- Rs. 8 million
 - Rs. 10 million
 - Rs. 12 million
 - Rs. 20 million
19. Manahil Limited (ML) is preparing its financial statements for the reporting period ending on December 31, 2024. ML has a loan liability that was originally for a term of three years. However, as of the reporting date, the loan is due to be settled within twelve months. An agreement to refinance the loan on a long-term basis is completed on February 15, 2025, before the financial statements are authorized for issue. How should ML classify the loan liability in its financial statements for the reporting period ending December 31, 2024?
- Classify the loan liability as non-current, as the original term was for a period longer than twelve months.
 - Classify the loan liability as non-current, as the agreement to refinance was completed before the financial statements were authorized for issue.
 - Classify the liability as current, as refinancing has not been completed within 30 days of the end of reporting period.
 - Classify the liability as current, as refinancing after the end of reporting period does not affect the classification of liabilities.
20. Hadi Limited (HL) trial balance as at 31 December 2016 reflects the following:

	Debit Rs. 000	Credit Rs. 000
Capital work-in-progress	145,000	
Plant and machinery – at cost	305,000	
Accumulated depreciation		53,250

No depreciation has been charged in the current year. Depreciation is provided at 10% per annum using the straight-line method

A machine which was purchased on 1 January 2015 for Rs. 25 million was traded-in, on 1 July 2016 for a new and more sophisticated machine. The disposal was not recorded, and the new machine was capitalized at Rs. 15 million being the net amount paid to supplier. The trade-in allowance amounted to Rs. 20 million.

Calculate the amount of depreciation to be charged for the year ended 31 December 2016, in respect of above?

- a) Rs. 26,500,000
- b) Rs. 27,750,000
- c) Rs. 28,250,000
- d) Rs. 29,500,000

ANSWERS

01.	(b)	The fact that a liability has arisen during the current accounting period does not make it a current liability. The other options would all lead to classification as a current liability.
02.	(d)	The revaluation gain on the factory will be presented under 'other comprehensive income'. The other items will be recognised in profit or loss. Note that gains on investment properties go through profit or loss.
03.	(c)	Inventories, provisions and intangible assets are shown separately. There is no such requirement for government grants.
04.	(d)	The time between acquisition of assets for processing and receipt of cash from customers
05.	(a)	Equity dividends are presented in the statement of changes in equity.
06.	(d)	An entity cannot rectify inappropriate accounting policies either by disclosure of the accounting policies used or by notes or explanatory material.
07.	(c)	The name of chief accountant is not required.
08.	(c)	The statement must be explicit and unreserved.
09.	(a)	Refinancing or rescheduling after the year-end does not change classification.
10.	(b)	The loan is not payable in twelve months due to grace period.
11.	(d)	The availability of space is not reason for any additional item. If any disclosure is necessary, the space is created.
12.	(b)	Other comprehensive income is not part of profit or loss.
13.	(b)	Statement of cash flows is not prepared under accrual basis of accounting.
14.	(c)	Both statements are correct.
15.	(c)	Both statements are correct.
16.	(b)	Rs. 80 million + Rs. 80 million x 10% x 6 / 12 = Rs. 84 million The interest will be included in debentures amount as it is payable at redemption.
17.	(a)	The interest is payable on July 1, 2015 and shall be presented as current liabilities.
18.	(b)	Research 20 million x 4/10 months = Rs. 8 million Amortisation 12 million / 20 years x 2/12 = Rs. 0.1 million Impairment 11.9 million – 10 million = Rs. 1.9 million Total Rs. 10 million
19.	(d)	Classify the liability as current, as refinancing after the end of reporting period does not affect the classification of liabilities.

20.	(d)		
			Rs. 000
		On addition $35,000 \times 10\% \times 6/12$	1,750
		On disposed $25,000 \times 10\% \times 6/12$	1,250
		Opening (other)	26,500
		$305,000 - 25,000 - 15,000 = 265,000 \times 10\% \times 12/12$	
		Total	29,500

STICKY NOTES

Minimum items to be presented in statement of financial position

1.	property, plant and equipment
2.	investment property
3.	intangible assets
4.	Financial assets
5.	investments accounted for using the equity method
6.	biological assets
7.	inventories
8.	trade and other receivables
9.	cash and cash equivalents
10.	trade and other payables
11.	provisions
12.	financial liabilities
13.	liabilities and assets for current tax
14.	deferred tax liabilities and deferred tax assets
15.	issued capital and reserves attributable to owners.

Minimum items to be presented in statement of comprehensive income

1.	Profit or loss
2.	Total other comprehensive income
3.	Comprehensive income for the period.

Minimum items to be presented in statement of changes in equity

1.	Total comprehensive income
2.	Effect of retrospective application and/or retrospective restatement.
3.	Reconciliation for each component of equity separately disclosing changes from: • Profit or loss • Other comprehensive income • Transaction with owners (issue of shares, dividend)



Notes to the financial statements

The notes shall:

- present information about the basis of preparation of the financial statements and the specific accounting policies used;
- disclose the information required by IFRSs that is not presented elsewhere in the financial statements; and
- provide information that is not presented elsewhere in the financial statements, but is relevant to an understanding of any of them.

INCOMPLETE RECORDS

IN THIS CHAPTER:

AT A GLANCE

SPOTLIGHT

1. Introduction
2. Techniques to tackle incomplete records
3. Comprehensive Examples
4. Objective Based Q&A

STICKY NOTES

AT A GLANCE

Small businesses frequently encounter challenges where financial data is incomplete or compromised due to lack of keeping proper accounting records or unforeseen events like theft, asset destruction, or loss of records. In such scenarios, reconstructing accounts becomes essential to re-establish financial accuracy and support effective decision-making.

Regardless of the root cause, accountants are tasked with piecing together available information, such as scattered invoices or fragmented bank statements, to compile financial statements or calculate missing figures. This chapter introduces crucial techniques for managing incomplete records, focusing on bridging gaps in financial data by establishing connections among the elements of financial statements. Fundamental accounting practices, such as analysing opening and closing balances of ledger accounts, are central to this process.

The methods covered also include summarising cash and bank transactions to identify discrepancies arising from cash misappropriation or unexplained withdrawals. Furthermore, the application of markup on cost and profit percentages is explored to estimate financial metrics like revenue and gross profit, enabling learners to address scenarios involving incomplete or inconsistent sales records.

Additionally, the use of the accounting equation to ascertain equity and the application of the business equation to calculate profit or drawings during the period, or net assets at specific points in time prove vital in reconstructing reliable financial records.

1 INTRODUCTION

1.1 The challenge of incomplete records

Incomplete records, as the term suggests, are accounting records where information is missing.

Problems of incomplete records may arise with small businesses where the owner of the business has not kept up-to-date accounting records or does not have a double entry book-keeping system (i.e. keeping only single entry bookkeeping records). He might simply keep invoices or receipts for expenses and copies of invoices to customers. In addition, details of bank transactions can be obtained from a bank statement or other banking records.

The task of the accountant is to use these invoices, receipts and banking records, together with other information obtained from the business owner, to prepare financial statements for the year (and in particular a statement of comprehensive income, which provides a basis for calculating the taxable income of the business owner from his or her business).

Other circumstances that cause problems include loss of records because of some kind of disaster, for example a fire in the office. Another scenario is where records have not been maintained because a dishonest employee has stolen cash or inventory.

Whatever the cause of the problem the accountant's task involves piecing together information that is available in order to produce a set of financial statements or to calculate missing figures.

1.2 Dealing with exam questions

Questions on incomplete records are a good test of knowledge and understanding of book-keeping and accounting. The task is often to identify the missing figures that the incomplete records do not provide.

Typical exam questions' requirement include:

- Calculating missing figures of inventory / cash / sales / profit etc.
- Preparing complete financial statements (with partial data available).
- Calculating the amount of fraud / defalcation / theft / loss by fire etc.
- Objective based questions (often require to calculate missing figures).

Possible approaches to establishing missing numbers include:

- establishing the value of assets and liabilities to calculate the business capital, particularly opening capital at the start of the financial period by applying accounting equation or business equation.
- using memorandum accounts, for receivables or payables, to calculate the sales or purchases for the period.
- using a memorandum account for bank and cash transactions, to establish a missing figure for cash receipts or cash payments, such as a missing figure for cash taken from the business by the owner as drawings.
- Using cost structures (gross profit percentage or mark-up) to establish a cost of sales, or a missing figure such as the value of inventory stolen or lost in a fire.
- Accounts of income and expenses carrying opening or closing accrual or prepayment balances.

2 TECHNIQUES TO TACKLE INCOMPLETE RECORDS

2.1 Preparing ledger accounts for missing information

When there are incomplete records, a memorandum account can be used to calculate a 'missing' figure, such as a figure for sales or purchases and expenses in the period. A memorandum account is not part of proper ledger accounting system, it is just prepared as working for determining missing amounts as balancing figure.

Usually, following ledger accounts are useful in this regard:

Ledger account	Key points			
Receivables	Mostly used where credit sales or total sales are to be determined unless the same can be calculated using mark-up/margin equations. It is important to consider impact of bad debts information carefully.			
Payables	Mostly used where credit purchases or total purchases are to be determined unless the same can be calculated using mark-up/margin and cost of sales equations			
Expenses	The following memorandum expense account based on concepts of accrual and prepayments is useful:			
	EXPENSES			
	Particulars	Rs.	Particulars	Rs.
	b/d (prepaid)	XX	b/d (payable)	XX
	Cash paid	XX	Expense (balancing)	XX
	c/d (payable)	XX	c/d (prepaid)	XX
		XX		XX
Income	The following memorandum income account based on concepts of accrual and prepayments is useful:			
	INCOME			
	Particulars	Rs.	Particulars	Rs.
	b/d (receivable)	XX	b/d (advance)	XX
	Income (balancing)	XX	Cash received	XX
	c/d (advance)	XX	c/d (receivable)	XX
		XX		XX
Cash/Bank account	This account is relevant: To find missing figure of any specific payment or receipt To find opening or closing balance of cash or bank			
Bank reconciliation	If bank statement information is given, it may be necessary to prepare reconciliation to determine cash at bank figure.			

► *Example 01:*

The following data relates to AB Traders:

Opening receivables	Rs. 240,000
Closing receivables	Rs. 280,000
Cheques received from credit customers	Rs. 1,450,000
Cash received from customers for cash sales	Rs. 560,000

Required:

Calculate total sales.

► *Answer:*

The receivable account may be prepared for determining credit sales as follows:

Receivables			
	Rs.		Rs.
b/d	240,000	Bank	1,450,000
Sales (credit) [balancing]	1,490,000	c/d	280,000
	<u>1,730,000</u>		<u>1,730,000</u>

Total sales = Credit sales Rs. 1,490,000 + cash sales Rs. 560,000 = **Rs. 2,050,000**

Alternatively, total sales may be determined using receivable account if we include cash sales in the ledger as well.

Receivables			
	Rs.		Rs.
b/d	240,000	Bank	1,450,000
Sales (total) [balancing]	2,050,000	Cash	560,000
		c/d	280,000
	<u>2,290,000</u>		<u>2,290,000</u>

► *Example 02:***Part (a):**

Calculate sales for the period from the following information.

	Rs. 000
Receivables at the start of the period	2,400
Receivables at the end of the period	1,800
Cash received from customers	12,500
Bad debt written off	200

Part (b):

Calculate sales for the period from the following information.

	Rs. 000
Receivables at the start of the period	2,400
Receivables at the end of the period	1,800
Cash received from customers	12,500
Bad debt to be written off	200

► *Answer:*

Part (a)

Receivables			
	Rs. 000		Rs. 000
b/d	2,400	Cash	12,500
		Bad debts	200
Sales (balancing)	12,100	c/d	1,800
	14,500		14,500

Part (b)

Receivables			
	Rs. 000		Rs. 000
b/d	2,400	Cash	12,500
Sales (balancing)	11,700	c/d [1,800 – 200]	1,600
	14,100		14,100

► *Example 03:*

The following data relates to AB Traders:

Opening trade payables	Rs. 120,000
Closing trade payables	Rs. 140,000
Cheques issued to suppliers	Rs. 725,000
Cash paid for purchases	Rs. 280,000

Required:

Calculate total Purchases.

► *Answer:*

The payable account may be prepared for determining credit purchases as follows:

Payables			
	Rs.		Rs.
Bank	725,000	b/d	120,000
c/d	140,000	Purchases (credit)	745,000
	865,000		865,000

Total purchases = Credit purchases Rs. 745,000 + cash purchases Rs. 280,000 = **Rs. 1,025,000**

Alternatively, total purchases may be determined using payable account if we include cash purchases in the ledger as well.

Payables			
	Rs.		Rs.
Bank	725,000	b/d	120,000
Cash	280,000		
c/d	140,000	Purchases (total)	1,025,000
	1,145,000		1,145,000

► *Example 04:*

CD Traders has two shops (both on rent). The following information is relevant:

	1 Jan	31 Dec
Prepaid rent (Shop 1)	Rs. 15,000	Rs. 18,000
Rent payable (Shop 2)	Rs. 20,000	Rs. 24,000

Total rent paid during the year was Rs. 480,000.

Required:

Calculate rent expense.

► *Answer:*

Rent expense account (memorandum) may be prepared as follows:

Rent			
	Rs.		Rs.
b/d (prepaid)	15,000	b/d (payable)	20,000
Cash	480,000	Profit or loss (expense)	481,000
c/d (payable)	24,000	c/d (prepaid)	18,000
	519,000		519,000

► *Example 05:*

EF Traders provides services on commission basis. The following information is relevant:

	1 Jan	31 Dec
Commission Receivable	Rs. 30,000	Rs. 36,000
Commission received in advance	Rs. 20,000	Rs. Nil

Total cash received on account of commission during the year was Rs. 970,000.

Required:

Calculate commission income.

► *Answer:*

Commission income account (memorandum) may be prepared as follows:

Commission			
	Rs.		Rs.
b/d (receivable)	30,000	b/d (advance)	20,000
Profit or loss (income)	996,000	Cash	970,000
c/d (advance)	0	c/d (receivable)	36,000
	<u>1,026,000</u>		<u>1,026,000</u>

► *Example 06:*

Calculate drawings for the period from the following information.

	Rs. 000
Cash in hand at the beginning of the year	100
Bank balance at the beginning of the year	2,400
Cash in hand at the end of the year	150
Bank balance at the end of the year	5,200
Receipts from customers	51,700
Payments to employees	3,400
Payments to suppliers	38,200

► *Answer:*

A combined account for cash and bank is appropriate as data for cash and bank receipt is not available separately:

Cash & Bank			
	Rs. 000		Rs. 000
b/d (cash)	100	Payables	38,200
b/d (bank)	2,400	Salaries	3,400
Receipts from customers	51,700	Drawings (balancing)	7,250
		c/d (cash)	150
		c/d (bank)	5,200
	<u>54,200</u>		<u>54,200</u>

► *Example 07:*

GH Traders has bank balance (as per bank statement) of Rs. 86,000.

Unpresented cheques of Rs. 12,000 and uncredited cheques of Rs. 15,000 are outstanding.

Required:

Calculate cash at bank as to be presented in statement of financial position.

► *Answer:***Bank reconciliation statement**

	Rs.
Balance as per bank statement	86,000
Less: Unpresented cheques	(12,000)
Add: Uncredited cheques	15,000
Balance as per cash book (in SFP)	89,000

► *Example 08:*

IJ Traders has bank overdraft (as per bank statement) of Rs. 6,000.

Unpresented cheques of Rs. 4,000 and uncredited cheques of Rs. 15,000 are outstanding.

Required:

Calculate cash at bank as to be presented in statement of financial position.

► *Answer:***Bank reconciliation statement**

	Rs.
Balance as per bank statement	(6,000)
Less: Unpresented cheques	(4,000)
Add: Uncredited cheques	15,000
Balance as per cash book (in SFP)	5,000

Note: Rs. 5,000 bank balance shall be presented under the heading current assets. If the answer was in negative, it would indicate bank overdraft and shall be presented under the heading current liabilities.

2.2 Using equations for missing information

Use of certain equations is also useful to determine missing information in the financial statements:

Equation	Details
Accounting equation	This is often used to calculate opening equity. $\text{Equity} = \text{Total assets} - \text{Total liabilities}$ Opening statement of financial position prepared on the basis of estimated values is often called "statement of affairs" of the entity.
Business equation	This represents movement in equity. $\text{Closing equity} = \text{Opening equity} + \text{Capital invested} + \text{Profit} - \text{Drawings}$
Cost of sales	$\text{Cost of sales} = \text{Opening inventory} + \text{Purchases (net)} - \text{Closing inventory}$
Property, plant & equipment	$\text{Net book value (opening)} = \text{NBV at end} \times 100 / (100 - \text{Dep}\%)$ $\text{Depreciation} = \text{NBV at end} \times \text{Dep}\% / (100 - \text{Dep}\%)$

► **Example 09:**

A sole trader does not keep any accounting records, and you have been asked to prepare a statement of comprehensive income and statement of financial position for the financial year just ended. To do this, you need to establish the opening capital of the business at the beginning of the year.

You obtain the following information about assets and liabilities at the beginning of the year:

	Rs. 000
Motor van (carrying amount)	1,600
Bank overdraft	560
Cash in hand	50
Receivables	850
Trade payables	370
Payables for other expenses	90
Inventory	410

Required:

Calculate the capital of the business as at the beginning of the year.

► **Answer:**

Total assets = 1,600,000 + 50,000 + 850,000 + 410,000 = Rs. 2,910,000

Total Liabilities = 560,000 + 370,000 + 90,000 = Rs. 1,020,000

Equity = Total Assets – Total Liabilities

Equity = 2,910,000 – 1,020,000 = Rs. 1,890,000

► **Example 10:**

The accountant for a sole trader has established that the total assets of the business at 31 December Year 4 were Rs. 376,000 and total liabilities were Rs. 108,000.

Checking the previous year's financial statements, he was able to establish that at 31 December Year 3 total assets were Rs. 314,000 and total liabilities were Rs. 87,000.

During Year 4 the owner has taken out drawings of Rs. 55,000.

In December Year 4 the owner had been obliged to input additional capital of Rs. 25,000.

Required:

What was the profit of the business for the year to 31 December Year 4?

► **Answer:**

Equity (Year 4) = Total Assets – Total Liabilities = 376,000 – 108,000 = Rs. 268,000

Equity (Year 3) = Total Assets – Total Liabilities = 314,000 – 87,000 = Rs. 227,000

Closing equity = Opening equity + Capital invested + Profit – Drawings

268,000 = 227,000 + 25,000 + Profit – 55,000

Profit = Rs. 71,000

► **Example 11:**

A business had opening inventory of Rs. 50,000 and closing inventory of Rs. 70,000. Its Cost of sales have been calculated as Rs. 900,000.

Required:

Calculate the amount of purchases from the above information.

► **Answer:**

Cost of sales = Opening inventory + Purchases – Closing inventory

$$900,000 = 50,000 + \text{Purchases} - 70,000$$

Purchases = Rs. 920,000

► **Example 12:**

An entity has plant with a net carrying amount of Rs. 720,000 as on 31 December 2021. It charges depreciation @20% using reducing balance method.

Required:

Calculate the amount of depreciation expense for the year ended 31 December 2021 and carrying amount of the plant on 1 January 2021.

► **Answer:**

$$\text{Depreciation} = \text{NBV at end} \times \text{Dep\%} / (100 - \text{Dep\%})$$

$$\text{Depreciation} = \text{Rs. } 720,000 \times 20 / 80$$

Depreciation = Rs. 180,000

$$\text{NBV (beginning)} = \text{NBV at end} \times 100 / (100 - \text{Dep\%})$$

$$\text{NBV (beginning)} = \text{Rs. } 720,000 \times 100 / 80$$

NBV (beginning) = Rs. 900,000

2.3 Mark-up and margin percentages

The mark up or margin percentages of profit can be used to determine sales, cost of sales or profit.

Type	Details	
Mark up	Markup is the percentage increase in price above the cost of product. Sometimes, this is incorrectly referred to as margin on cost.	
	$\text{Cost} = \text{Sales} \times \frac{100}{100 + \text{markup}}$	$\text{Sales} = \text{Cost} \times \frac{100 + \text{markup}}{100}$
Margin	Margin is the percentage of profit on the selling price. Sometimes, this is incorrectly referred to as mark-up on selling price.	
	$\text{Cost} = \text{Sales} \times \frac{100 - \text{margin}}{100}$	$\text{Sales} = \text{Cost} \times \frac{100}{100 - \text{margin}}$

► **Example 13:**

An entity's sales is Rs. 2,700,000 and it sells at cost plus 25%.

Required:

Calculate cost of sales figure.

► **Answer:**

$$\text{Cost} = 2,700,000 \times \frac{100}{100 + 25} = \text{Rs. } 2,160,000$$

► **Example 14:**

An entity's cost of sales is Rs. 2,160,000 and it sells at cost plus 25%.

Required:

Calculate the amount of sales.

► *Answer:*

$$\text{Sales} = 2,160,000 \times \frac{100 + 25}{100} = \text{Rs. } 2,700,000$$

► *Example 15:*

An entity's sales is Rs. 2,700,000 and it sells at 20% margin.

Required:

Calculate Cost of Sales figure.

► *Answer:*

$$\text{Cost} = 2,700,000 \times \frac{100 - 20}{100} = \text{Rs. } 2,160,000$$

► *Example 16:*

An entity's cost of sales is Rs. 2,160,000 and it sells at 20% margin.

Required:

Calculate the amount of sales.

► *Answer:*

$$\text{Sales} = 2,160,000 \times \frac{100}{100 - 20} = \text{Rs. } 2,700,000$$

2.4 Multiple cost structures

A further challenge arises when an entity has multiple cost structures. This possible circumstances include:

- The entity has different products with different mark up and margin%.
- The entity has different mark up and margin % for cash and credit sales.
- The entity changed mark-up and margin during the period.
- The entity sold some of goods on special discount / special scheme.
- The entity sold some goods below normal selling price due to damage etc.

In such case, a columnar table may be made for each cost structure with available information and then gaps should be filled using markup and margin formulas.

► *Example 17:*

KL Traders has total sales of Rs. 3,000 million. The company sells three products.

Product A:	60% of sales are of this product which is sold at a mark-up of 20%.
Product B:	It is sold at a margin of 30%. The cost of goods sold relating to this product is Rs. 462 million.
Product C:	This product earns gross profit equal to 10% of its sales price. The gross profit on this product during the year was Rs. 54 million.

Required:

Prepare sales, cost of sales and gross profit workings for each product and in total for the business of KL Traders.

► *Answer:*

First step would be to make columns for three products and fill in the available information:

	Product A		Product B		Product C		Total
	Rs. m	%	Rs. m	%	Rs. m	%	Rs. m
Sales	1,800	120		100		100	3,000
Cost of sales		100	(462)	70		90	
Gross profit		20		30	54	10	

Based on above information, we can calculate following amounts:

- Product A: Cost of sales = Sales 1,800 x 100 / 120 = Rs. 1,500m
- Product B: Sales = Cost of sales 462 x 100 / 70 = Rs. 660
- Product C: Sales = Gross profit 54 x 100 / 10 = Rs. 540

After incorporating the above amounts, the table would be like this:

	Product A		Product B		Product C		Total
	Rs. m	%	Rs. m	%	Rs. m	%	Rs. m
Sales	1,800	120	660	100	540	100	3,000
Cost of sales	(1,500)	100	(462)	70		90	
Gross profit		20		30	54	10	

Now, by calculating totals and balancing amount, whole table can be completed as follows:

	Product A		Product B		Product C		Total
	Rs. m	%	Rs. m	%	Rs. m	%	Rs. m
Sales	1,800	120	660	100	540	100	3,000
Cost of sales	(1,500)	100	(462)	70	(486)	90	(2,448)
Gross profit	300	20	198	30	54	10	552

3 COMPREHENSIVE EXAMPLES

► **Example 18:**

A fire on 31 March destroyed some of the inventory of a company, and its inventory records were also lost. The following information is available.

The company makes a standard gross profit of 30% on its sales.

	Rs.
Inventory at 1 March	127,000
Purchases for March	253,000
Sales for March	351,000
Inventory in good condition at 31 March	76,000

Required:

What was the cost of the inventory lost in the fire?

► **Answer:**

Using margin equation, cost of sales shall be calculated:

$$\text{Cost} = 351,000 \times \frac{100 - 30}{100} = \text{Rs. } 245,700$$

Using COS equation, closing inventory shall be calculated:

COS = Opening inventory + Purchases – Closing inventory

$$245,700 = 127,000 + 253,000 - \text{closing inventory}$$

$$\text{Closing inventory} = \text{Rs. } 134,300$$

	Rs.
Inventory as should have been	134,300
Inventory in good condition	76,000
The inventory lost in fire (difference)	58,300

► **Example 19:**

Part (a)

A business makes all of its sales at a mark-up of 25%. During the year sales totalled Rs.98,000 and purchases were Rs.71,000. The inventory at the start of the year was valued at Rs.10,200.

Required:

What was the value of the closing inventory at the end of the year?

Part (b)

A business has the following assets and liabilities at the start and end of March.

	1 March	31 March
	Rs.	Rs.
Trade receivables	6,100	7,400
Trade payables	3,900	3,500

The summarised bank statements for the year showed the following figures:

- Bankings for the month were Rs.78,500
- Payments to suppliers for the month were Rs.49,700
- The owner banks her takings from the till each month but before doing so in March she took Rs. 5,000 for her own use.

Required:

What are the sales for the year?

Part (c)

An accountant has prepared the following list of the assets and liabilities of a business, but has forgotten to enter the cash balance.

	Rs.
Trade payables	4,900
Inventory	9,300
Non-current assets	98,900
Capital	97,200
Bank loan	15,700
Receivables	16,800
Bank	?

Required:

What is the missing figure for 'Bank'?

► *Answer:*

Part (a)

	Rs.
Sales	98,000
Less: Cost of sales	
Opening inventory	10,200
Purchases	71,000
Closing inventory (balancing)	(2,800)
Rs. 98,000 x 100/125	(78,400)
Gross profit	19,600

Part (b)

Trade receivables			
b/d	6,100	Bank (78,500 + 5,000)	83,500
Sales (balancing)	84,800	c/d	7,400
	90,900		90,900

Part (c)

Assets		Rs.
Non-current assets		98,900
Inventory		9,300
Receivable		16,800
Bank		-
		125,000

Equity & Liabilities		
Capital		97,200
Bank loan		15,700
Trade payables		4,900
Bank overdraft (balancing)		7,200
		125,000

► *Example 20:***Part (a)**

A greengrocer made sales during the month of Rs.49,200. Opening inventory amounted to Rs.3,784 and month-end inventory was Rs.5,516. During the month he purchased for cash goods which cost Rs.38,632.

Required:

Determine the gross profit and calculate the gross profit percentage as a percentage of sales value.

Part (b)

A rival has made sales of Rs.50,100 at a fixed mark-up of 25%. Closing inventory was valued at Rs.5,438 and he purchased goods during the month amounting to Rs.38,326.

Required:

Determine the value of the opening inventory.

Part (c)

A local store makes sales at a fixed gross profit of 10% on sales value. Sales during the month amounted to Rs.186,460; closing inventory was Rs.16,800 and represents an increase of 25% over the value of the opening inventory.

Required:

Determine the cost of purchases during the month.

► *Answer:***Part (a)**

	Percentage	Rupees
Sales	100%	49,200
Cost of sales (3,784 + 38,632 - 5,516)	(75%)	(36,900)
Gross profit (12,300/49,200 x 100)	25%	12,300

Part (b)

Opening inventory **W1** = Rs. 7,192

W1 – Calculation of opening inventory	Rs.
Sales	50,100
Less: Cost of sales	
Opening inventory (balancing)	7,192
Purchases	38,326
Closing inventory	(5,438)
Rs. 50,100 x 100 / 125	(40,080)
Gross profit	10,020

Part (c)

Purchases **W1** = Rs. 171,174

W1 – Calculation of purchases	Rs.
Sales	186,460
Less: Cost of sales W2	
Opening inventory (16,800 x 100/125)	13,440
Purchases (balancing)	171,174
Closing inventory	(16,800)
186,460 x 90%	(167,814)
Gross profit	18,646

► **Example 21:**

Irum is a sole trader. She does not keep a full set of accounting records but does keep some records of transactions and documents. She has asked you to prepare her accounts for the year ended 31 December 2015. You have been given a list of the assets and liabilities of the business at the start and end of the year.

Assets and liabilities	At 1 Jan 2015	At 31 Dec 2015
	Rs.000	Rs.000
Trade receivables	5,500	6,100
Trade payables	2,800	3,500
Inventory	10,400	?

Irum has no idea what her inventory value was at 31 December as that she did not count or value her inventory at the year-end.

She has also been given you a summary of her bank statements for the year.

Summary of bank statements

Receipts	Rs.000	Payments	Rs.000
1 Jan Balance b/d	1,620	To suppliers	42,800
Bankings	65,400	For expenses	9,300
		Living expenses	10,400
		31 Dec Balance c/d	4,520

You have also been able to gather the following information from Irum:

- Irum banks her takings from the till each week but before doing so pays Rs.50,000 to her employees and takes Rs.30,000 herself. The business operates for 50 weeks each year.
- The till always has a cash float of Rs.100,000.
- The sales of the business are both cash and credit sales and are all made at a mark-up of 40%.

Required:

- Calculate sales for the year.
- Calculate the value of the closing inventory at 31 December 2015.

► **Answer:**

Part (a)

Sales for the year **W1**

= Rs. 70,000

W1 - Trade receivables			
b/d	5,500	Cash W2	69,400
Sales (balancing)	70,000	c/d	6,100
	90,900		90,900

W2 – Cash			
b/d	100	Bank	65,400
Trade receivables (bal.)	69,400	Salaries (50 x 50)	2,500
		Drawings (30 x 50)	1,500
		c/d	100
	69,500		69,500

Part (b)

Closing inventory W1

= Rs. 3,900

W1 – Calculation of closing inventory		Rs.
Sales		70,000
Less: Cost of sales		
Opening inventory		10,400
Purchases W2		43,500
Closing inventory (balancing)		(3,900)
Rs. 70,000 x 100 / 140		(50,000)
Gross profit		20,000

W2 - Trade payables			
Bank	42,800	b/d	2,800
c/d	3,500	Purchases (balancing)	43,500
	46,300		46,300

► **Example 22:**

Rakaposhi Traders (RT) was unable to retrieve complete information required to prepare its statement of profit or loss due to a computer virus attack. In order to compute profit for the year ended 31 December 2019, RT has gathered the following information:

- i. List of all assets and liabilities as on 1 January 2019:

Liabilities	Rs. 000	Assets	Rs. 000
Creditors	310	Furniture - net	460
Accrued rent	33	Inventories	200
		Debtors	170
		Cash in hand	37
		Cash at bank	85
	343		952

- ii. Inventories increased by 30% during the year.
- iii. Credit sales during the year amounted to Rs. 2,500,000. Collections from debtors amounted to Rs. 2,400,000 out of which Rs. 300,000 were received in cash. A debtor's balance of Rs. 15,000 is irrecoverable.
- iv. Balance as per bank statement as on 31 December 2019 amounted to Rs. 90,000. However, it does not include a cheque of Rs. 40,000 deposited on 31 December 2019.
- v. Following information has been collected from the counterfoils of cheque books:

	Rs. 000
Payment to creditors	1,375
Drawings	275
Salaries	600
Cash withdrawn for office use	120

- vi. Cash in hand as at 31 December 2019 amounted to Rs. 50,000. Details of cash sales and cash payments (expenses, payment to creditors and cash purchases) are not available.
- vii. On 1 April 2019, the owner brought into the business a vehicle having a market value of Rs. 360,000.
- viii. Creditors' closing balance of Rs. 425,000 was determined from account statements obtained from the creditors.
- ix. Rent amounting to Rs. 23,000 was outstanding as on 31 December 2019.
- x. Depreciation is charged at 10% on fixed assets.

Required:

Compute the net profit or net loss for the year ended 31 December 2019.

► Answer:

Rakaposhi Traders**Net profit/(loss) for the year ended 31 December 2019**

	Rs. 000
Closing net assets (W-1)	994
Opening net assets 952-343	(609)
Increase in net assets	385
Drawings for the year	275
Additional investment for the year	(360)
Net profit for the year	300

W-1: Closing net assets	Rs. 000
Furniture – net 460×0.90	414
Vehicle – net $360 - (360 \times 0.1 \times 9 \div 12)$	333
Inventories 200×1.3	260
Debtors $170 + 2,500 - 2,400 - 15$	255
Cash at bank $90 + 40$	130
Cash in hand	50
	1,442
Creditors	425
Rent accrued	23
	(448)
	994

► **Example 23:**

Tahir retired from his employment abroad and returned to this country, where he purchased a small kiosk.

He took over the business on 1 July 2014, acquiring the existing inventory at a valuation of Rs.1,142,000. The rest of the purchase price was apportioned as to Rs.1,500,000 for fixtures and fittings and the balance for goodwill.

The following day he acquired a second-hand computer and accounts package at a price of Rs. 80,000. Unfortunately, Tahir made an error when printing his year-end accounts causing him to lose all data except for a printed summary listing of payments from the till. Other than this, the only records available were his bank statements and a number of vouchers. Surplus cash was banked during the year.

A summary of his bank account for the year ended 30 June 2015 shows the following.

	Rs.000		Rs.000
Cash introduced	5,000	Purchase of business	3,192
Bankings from shop	16,427	Purchase of accounts computer	80
Loan from mother (long-term) (interest at 5% pa)	1,000	Rent (15 months to 30 September 2015)	500
		Rates (9 months to 31 March 2015)	84
		Electricity	92
		Purchases for resale	14,700
		Private cheques	1,122
		Balance 30 June 2015	2,657
	22,427		22,427

The computer print-out was as follows:

	Rs.000
Cash purchases for resale	1,606
Staff wages	742
Sundry shop expenses	156
Cash drawings	520

On 30 June 2015 inventory, measured at cost, amounted to Rs.1,542,000, amounts due from customers Rs.74,000, and cash in hand amounted to Rs.54,000.

Depreciation is to be recognised on fixtures and fittings and computers at a rate of 10%.

Accounts outstanding on 30 June 2015 were purchases of Rs.470,000 and rates of Rs.120,000 for the year ended 31 March 2016.

Required:

Prepare Tahir's statement of comprehensive income for the year ended 30 June 2015 and a statement of financial position at that date.

► Answer:

Tahir**Statement of comprehensive income for the year ended June 30, 2015**

	Rs. 000	Rs. 000
Sales W1		19,579
Less: Cost of goods sold		
Opening Stock	1,142	
Purchases 1,606 W2 + 15,170 W3	16,776	
Closing Stock	(1,542)	(16,376)
Gross profit		3,203
Less: Expenses		
Rent (500 – (500x3/15))	(400)	
Rates (84 + (120x3/12) 30)	(114)	
Electricity	(92)	
Staff salaries	(742)	
Sundry expenses	(156)	
Interest on loan (1,000 x 5%)	(50)	
Depreciation (1,580 x 10%)	(158)	(1,712)
Net profit		1,491

Tahir**Statement of financial position as at June 30, 2015**

Assets	Rs. 000	Rs. 000
<i>Non-current assets</i>		
Goodwill (3,192 – 1,142 – 1,500)	550	
Furniture & fixtures (1,500 + 80 – 158)	1,422	1,972
<i>Current assets</i>		
Inventory	1,542	
Trade Receivables	74	
Prepaid rent (500 x 3/15)	100	
Bank	2,657	
Cash	54	4,427
		6,399

Equity & Liabilities	Rs. 000	Rs. 000
Capital and reserves		
Capital	5,000	
Add: profit	1,491	
Less: drawings [1,122 + 520]	(1,642)	4,849
Non-current liabilities		
Loan from mother		1,000
Current liabilities		
Trade payables	470	
Accrued rates (120 x 3/12)	30	
Accrued interest (1,000 x 5%)	50	550
		6,399

Workings:**W1 - Trade receivables**

b/d	-	Cash W2	19,505
Sales (bal.)	19,579	c/d	74
	<u>19,579</u>		<u>19,579</u>

W2 - Cash

b/d	-	Purchases	1,606
Trade receivables (bal.)	19,505	Wages	742
		Expenses	156
		Drawings	520
		Bank	16,427
		c/d	54
	<u>19,505</u>		<u>19,505</u>

W3 - Trade payables

Bank	14,700	b/d	-
c/d	470	Purchases (bal.)	15,170
	<u>15,170</u>		<u>15,170</u>

► **Example 24:**

Following information pertains to Alpha Traders (AT) for the year ended 31 December 2017:

- i. 60% goods are sold for cash to walk-in customers at list price. Remaining goods are sold to corporate customers on credit at a trade discount of 2% on list price. They only pay through cheques.
- ii. Balances extracted from AT's records:

	31-Dec-2017	31-Dec-2016
	----- Rs. in '000 -----	
Furniture and fittings – net	?	10,175
Stock-in-trade	14,500	12,300
Trade debtors – gross	5,900	4,400
Prepaid rent	180	145
Cash in hand	430	750
Trade creditors	9,700	8,500
Accrued salaries	310	460

- iii. All furniture and fittings were purchased on 1 July 2015 and are depreciated using straight-line method at 5% per annum.
- iv. Provision for doubtful debts is maintained at 4%. During the year, balances totalling Rs. 260,000 were written-off.
- v. Summarised bank statement:

Deposits	Rs. 000	Withdrawals	Rs. 000
Opening balance	9,800	Utilities	1,400
Corporate customers	34,240	Rent, rates and taxes	2,100
Cash	56,380	Repairs & maintenance	2,800
Insurance claim	5,500	Cash	6,320
Return outward	2,170	Creditors	87,200
Delivery charges recovered	330	Delivery truck (second hand)	2,300
		Miscellaneous expenses	1,300
		Closing balance	5,000
	108,420		108,420

- vi. Cash payments for the year:

	Rs. in '000
Salaries	6,500
Repairs & maintenance	500
Drawings	?

- vii. Insurance claim represents cost of goods lost in transit during the year.
- viii. A cheque of Rs. 300,000 issued on 15 December 2017 against rent, has not yet been presented whereas cheque from a debtor, deposited on 31 December 2017 amounting to Rs. 3,200,000 is not appearing in the bank statement.

- ix. Creditors are paid through cheques only. Payments made to creditors include:
- Rs. 48,000,000 after availing discount of 4%.
 - A cheque of Rs. 1,900,000 issued to a supplier in December 2016. No discount was allowed by the supplier on this payment.
- x. The delivery truck was purchased on 1 March 2017. Prior to use, the truck was repaired at a cost of Rs. 260,000. The repair work was completed on 31 March 2017. The amount is included in payment for repairs and maintenance above. Depreciation on delivery truck is charged on a straight-line basis at 12.5% per annum.

Required:

Prepare the following:

- Statement of profit or loss for the year ended 31 December 2017.
- Statement of financial position as on 31 December 2017.

► **Answer:**

Part (a) Alpha Traders

Statement of profit or loss for the year ended 31 December 2017	Rs. 000
Sales 39,200 W1 + 60,000 W3	99,200
<u>Cost of sales</u>	
Opening inventory	12,300
Purchases 88,500 W2 – 2,170 Return outwards – 5,500 abnormal loss	80,830
Closing inventory	(14,500)
	(78,630)
Gross profit	20,570
<u>Other income</u>	
Delivery charges	330
Discount received W2	2,000
	2,330
<u>Expenses</u>	
Rent exp. +145 Op. Prepaid – 180 Cl. Prepaid + 2,100 Bank + 300 cheque	2,365
Salaries – 460 Op. accrued + 310 Cl. Accrued + 6,500 cash	6,350
Depreciation – Furniture and Fittings 10,175 / 92.5% x 5%	550
Bad debts	260
Doubtful debts [5,900 x 4%] – [4,400 x 4%]	60
Abnormal loss 5,500 – 5,500 insurance claim received	-
Utilities	1,400
Repair & maintenance 2,800 bank + 500 cash – 260 related to Truck	3,040
Miscellaneous expenses	1,300
Depreciation – Delivery Truck 2,560 SFP x 12.5% x 9/12	240
	(15,565)
Net Profit	7,335

Part (b) Alpha Traders

Statement of financial position as on 31 December 2017	2017	2016
	Rs. 000	Rs. 000
Non-current assets		
Furniture and Fittings (net) 10,175 – 550 SPL	9,625	10,175
Delivery Truck (net) [2,300+260=2,560 – 240 SPL]	2,320	-
	11,945	
Current assets		
Stock in trade	14,500	12,300
Prepaid rent	180	145
Receivable [5,900 – 236 SPL] & [4,400 – 176 SPL]	5,664	4,224
Bank [5,000 – 300 issued + 3,200 deposit] & [9,800 – 1,900 LY]	7,900	7,900
Cash in hand	430	750
	28,674	
	40,619	35,494
Equity		
Capital	26,534	
Net profit	7,335	
Drawings W3	(3,260)	
	30,609	26,534 (<i>bal.</i>)
Current liabilities		
Trade creditors	9,700	8,500
Salaries payable	310	460
	10,010	
	40,619	35,494

W1 Receivables			
Particulars	Rs. 000	Particulars	Rs. 000
b/d	4,400	Bank	34,240
Sales (Credit) (bal.)	39,200	Bank (Un-credited cheque)	3,200
		Bad debts	260
		c/d	5,900
	43,600		43,600

W2 Trade creditors			
Particulars	Rs. 000	Particulars	Rs. 000
Bank	87,200	b/d	8,500
Bank (Cheque related to last year)	(1,900)	Purchases (bal.)	88,500
Discount 48,000 / 96 x 4	2,000		
c/d	9,700		
	97,000		97,000

W3 Cash			
Particulars	Rs. 000	Particulars	Rs. 000
b/d	750	Bank	56,380
Bank	6,320	Salaries	6,500
Sales (cash) *	60,000	Repair and maintenance	500
		Drawings (bal.)	3,260
		c/d	430
	67,070		67,070

*Credit sales Rs. 39,200 $W1 \times 100 / 98 = \text{Rs. } 40,000$ at list price $\times 60 / 40 = \text{Rs. } 60,000$ on cash

► **Example 25:**

Following is the balance sheet of Ashfaq as at 30 June 2013:

Owner's equity / Liabilities	Rupees	Assets	Rupees
Ashfaq's capital	4,396,600	Motor car	2,000,000
Creditors	1,102,000	Furniture	1,000,000
Accrued rent	20,000	Stock-in-trade	1,805,000
Loan taken from a friend	27,900	Debtors	350,000
		Prepaid insurance	15,000
		Balance at bank	360,600
		Cash in hand	15,900
	5,546,500		5,546,500

Ashfaq needs to submit his Trading and Profit and Loss Account for the year ended 30 June 2014 and Balance Sheet as of that date to his bankers in order to obtain an overdraft facility.

He has not maintained proper books of account of the business but has provided you the following information:

- He purchased goods from a single supplier who allows a discount of 3% on goods purchased in excess of Rs.3,000,000 in a year. The discount for the year ended 30 June 2014 amounts to Rs.265,800 and would be received in August 2014.
- All goods are sold at cost plus 60%.

- iii. All cash received against sale of goods has been banked with the exception of the following weekly average cash expenses/drawings:

	Rupees
Drawings	30,000
Carriage outward	5,000
Petrol	3,000
Misc. expenses	2,500

- iv. Cash in hand on 30 June 2014 amounted to Rs. 26,700.

- v. An analysis of Ashfaq's bank statement revealed the following information:

Receipts	Rupees	Payments	Rupees
Collection from debtors	464,400	Purchase of goods	9,850,700
Cash deposited into bank	13,717,800	Car expenses (for business)	73,000
		Rent	42,000
		Repayment of loan to friend	27,900
		Salaries	1,600,000
		Purchase of freehold land	2,500,000
		Travelling expenses	40,000
		Printing & stationery	46,000
		Advertisement	125,000
		Insurance	50,000
		Truck hire charges	657,000
		Misc. expenses	362,300
	14,182,200		15,373,900

- vi. Depreciation on motor car and furniture is to be provided @ 30% and 15% respectively under the reducing balance method.
- vii. Stock-in-trade on 30 June 2014 amounted to Rs. 702,000.

Required:

Prepare Trading and Profit and Loss Account for the year ended 30 June 2014 and Balance Sheet as on 30 June 2014.

► Answer:

Ashfaq**Trading and Profit and loss account****For the year ended 30 June 2014**

		Rs.
Sales	160%	20,315,520
Less: Cost of goods sold		
Opening Stock		1,805,000
Purchases W1		11,594,200
Closing Stock		(702,000)
	100%	(12,697,200)
Gross profit	60%	7,618,320
Less: Expenses		
Carriage outward		260,000
Petrol		156,000
Car expenses		73,000
Rent (42,000 - 20,000 opening accrual)		22,000
Salaries		1,600,000
Traveling expenses		40,000
Printing & stationary		46,000
Advertisement		125,000
Insurance (50,000 + 15,000 opening prepaid)		65,000
Depreciation (600,000+150,000)		750,000
Truck hire charges		657,000
Misc. expense (362,300 bank + 130,000 cash)		492,300
		(4,286,300)
Net profit		3,332,020

Ashfaq**Balance Sheet as at 30 June 2014**

	Rs.
<i>Non-current assets</i>	
Freehold land	2,500,000
Motor car 2,000,000 – 600,000 depreciation	1,400,000
Furniture 1,000,000 – 150,000 depreciation	850,000
	4,750,000
<i>Current assets</i>	
Inventory	702,000
Trade Receivables W3	4,366,520
Cash	26,700
	5,095,220
	9,845,220
Capital and reserves	
Capital	4,396,600
Add: profit	3,332,020
Less: drawings	(1,560,000)
	6,168,620
<i>Current liabilities</i>	
Trade payables W1	2,845,500
Bank overdraft 360,600 + 14,182,200 – 15,373,900	831,100
	3,676,600
	9,845,220

W1 Creditors a/c

	Rupees		Rupees
Bank	9,850,700	Balance b/d	1,102,000
Balance c/d	2,845,500	Purchases (W1.1)	11,594,200
	12,696,200		12,696,200

W1.1: Rs. 3,000,000 + (Rs.265,800/0.03) = 11,860,000 – 265,800 discount = Rs. 11,594,200

W2 Cash a/c

	Rupees		Rupees
Balance b/d	15,900	Bank	13,717,800
Cash sales and RA	15,834,600	Drawings (30,000 × 52)	1,560,000
		Carriage outward (5,000 × 52)	260,000
		Petrol (3,000 × 52)	156,000
		Misc. expense (2,500 × 52)	130,000
		Balance c/d	26,700
	15,850,500		15,850,500

W3 Debtors

	Rupees		Rupees
Balance b/d	350,000	Bank	464,400
Sales SPL	20,315,520	Cash W2	15,834,600
		Balance c/d (balancing)	4,366,520
	20,665,520		20,665,520

► **Example 26:**

Babar had purchased a running business from Razi on 1 January 2014 at a total agreed price of Rs. 960,000. Babar died on 16 June 2014 and his son Sami took over the business. Sami wants to assess the profitability of the business and for that purpose he has collected the following information from the records maintained by him and his father:

- Correspondence between Babar and Razi has revealed that they had agreed to value the inventory and other assets of the business at Rs.600,000 and Rs.120,000 respectively. However, in view of Razi's standing in the market, the deal had been finalised at a lump sum price of Rs. 960,000 payable in two equal instalments. The first instalment was paid by Babar from his personal account.
- Babar had opened a bank account in the name of the business.

An analysis of the bank statement revealed the following details:

Receipts	Rupees
Amount deposited by Babar on 1 January 2014 from his personal account	2,000,000
Day to day collections banked at day end	3,800,000
Payments	
Second instalment to Mr. Razi on 31 January 2014	480,000
Purchases	3,150,000
Lease rent	120,000
Electricity	22,000
Furniture purchased on 1 July 2014	25,000

- iii. Babar and Sami kept a notebook which shows that the following payments were made out of daily sale proceeds before depositing them in the bank:

	Rupees
Salaries and EOBI payments	184,300
Purchases	49,500
Sundry shop expenses	35,600
Drawings	192,500

- iv. On 31 August 2014, there was a burglary at the warehouse and inventory costing Rs. 50,000 was stolen. Due to defect in the insurance policy, the insurance company acknowledged the claim of Rs.20,000 only, which was received on 5 November 2014.
- v. On 31 December 2014, stock on hand costed Rs.450,000. Cash in hand, trade creditors and accrued expenses (electricity) amounted to Rs.34,500, Rs. 82,500 and Rs. 5,200 respectively.
- vi. Depreciation on fixtures and fittings is to be provided at the rate of 10% per annum.

Required:

Prepare Trading and Profit and Loss Account for the year ended 31 December 2014 and Balance Sheet as on 31 December 2014.

► **Answer:**

Babar

Trading and Profit and loss account

For the year ended 31 December 2014

	Rs.
Sales W2	4,296,400
<i>Less: Cost of goods sold</i>	
Opening Stock (Razi)	600,000
Purchases 3,282,000 W3 – 50,000 abnormal loss	3,232,000
Closing Stock	(450,000)
	(3,382,000)
Gross profit	914,400
<i>Less: Expenses</i>	
Salaries	184,300
Sundry shop expenses	35,600
Lease rentals	120,000
Loss on burglary	30,000
Electricity(22000+5200)	27,200
Depreciation 25,000 x 10% x 6/12	1,250
	(398,350)
Net profit	516,050

Babar**Balance Sheet as at 31 December 2014**

	Rs.
<i>Non-current assets</i>	
Goodwill 960,000 – 600,000 – 120,000	240,000
Furniture 25,000 – 1,250	23,750
	263,750
<i>Current assets</i>	
Inventory	450,000
Other assets (Razi)	120,000
Bank W1	2,023,000
Cash	34,500
	2,627,500
	2,891,250
Capital and reserves	
Capital 480,000 (to Razi) + 2,000,000 (in bank)	2,480,000
Add: profit	516,050
Less: drawings	(192,500)
	2,803,550
<i>Current liabilities</i>	
Trade payables	82,500
Payable to Razi 480,000 – 480,000 bank	0
Accrued expenses	5,200
	87,700
	2,891,250

W1 Bank

	Rupees		Rupees
Capital introduced	2,000,000	Payment of 2 nd instalment to Razi	480,000
Cash deposited	3,800,000	Payment for purchases	3,150,000
Cash received from insurance	20,000	Lease payment	120,000
		Electricity	22,000
		Furniture & Fixtures	25,000
		Balance at bank	2,023,000
	5,820,000		5,820,000

W2 Cash

	Rupees		Rupees
		Bank	3,800,000
Sales	4,296,400	Salaries and EOBI	184,300
		(Payments for) Purchases	49,500
		Sundry shop expenses	35,600
		Drawings	192,500
		c/d	34,500
	4,296,400		4,296,400

W3 Payables

	Rupees		Rupees
Cash	49,500	b/d	0
Bank	3,150,000	Purchases	3,282,000
c/d	82,500		
	3,282,000		3,282,000

► **Example 27:**

On 1 July 2017, Nezam took over a running business namely FC Traders (FCT). Proper books of account are not maintained for FCT. Following information has been gathered for preparation of statement of profit or loss for the year ended 30 June 2018:

- i. Balances of certain assets and liabilities:

Assets and liabilities	30-Jun-2018	1-Jul-2017
	----- Rs. in '000 -----	
Equipment	?	4,000
Furniture and fixtures	?	2,500
Trade debtors	1,600	-
Inventory	2,400	2,800
Unused miscellaneous supplies	400	300
Unpaid suppliers' bills	2,800	1,850
Shop rent payable	400	200
Cash and bank	?	1,000

- ii. Summary of bank payments for the year ended 30 June 2018:

	Rs. in '000
Suppliers	13,600
Repair and maintenance	950
Shop rent	2,000
Miscellaneous supplies	800
Utilities	1,200

- iii. Payments made out of cash sales before being deposited into the bank:

	Rs. in '000
Salaries and wages	1,800
Purchase of inventory	3,000
Part payment of sales commission to riders	90

- iv. Unpaid suppliers' bills as at 30 June 2018 include a bill of Rs. 320,000 which was mistakenly taken at Rs. 230,000.
- v. During the year, goods costing Rs. 540,000 were withdrawn by Nezam for personal use.
- vi. Inventory as at 30 June 2018 includes goods costing Rs. 250,000 which were badly damaged in an accident and have no sales value.
- vii. Mark-up on goods sold are as follows:

	Mark-up on cost
50% of goods – sold on cash counter	35%
20% of goods – sold for cash through riders	40%
30% of goods – sold for credit	45%

- viii. The riders are entitled to 3% commission.
- ix. Fixed asset at 30 June 2018 are to be depreciated at 10% per annum.
- x. Salaries and wages for June 2018 amounting to Rs. 165,000 were paid on 5 July 2018.

Required:

Prepare statement of profit or loss for the year ended 30 June 2018.

► *Answer:*

FC Traders

Statement of Profit or loss for the year ended 30 June 2018

	Rs. 000
Sales at counter [COS x 50% x 135/100]	11,813
Sales on credit [COS x 30% x 145/100]	7,612
Sales through riders [COS x 20% x 140 /100]	4,900
	24,325
<u>Cost of sales</u>	
Opening inventory	2,800
Purchases 14,640 credit W1 + 3,000 cash – 250 damaged – 540 drawings	16,850
Closing inventory [2,400 – 250 damaged]	(2,150)
	(17,500)
Gross profit	6,825

	Rs. 000
<u>Expenses</u>	
Repair and maintenance	950
Shop rent b/d 200 – 2,000 cash – c/d 400	2,200
Misc. supplies b/d 300 + 800 cash – c/d 400	700
Utilities	1,200
Salaries and wages 1,800 + 165 accrued	1,965
Riders commission [4,900 x 3%]	147
Depreciation 4,000 x 10% + 2,500 x 10%	650
Abnormal loss (damaged stock)	250
	(8,062)
Net loss	(1,237)

W1: Creditors

Bank	13,600	b/d	1,850
c/d [2,800 + (320 – 230)]	2,890	Purchases	14,640
	16,490		16,490

► **Example 28:**

Mr. Razi, a sole proprietor, runs a small business. On 30 June 2015, he realized that his cash and bank balances have reduced considerably. He suspected that one of his employees is involved in misappropriation. He has provided you the following information:

Opening balances on 1 July 2014	Rs. in '000'
Cash and bank	389
Debtors	1,560
Stock	856
Land	450
Equipment – WDV (purchased on 1 April 2014 at a cost of Rs. 600,000)	585
Creditors	1,348
Accrued expenses: Marketing	30
Utilities	25
Salaries	48
Other miscellaneous	15

Receipts and payments for the period from 1 July 2014 to 30 June 2015	Rs. in '000'
Receipts from cash sales	1,728
Receipts from debtors	4,475
Payments made to creditors	4,774
Payments for marketing expenses	205
Payments for utility expenses	240
Payments for salaries	600
Payments for other miscellaneous expenses	107
Equipment (purchased on 1 October 2014)	250
Drawings by Razi	125

Other information:

- i. Razi makes 35% margin on gross sales price. However, during the year, he offered 5% discount on credit sales and 10% discount on cash sales. 70% of his total sales were on credit.
- ii. Actual bills for the year were as follows:

	Rs. in '000'
Marketing expenses	200
Utility expenses	250
Other misc. expenses	100

- iii. Salary of the staff was Rs. 52,000 per month.
- iv. Balances of debtors and creditors as on 30 June 2015 were Rs.1,091,000 and Rs.1,195,000 respectively.
- v. Closing stock at 30 June 2015 was Rs.1,167,000. It included 150 units costing Rs. 1,500 each which were damaged and Razi incurred Rs. 900 per unit in July 2015 to bring them into saleable condition.
- vi. Razi depreciates equipment on straight line basis at the rate of 10% per annum.

Required:

Prepare income statement for the year ended 30 June 2015 and balance sheet as at 30 June 2015. Also compute the amount of cash shortage, if any.

► **Answer:**

Mr. Razi**Income Statement****For the year ended 30 June 2015**

	Rupees
Sales W1	5,984,000
<u>Cost of Sales</u>	
Opening stock	856,000
Purchases (bal.)	4,471,000
Closing stock 1,167,000 – NRV loss W2 13,800	(1,153,200)
[Gross 6,400,000 W1 x 65%] + NRV loss W2 13,800	4,173,800
Gross profit	1,810,200
Marketing expenses W6	(200,000)
Utility expenses W6	(250,000)
Salaries W6	(624,000)
Other misc. expenses W6	(100,000)
Depreciation expense $600,000 \times 10\% + 250,000 \times 10\% \times 9/12$	(78,750)
Loss due to cash shortage $150,000 \text{ W5} + 250,000 \text{ W3}$	(400,000)
Net profit	157,450

Mr. Razi**Balance Sheet****As at 30 June 2015**

	Rupees
Non-Current Assets	
Land	450,000
<u>Office equipment</u>	
Cost (600,000 + 250,000)	850,000
Accumulated depreciation (15,000 + 78,750)	(93,750)
	756,250
	1,206,250
Current Assets	
Stock [1,167,000-13,800 W2]	1,153,200
Debtors	1,091,000
Bank W4	291,000
	2,535,200
Total Assets	3,741,450
Equity	
Razi's capital opening	2,374,000
Profit for the year	157,450
Drawings	(125,000)
	2,406,450
Current Liabilities	
Creditors	1,195,000
Accrued expenses W6	140,000
Total Equity and Liabilities	3,741,450
	Rupees
Cash misappropriated in debtors W3	250,000
Cash misappropriated in creditors W5	150,000
Cash shortage	400,000

Workings:**W1: Determination of gross sales revenue and discount allowed**

	Net sales	Discount allowed	Gross sales
Cash sales	1,728,000	192,000	1,920,000
	<i>(Given)</i>	<i>(1,728,000 x 0.1/0.9)</i>	<i>(1,728,000 + 192,000)</i>
Credit sales	4,256,000	224,000	4,480,000
	<i>(4,480,000 - 224,000)</i>	<i>(4,480,000 x 5%)</i>	<i>(1,920,000 x 70 / 30)</i>
Total	5,984,000	416,000	6,400,000

Note: The discount is trade discount in nature.

W2: Adjustment for NRV on damaged stock	Rupees
Selling price of damaged stock (1,500 ÷ 0.65)	2,308
Net realizable value (2,308 – 900)	1,408
NRV expense per unit (1,500 – 1408)	92
Total NRV expense (92 x 150 units)	13,800

W3 Debtors

	Rupees		Rupees
Opening balance	1,560,000	Receipts	4,475,000
Sales (Credit) W1	4,256,000	Cash misappropriated	250,000
		Closing balance	1,091,000
	5,816,000		5,816,000

W4 Bank

	Rupees		Rupees
b/d	389,000	Payments made to creditors	4,774,000
Receipts from cash sales	1,728,000	Payment for marketing exp.	205,000
Receipts from debtors	4,475,000	Payment for utility expenses	240,000
		Payment for salaries	600,000
		Payment for other misc. exp	107,000
		Drawing	125,000
		Office equipment	250,000
		Closing balance	291,000
	6,592,000		6,592,000

W5 Creditors

	Rupees		Rupees
Payments	4,774,000	Opening balance	1,348,000
		Purchases (from COS)	4,471,000
Closing balance	1,195,000	Cash misappropriated	150,000
	5,969,000		5,969,000

W6 Accrued expenses

	A	B	C	A+B-C
	Expense for the year	Accruals 01-07-2014	Payment during the year	Accruals 30-06-2015
	----- Rupees -----			
Marketing expenses	200,000	30,000	205,000	25,000
Utility expenses	250,000	25,000	240,000	35,000
Salaries (52,000 x 12)	624,000	48,000	600,000	72,000
Other misc. expenses	100,000	15,000	107,000	8,000
	1,174,000	118,000	1,152,000	140,000

► Example 29:

Rahil runs a retail business. He appointed a cashier at a monthly salary of Rs. 13,000 on 1 April 2016. The cashier did not report for work on 1 July 2016 and it was found that he had left, taking with him the balance in the till.

It had been Rahil's practice to deposit on each weekend the available balance in the till after retaining a float of Rs.5,000. He maintains record of sales on credit and a file of unpaid invoices in respect of goods purchased by him.

The following information has been ascertained from the available records:

- i. Balance Sheet as on 31 March 2016 was as follows:

	Rupees		Rupees
Rahil's capital	233,000	Fixtures and fittings -WDV	161,000
Creditors for goods	159,000	Inventory	111,000
Creditors for expenses	16,000	Debtors	55,000
		Cash at bank	76,000
		Cash in hand	5,000
	408,000		408,000

- ii. Following is a summary of the bank statement from 1 April to 30 June 2016:

	Rupees		Rupees
Balance on 1 April 2016	76,000	Payment to suppliers for goods	604,000
Cheques received from customers	29,000	Rent & other expenses	37,000
Cash deposited	627,000	Balance on 30 June 2016	91,000
	732,000		732,000

iii. The following amounts were paid from the till:

	Rs. per month
Salary to cashier	13,000
Rahil's drawings	26,000
Petty expenses	5,000

iv. Fixtures and fittings are depreciated at 10% per annum using reducing balance method.

v. Inventory on 1 July 2016 was Rs. 58,000.

vi. Credit sales during the quarter ended 30 June 2016 amounted to Rs.64,000 whereas the debtors balances as on 30 June 2016 amounted to Rs.66,000. However, direct confirmations from debtors showed that receivables in fact totalled Rs.54,000.

vii. Creditors for goods and expenses had always been paid by cheque. Unpaid invoices for goods on 30 June 2016 totalled Rs.181,000 and creditors for expenses amounted to Rs.13,000. Detailed scrutiny of records revealed that a cash receipt of Rs.8,000 which had been received against goods returned to a supplier had not been recorded.

viii. Rahil sells goods at a gross profit margin of 20% on sales.

Required:

a) Prepare a statement showing calculation of the amount of defalcation.

b) Prepare a balance sheet as on 30 June 2016.

► **Answer:**

Part (a)

Statement of amount of defalcation	Rs.
Debtors balance short W1	12,000
Cash against purchase return W2	8,000
Cash missing from till W3	44,750
TOTAL	64,750

Part (b)

Balance Sheet of Rahil

As on 30 June 2016

Liabilities	Rupees	Assets	Rupees
Sundry creditors	181,000	Fixtures and fittings (net)	156,975
Expenses owing	13,000		
<i>Capital:</i>			
Balance on 1 April 2016	233,000		
Add: Net profit W4	10,975	Stock in trade	58,000
Less: Drawings	(78,000)	Sundry debtors	54,000
	165,975	Balance at bank	91,000
	359,975		359,975

W1 Debtors

	Rupees		Rupees
b/d	55,000	Bank (Cheques received)	29,000
Credit sales 3 months	64,000	Cash (bal.)	24,000
		Short 66,000 – 54,000	12,000
		c/d	54,000
	119,000		119,000

W2 Creditors

	Rupees		Rupees
Purchase return	8,000	b/d	159,000
Bank	604,000	Cash against return	8,000
c/d	181,000	Purchases (bal.)	626,000
	793,000		793,000

W3 Cash

	Rupees		Rupees
b/d	5,000	Bank	627,000
Debtors W1	24,000	Salary 13,000 x 3 month	39,000
Cash sales (note)	774,750	Drawings 26,000 x 3	78,000
		Petty expenses 5,000 x 3	15,000
		Loss	44,750
	803,750		803,750

Note: Total sales 838,750 **W4** – 64,000 credit sales = Rs. 774,750 cash sales

W4 Net Profit for 3 months	Rs.	%
Sales	838,750	100%
<u>Cost of sales</u>		
Opening inventory	111,000	
Purchases 626,000 – 8,000 returns	618,000	
Closing inventory	(58,000)	
	(671,000)	80%
Gross Profit	167,750	20%
Depreciation 161,000 x 10% x 3/12	(4,025)	
Salary	(39,000)	
Petty expenses 16,000 opening - 15,000 paid – 13,000 closing	(12,000)	
Rent and other expenses	(37,000)	
Loss due to defalcation	(64,750)	
	10,975	

► *Example 30:*

Saleem is the owner of S-Mart, a grocery store. His accountant resigned and left on 1 January 2017. Saleem suspects that the previous accountant was involved in some sort of misappropriation. The information available with him is as follows:

- i. Summary of bank statement:

Receipts	Rupees	Payments	Rupees
Balance as at 1 Jan 2016	250,000	Suppliers	1,807,500
Cheques from debtors	824,000	Salaries	48,000
Cash sales	1,450,000	Rent	72,000
Sale of vehicle on 1 Jan 2016	15,000	Utilities	36,000
		Other expenses	24,750
		New vehicle on 1 Mar 2016	230,000
		Balance as at 31 Dec 2016	320,750
	2,539,000		2,539,000

- ii. Other balances extracted from the records maintained by the previous accountant:

Particulars	31-Dec-2016	31-Dec-2015
	----- Rupees -----	
Furniture and fixtures – WDV	555,000	550,000
Equipment – WDV	64,000	80,000
Vehicle – WDV	210,000	18,500
Inventory	215,000	250,000
Debtors	340,000	260,000
Advance rent	-	3,000
Cash in hand	31,510	45,000
Creditors	354,500	100,000
Salaries payable	22,000	18,000

- iii. Before depositing the receipts from cash sales in the bank, Saleem took Rs. 12,000 per month for personal use. All other payments were made through bank and the debtors settled their accounts through cheques.
- iv. The creditors have confirmed the balances due from them. However review of the statement provided by one of the creditors indicates that goods returned for cash amounting to Rs. 24,000 were not recorded in the books.
- v. Unpaid invoice for furniture purchased during the year for Rs. 45,000 is included in creditors.
- vi. The margin on cash sales and credit sales is 20% and 25% respectively. From 1 July 2016, prices to cash customers were further reduced by 6% due to which quantity sold against cash in the 2nd half of the year increased by 25% as compared to the first half of the year.
- vii. All the debtors confirmed their balances except an amount of Rs. 50,000. On investigation it was found that the related goods had been issued against fake invoices.

Required:

- a) Determine the amount of suspected fraud.
- b) Prepare statement of profit or loss for the year ended 31 December 2016.

► Answer:

Part (a)

Loss due to defalcation	Rs.
Cash embezzled through purchase returns (iv)	24,000
Stock embezzled through fake debtors (vii) $50,000 \times 75 / 100$	37,500
Difference in cash W1	50,740
	112,240

Part (b)

Statement of profit or loss	Rs.
Sales W5	2,485,250
<u>Cost of sales</u>	
Opening inventory	250,000
Purchases 1,979,500 W3 – 24,000 return (iv)	1,955,500
Closing inventory	(215,000)
	(1,990,500)
Gross profit	494,750
<u>Expenses</u>	
Rent expenses 72,000 + 3,000	75,000
Utilities	36,000
Other expenses	24,750
Loss on sale of vehicle 18,500 NBV – 15,000 sale proceeds	3,500
Salaries expenses 48,000 – 18,000 + 22,000	52,000
Depreciation – Furniture 550,000 + 45,000 – 555,000	40,000
Depreciation – Equipment 80,000 – 64,000	16,000
Depreciation – Vehicle 230,000 – 210,000	20,000
Loss due to defalcation (part a)	112,240
	(379,490)
	115,260

W1 Cash Account			
Particulars	Rs.	Particulars	Rs.
b/d	45,000	Drawings 12,000 x 12 (iii)	144,000
Sales (on cash) W5	1,631,250	Bank	1,450,000
		Difference	50,740
		c/d	31,510
	1,676,250		1,676,250

W2 Payables			
Particulars	Rs.	Particulars	Rs.
Bank	1,807,500	b/d	100,000
Purchase return	24,000	Cash for return	24,000
c/d 354,500 – 45,000 furniture (v)	309,500	Purchases	2,017,000
	2,141,000		2,141,000

W3 Purchases			
Particulars	Rs.	Particulars	Rs.
Payables W2	2,017,000	Stock embezzled – Fake RA	37,500
		Transfer to COS/SPL	1,979,500
	2,017,000		2,017,000

W4 Receivables			
Particulars	Rs.	Particulars	Rs.
b/d	260,000	Bank	824,000
Sales (credit)	854,000	c/d 340,000 – 50,000 (vii)	290,000

W5	Cash normal Qty = x		Cash discounted Qty = 1.25x		Credit		Total
Sales	750,000	100	881,250	94	854,000 W4	100	2,485,250
COS	(600,000) (bal.)	80	(750,000) (bal.)	80	(640,500)	75	(1,990,500)
Profit	150,000	20	131,250	14	213,500	25	494,750

► **Example 31:**

Friday Traders (FT) is engaged in the business of supplying Blenders and Juicers. FT purchases its products from Sigma Electronics. FT is presently negotiating with a bank for a long term loan and has been asked to provide the latest financial statements. Since FT does not maintain proper accounting records, you are requested to prepare the financial statements from the following information:

- i. Assets and liabilities as on 1 January 2018:

	Rs. in '000
Equipment (40% depreciated)	2,490
Stock (stock value of Blenders was double of the Juicers)	3,705
Prepaid rent up to 30 April 2018	280
Trade debtors (only for Blenders)	1,410
Payable to Sigma Electronics	3,600
Salaries payable	98
Bank overdraft	740

- ii. Sales of Blenders are made on credit while Juicers are sold on cash basis.
- iii. Upto last year, FT was earning a gross profit of 30% on cost of Blenders and 35% on sale value of Juicers. With effect from 1 January 2018:
 - FT increased sales prices of both the products by 20%; and
 - Sigma Electronics increased the prices of Juicers only by 40%.
- iv. 60% of the amount of purchases made during the year represents blenders.
- v. Summary of bank transactions during the year:

	Rs. in '000
Receipts from credit customers	6,570
Payments:	
Sigma Electronics	8,850
Insurance for one year starting 1 February 2018	204
Rent	826
Equipment	550
Salaries and wages	685
	11,115

- vi. Debtors amounting to Rs. 138,000 are considered as irrecoverable.
- vii. Rent of the premises was increased by 30% with effect from 1 September 2018.
- viii. Following payments were made from cash sales and remaining amounts were deposited into the bank:

	Rs. in '000
Repairs and maintenance	186
Salaries and wages	124
Drawings	477
	787

- ix. Equipment is depreciated at 8% on cost.
- x. Some balances ascertained as at 31 December 2018:

	Rs. in '000
Stock* – Juicers	975
– Blenders	2,597
Payable to Sigma Electronics	2,420
Salaries payable	134

****Comprises of stock purchased in 2018***

Required:

- a) Prepare statement of profit or loss account for the year ended 31 December 2018.
- b) Prepare statement of financial position as at 31 December 2018.

► Answer:

Part (a)**Statement of profit or loss for the year ended 31 December 2018**

		Juicers	Blenders
		Rs. 000	Rs. 000
Sales			
Credit sales – Blenders	$4,475 \times 156 \div 100$ (W1)		6,981
Cash sales – Juicers	Opening stock: $1,235 \times 120 \div 65$ (W1)	2,280	
	Rem.: $(3,328 - 1,235) \times 120 \div 91$ (W1)	2,760	
		5,040	6,981
Cost of goods sold:			
Opening stock		1,235	2,470
Purchases	7,670 (W3) in 40:60	3,068	4,602
Closing stock		(975)	(2,597)
		(3,328)	(4,475)
Gross profit		1,712	2,506
Total gross profit			4,218
Operating expenses:			
Insurance	$204 \times 11 \div 12$		187
Rent	$(70 \times 8) + (91 \times 4)$		924
Repair			186
Bad debts written off			138
Salary	$(124 + 685) + (134 - 98)$		845
Depreciation – equipment	$(2,490 \div 0.6 \times 8\%) + (550 \times 8\%)$		376
			(2,656)
Net profit			1,562

W1: POLICIES

	Blenders		Juicers		
	Previous	Updated	Previous	Updated with sales	Updated with sales & cost
Sales	130	156 [130×1.2]	100	120 [100×1.2]	120
Cost	100	100	65	65	91 [65×1.4]
Profit	30	56	35	55	29

W2: Trade debtors (gross)			
	Rs. 000		Rs. 000
b/d	1,410	Receipts	6,570
Sales	6,981	Write off	138
		c/d (balancing)	1,683
	8,391		8,391

W3: Trade payables (Sigma Electronics)			
	Rs. 000		Rs. 000
Bank	8,850	b/d	3,600
c/d	2,420	Purchases (balancing)	7,670
	11,270		11,270

Part (b)

Statement of financial position as on 31 December 2018

		Rs. in '000
Assets		
Non-current assets		
Equipment	2,490+550-376	2,664
Current assets:		
Stock	975+2,597	3,572
Trade debtors	(W-2)	1,683
Prepaid rent	280+826-924	182
Prepaid insurance	204-187	17
		5,454
		8,118
Equity and liabilities:		
Opening capital	2,490+3,705+280+1,410-3,600-98-740	3,447
Net profit		1,562
Drawings		(477)
		4,532
Current liabilities		
Trade payables	(W-3)	2,420
Bank overdraft	(W-4)	1,032
Salary payable		134
		3,586
		8,118

W4: Bank			
	Rs. 000		Rs. 000
Receipt from debtors	6,570	b/d	740
Amount banked	4,253	Trade payable	8,850
[5,040 – 186 – 124 – 477]		Insurance	204
		Rent	826
		Equipment	550
c/d (balancing)	1,032	Salaries and wages	685
	11,855		11,855

► **Example 32:**

You have been appointed as accountant of Gandhara Enterprises (GE) to replace Nasim who was terminated on suspicion of fraud. Following information has been compiled for preparation of GE's financial statements for the year ended 30 June 2020:

- i. Summarised bank statement:

Receipts	Rs. 000	Payments	Rs. 000
Opening balance	600	Creditors	8,300
Cheques from debtors	7,420	Salaries	900
Cash	2,400	Repair and maintenance	450
Rent	980	Utilities	500
		Office furniture	150
		Drawings	640
		Closing balance	460
	11,400		11,400

- ii. Other balances worked out from the available records:

Particulars	30-Jun-2020	30-Jun-2019
	----- Rs. in '000 -----	
Fixed assets – WDV	3,400	3,460
Inventories	750	715
Goods in transit	140	-
Debtors	900	730
Unearned rent	300	450
Cash in hand	48	36
Creditors	895	690
Salaries payable	86	120

- iii. All debtors settle their accounts through cheques. All payments are made through cheques except for average monthly petty expenses of Rs. 25,000.

- iv. Cheques of Rs. 950,000 issued to creditors in the last week of June 2020 were presented in July 2020. Cheques from debtors amounting to Rs. 860,000 deposited on 30 June 2020 were cleared in July 2020.
- v. Goods are sold on cash and credit at cost plus 25% and 30% respectively.
- vi. Apart from misappropriating amounts from cash sales, the following matters were also noted in respect of Nasim's fraud:
 - Physical cash count revealed that cash in hand was Rs. 20,000.
 - Fixed assets having written down value of Rs. 65,000 were sold for Rs. 120,000 which was not recorded in the books.
 - Goods in transit represent goods purchased in May 2020. However, in actual there were no goods in transit.
 - Goods costing Rs. 130,000 appearing in the closing inventory sheets were not found physically.
 - All the debtors confirmed their balances except for an amount of Rs. 260,000. It was found that the related goods had been issued against fake invoices.

Required:

- a) Determine the amount of suspected fraud.
- b) Prepare GE's statement of profit or loss for the year ended 30 June 2020.

► **Answer:****Part (a)**

Amount of suspected fraud:		Rs. in '000
Difference in cash balance	48-20	28
Proceeds from sale of fixed assets	65+55	120
Fake credit sales invoices	260÷1.3	200
Fake goods in transit		140
Embezzlement through inventory	750-620	130
Cash defalcated from cash sales	(W-1)	763
		1,381

W1: Cash			
	Rs. 000		Rs. 000
b/d	36	Petty expenses 25 x 12	300
Cash Sales	3,475	Cash banked	2,400
		Cash shortage [48 - 20]	28
		Cash defalcated from cash sales (balancing)	763
		c/d	20
	3,511		3,511

Part (b) Gandhara Enterprises**Statement of profit or loss for the year ended 30 June 2020**

		Rs. 000
Sales – Credit	(W-2)	8,190
– Cash	$[9,080 - (8,190 \div 1.3)] \times 1.25$	3,475
		11,665
Cost of goods sold		
Opening inventory		715
Purchases	(W-3)	9,455
Goods in transit		(140)
Good issues against fake invoices	$260 \div 1.3$	(200)
Goods physically not found		(130)
Closing stock	$750 - 130$	(620)
Cost of sales		(9,080)
Gross profit		2,585
Operating expenses		
Salaries	$86 + 900 - 120$	866
Utilities		500
Repair and maintenance		450
Petty cash expenses	25×12	300
Depreciation	$3,460 + 150 - 3,400$	210
Loss due to defalcation	(a)	1,381
Total operating expenses		(3,707)
		(1,122)
Rent income	$980 + 450 - 300$	1,130
Gain on disposal of fixed assets	$120 - 65$	55
Net profit		63

W2: Debtors

	Rs. 000		Rs. 000
b/d	730	Bank	7,420
Credit sales (bal.)	8,190	Uncleared cheques	860
		c/d $[900 - 260]$	640
	<u>8,920</u>		<u>8,920</u>

W3: Creditors

	Rs. 000		Rs. 000
Bank	8,300	b/d	690
Unpresented cheques	950	Purchases (bal.)	9,455
c/d	895		
	<u>10,145</u>		<u>10,145</u>

1. OBJECTIVE BASED Q&A

1. Yusuf does not keep a full set of business records, but the following information is available for the month of June 2019.

	Rs. 000
Accounts receivable, 1 June 2019	800
Accounts receivable, 30 June 2019	550
Credit sales	6,800
Cash received from customer (credit)	6,730
Irrecoverable debt written off	40
General allowance for doubtful debts at 30 June 2019	100

Assuming no other transactions, how much discount was allowed to customers during the month?

- Rs. 240,000
 - Rs. 280,000
 - Rs. 340,000
 - Rs. 380,000
2. Many of the records of Ghalib have been destroyed by fire. The following information is available for the period under review.
- Sales totalled Rs. 480,000
 - Inventory at cost was opening Rs. 36,420, closing Rs. 40,680
 - Trade payables were opening Rs. 29,590, closing Rs. 33,875
- Gross profit for the period should represent a margin of 50%
- What was the total for the period of cash paid to suppliers?
- Rs. 239,975
 - Rs. 315,715
 - Rs. 319,975
 - Rs. 328,545
3. In the year to 31st April 2016, Abdullah's sales were Rs. 182,000. All of his sales were made at a mark-up of 30%. His opening inventory value was Rs. 11,800 and his closing inventory value was Rs. 9,700.

What was the value of Abdullah's purchases in the year to 31 April 2016?

- Rs. 125,300
- Rs. 137,900
- Rs. 140,000
- Rs. 142,100

4. The following information is relevant to the calculation of the sales figure for Arif, a sole trader who does not keep proper accounting records:

	Rs.
Opening accounts receivable	29,100
Cash received from credit customers and paid into the bank	381,600
Expenses paid out of cash received from credit customers before banking	6,800
Irrecoverable debts written off	7,200
Refunds to credit customers	2,100
Discounts allowed to credit customers	9,400
Cash sales	112,900
Closing accounts receivable	38,600

The figure which should appear in Arif's statement of comprehensive income for sales is:

- Rs. 525,300
 - Rs. 511,700
 - Rs. 529,500
 - Rs. 510,900
5. A sole trader who does not keep full accounting records wishes to calculate her sales revenue for the year.

The information available is:

		Rs.
1	Opening inventory	17,000
2	Closing inventory	24,000
3	Purchases	91,000
4	Standard gross profit percentage on sales revenue	40%

Which of the following is the sales figure for the year calculated from these figures?

- Rs. 117,600
 - Rs. 108,000
 - Rs. 210,000
 - Rs. 140,000
6. Salman is a sole proprietor whose accounting records are incomplete. All the sales are cash sales and during the year Rs. 50,000 was banked, including Rs. 5,000 from the sale of a business car. He paid Rs. 12,000 wages in cash from the till and withdrew Rs. 2,000 as drawings. The cash in the till at the beginning and end of the year was Rs. 300 and Rs. 400 respectively. There were no other payments in the month.

What were the sales for the year?

- Rs. 58,900
- Rs. 59,100
- Rs. 63,900
- Rs. 64,100

7. There is Rs. 100,000 in the cash till at the year-end at F Ltd, but the accountant has discovered that some cash has been stolen. At the beginning of the year there was Rs. 50,000 in the cash till and receivables were Rs. 2,000,000. Total sales in the year were Rs. 230,000,000. Accounts receivable at the end of the year were Rs. 3,000,000. Cheques banked from credit sales were Rs. 160,000,000 and cash sales of Rs. 50,000,000 have been banked.

How much cash was stolen during the year?

- a) Rs. 21,050,000
 - b) Rs. 18,950,000
 - c) Rs. 19,050,000
 - d) Rs. 50,000
8. A business operates on a gross margin of $33\frac{1}{4}\%$. Gross profit on a sale was Rs. 800,000 and expenses were Rs. 680,000.

The net profit percentage is

- a) 3.75%
 - b) 5%
 - c) 11.25%
 - d) 22.67%
9. A toyshop makes purchases of Rs. 20,248,000 and sales of Rs. 26,520,000. The proprietor's children take goods costing Rs. 486,000 without paying for them. Closing stock was valued at its cost of Rs. 2,240,000 and the gross margin achieved was a constant 30% on sales.

What was the cost of the opening stock?

- a) Rs. 556,000
 - b) Rs. 1,042,000
 - c) Rs. 2,392,000
 - d) Rs. 2,878,000
10. Which of the following calculations could produce an acceptable figure for a trader's net profit for a period if no accounting records had been kept?
- a) Closing net assets plus drawings minus capital introduced minus opening net assets
 - b) Closing net assets minus drawings plus capital introduced minus opening net assets
 - c) Closing net assets minus drawings minus capital introduced minus opening net assets
 - d) Closing net assets minus drawings plus capital introduced plus opening net assets

11. On 30 September 2018 part of the inventory of a company was completely destroyed by fire.

The following information is available:

Inventory at 1 September 2018 at cost	Rs. 49,800,000
Purchases for September 2018	Rs. 88,600,000
Sales for September 2018	Rs. 130,000,000
Inventory at 30 September 2018 undamaged items	Rs. 32,000,000
Standard gross profit percentage on sales	30%

Based on this information, what is the cost of the inventory destroyed?

- a) Rs. 17,800,000
- b) Rs. 47,400,000
- c) Rs. 15,400,000
- d) Rs. 6,400,000

12. Sarim does not keep full accounting records. His last accounts show that his capital balance was Rs. 42,890,000. At the year end, he calculated that his assets and liabilities were:

	Rs. 000
Non-current assets	41,700
Inventory	9,860
Receivables	7,695
Payables	4,194
Bank overdraft	5,537

On reviewing his calculations, you note that he did not include Rs. 258,000 of unpaid invoices for expenses.

What is the value of Sarim's closing capital?

- a) Rs. 49,266,000
- b) Rs. 49,544,000
- c) Rs. 60,360,000
- d) Rs. 60,876,000

13. During the year to 30th November 2015 Amna bought goods for resale at a cost of Rs. 75,550,000. Her inventory at 1st December 2014 was valued at Rs. 15,740,000. She did not count her inventory at 30th November 2015, but she knows that her sales for the year to 30th November 2015 were Rs. 91,800,000. All sales were made at a mark-up of 20%.

Based on the information above, what was the value of Amna's inventory at 31 November 2015?

- a) Rs. 13,630,000
- b) Rs. 14,790,000
- c) Rs. 16,690,000
- d) Rs. 17,850,000

14. On 1 September 2018, Waris had inventory of Rs. 380,000. During the month, sales totalled Rs. 650,000 and purchases Rs. 480,000. On 30 September 2018 a fire destroyed some of the inventory. The undamaged goods were valued at Rs. 220,000. The business operates with a standard gross profit margin of 30%.

Based on this information, what is the cost of the inventory destroyed in the fire?

- a) Rs. 185,000
- b) Rs. 140,000
- c) Rs. 405,000
- d) Rs. 360,000

15. You are given the following incomplete and incorrect extract from the Statement of comprehensive income of a company that trades at a markup of 25% on cost:

	Rs.	Rs.
Sales		174,258
Less: Cost of goods sold		
Opening inventory	12,274	
Purchases	136,527	
Closing inventory	X	
		(X)
Gross profit		X

Having discovered that the sales figure should have been Rs. 174,825 and the purchase returns of Rs. 1,084 and sales returns of Rs. 1,146 have been omitted, the closing inventory should be:

- Rs. 8,662
 - Rs. 8,774
 - Rs. 17,349
 - Rs. 17,458
16. Profit is Rs. 1,051,000. Capital introduced is Rs. 100,000. There is an increase in net assets of Rs. 733,000. What are drawings?
Rs. _____
17. The bookkeeper of Lego has disappeared. There is no cash in the till and theft is suspected. It is known that the cash balance at the beginning the year was Rs. 240,000. Since then, total sales have amounted to Rs. 41,250,000. Credit customers owed Rs. 2,100,000 at the beginning of the year and owe Rs. 875,000 now. Cheques banked from credit customers have totalled Rs. 2,429,000. Expenses paid from the till receipts amount to Rs. 180,500 and cash receipts of Rs. 9,300,000 have been lodged in the bank.
What is the amount that bookkeeper stole during the period?
Rs. _____
18. Taiwan Tyres does not keep full accounting records, but the following information is available in respect of accounting year ended 31st December 2018.

	Rs.
Cash purchases in year	3,900,000
Cash paid for goods supplied on credit	27,850,000
Payables at 1st January 2018	970,000
Payable at 31st December 2018	720,000

In the statement of comprehensive income for 2018, figure for purchases will be?

Rs. _____

19. Deen has been trading for some time, but he neglected to maintain full accounting. He is able to provide the following information.

He is owed Rs. 7,900 by his customers.

He has lodged Rs. 120,700 to his bank account since starting his business. This includes his initial capital of Rs. 22,000.

All his sales are made at cost plus 30%

The value of Deen's sale since he began trading is?

Rs. _____

20. The diesel fuel included in the inventory at 1 November 2017 was Rs. 12,500,000 and there were invoices wait for Rs. 1,700,000. During the year to 31 October 2018, diesel fuel bills of Rs. 85,400,000 were paid, and a delivery worth Rs. 1,300,000 had yet to be invoiced.

At 31 October 2018, the inventory of diesel fuel was valued at Rs. 9,800,000.

The diesel fuel to be charged to the Statement of comprehensive income for the year to 31 October 2018 is:

Rs. _____

21. In which of the following systems of recording the financial statements reflect true and fair view of an entity and accounting records are considered to be more accurate?

- a) Cash book system
- b) Single entry system
- c) Double entry system
- d) None of the above

22. Statement of financial position produced from incomplete accounting record is commonly known as

- a) Statement of financial position
- b) Statement of affairs
- c) Statement of net assets
- d) Statement of financial operations

23. Which of the following businesses usually maintain incomplete accounting record of the business activities?

- a) Large businesses
- b) Companies
- c) Partnership firms
- d) Small businesses

24. In single entry system, it is not possible to prepare,

- a) Statement of financial position
- b) Profit or loss account
- c) Trial balance from ledgers
- d) Receipt and payment account

25. The opening capital is ascertained by preparing:

- a) Cash book
- b) Creditors A/c
- c) Debtors A/c
- d) Opening statement of affairs

26. Identify the correct formula used to ascertain the closing balance of capital?
- Closing capital = Opening capital + Net profit – Expenses
 - Closing capital = Opening capital + Net profit + Drawings
 - Closing capital = Opening capital + Net profit – Drawings
 - Closing capital = Opening capital + Revenue – Expenses
27. Net profit is calculated by:
- Closing capital + Drawings - Fresh capital injected – Opening capital
 - Closing capital – Drawings + Fresh capital injected – Opening capital
 - Closing capital + Drawings + Fresh capital injected + Opening capital
 - None of the above
28. If opening capital = Rs.10 million and closing capital = Rs.20 million. Assuming no drawings during the accounting period, calculate the net profit or loss for the period?
- Net profit = Rs.20 million
 - Net loss = Rs.20 million
 - Net profit = Rs.10 million
 - Net loss = Rs.10 million
29. Which one of the following accounts is supposed to be used to get the figure of credit purchases made during the current accounting period?
- Debtor account
 - Creditor account
 - Revenue account
 - Expenses account
30. To obtain the amount of credit sales made during an accounting period, which account is generally used in single entry and incomplete records?
- Debtor account
 - Creditor account
 - Revenue account
 - Expenses account
31. If Plant (closing balance) = Rs. 8 million, Land (opening balance) = Rs. 5 million and Creditors (opening balance) = Rs. 1 million then opening capital balance is?
- Rs.3 million
 - Rs.4 million
 - Rs.5 million
 - Rs.8 million
32. Opening and closing debtors were Rs. 412,800 and Rs. 524,400 respectively. During the year Rs. 2,684,500 was received from sales after allowing a cash discount of Rs. 17,420. Debts of Rs. 34,840 were written off as bad during the year. Find out the credit sales during the year?
- Rs.2,778,680
 - Rs.2,813,520
 - Rs.2,848,360
 - Rs.2,753,670

33. Opening and closing creditors were Rs. 450,000 and Rs. 700,000 respectively. During the year, Rs. 3,400,000 was paid to suppliers. Find out the credit purchases during the year?
- a) Rs.3,150,000
 - b) Rs.3,400,000
 - c) Rs.3,650,000
 - d) None of the above
34. Staff salary payable for the month end was Rs. 74,540 and Rs. 96,720 as its opening balance. Salary paid during the period was Rs. 856,420. Find out the accrued salary during the period?
- a) Rs.834,240
 - b) Rs.856,420
 - c) Rs.861,540
 - d) Rs.878,600

ANSWERS

01.	(b)	Accounts receivables				
		Particulars	Rs. 000		Particulars	Rs. 000
		Bal. b/d	1,700		Bad debts	40
		Sales	6,800		Cash	6,730
					Discount (bal.)	280
					c/d	550
			7,600			7,600
02.	(a)	Accounts payable				
		Particulars	Rs.		Particulars	Rs.
		Cash (bal.)	239,975		b/d	29, 90
		c/d	33,875		Purchases	244,260
			237,850			237,850
		Inventory				
		Particulars	Rs.		Particulars	Rs.
		Bal. b/d	36,420		OS 480,000x0.5	240,000
		Purchases (bal.)	244,260		c/d	40,680
	280,680			280,680		
03.	(b)	Inventory				
		Particulars	Rs.		Particulars	Rs.
		Bal. b/d	11,800		COS 182,000/130x100	140,000
		Purchases (bal.)	137,900		c/d	9,700
			1 9,700			149,700
04.	(a)	Total sales = Rs. 112,900 + Rs. 412,400 = 525,300				
		Accounts receivables				
		Particulars	Rs.		Particulars	Rs.
		Bal. b/d	29,100		Bad debts	7,200
		Sales (bal.)	412,400		Cash 381,600+6,800	388,400
		Refunds	2,100			
					Discount allowed	9,400
					c/d	38,600
			443,600			443,6 0

05.	(d)	Cost of sales = 17,000 + 91,000 – 24,000 = 84,000 Sales = 84,000/60 x 100 = Rs. 140,000				
06.	(b)	Sales = 64,100 – 5,000 = 59,100				
		Cash a/c				
		Particulars	Rs.		Particulars	Rs.
		Bal. b/d	300		Bank	50,000
		Cash from sales	64,100		Wages	12,000
					Drawings	2,000
					c/d	400
			64,400			64,400
07.	(b)	Accounts receivables				
		Particulars	Rs.		Particulars	Rs.
		Bal. b/d	2,000,000		Cash	179,000,000
		Sales +230,000,000-50,000,000	180,000,000		c/d	3,000,000
			182,000,000			182,000,000
		Cash a/c				
		Particulars	Rs.		Particulars	Rs.
		Bal. b/d	50,000		Bank 160,000,000+50,000,000	210,000,000
Cash sales	50,000,000		Cash stolen	18,950,000		
Receivables	179,000,000		c/d	100,000		
	229,050,000			229,050,000		
08.	(b)	Sales = 800,000 /33.25 x 100 = 2,406,015 Net profit = 800,000 – 680,000 = 120,000 Net profit % = 120,000/2,406,015 x 100 = 5%				
09.	(b)	Inventory				
		Particulars	Rs.		Particulars	Rs.
		Bal. b/d (bal.)	1,042,000		COS 26,520,000x0.7	18,564,000
		Purchases	20,248,000		Drawings	486,000
					c/d	2,240,000
			21,290,000			21,290,000
10.	(a)	Profit = Closing net assets + drawings – capital introduced - opening net assets				

11.	(c)	<table><tr><th colspan="4">Inventory</th></tr><tr><th>Particulars</th><th>Rs. 000</th><th></th><th>Particulars</th><th>Rs. 000</th></tr><tr><td>Bal. b/d</td><td>49,800</td><td></td><td>COS 130,000x70%</td><td>91,000</td></tr><tr><td>Purchases</td><td>88,600</td><td></td><td>Destroyed (bal.)</td><td>15,400</td></tr><tr><td></td><td></td><td></td><td>c/d</td><td>32,000</td></tr><tr><td></td><td>138,400</td><td></td><td></td><td>138,400</td></tr></table>	Inventory				Particulars	Rs. 000		Particulars	Rs. 000	Bal. b/d	49,800		COS 130,000x70%	91,000	Purchases	88,600		Destroyed (bal.)	15,400				c/d	32,000		138,400			138,400
Inventory																															
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12.	(a)	<table><tr><th colspan="2"></th><th>Rs. 000</th></tr><tr><td colspan="2">Non-current assets</td><td>41,700</td></tr><tr><td colspan="2">Inventory</td><td>9,860</td></tr><tr><td colspan="2">Receivables</td><td>7,695</td></tr><tr><td colspan="2">Payables</td><td>(4,194)</td></tr><tr><td colspan="2">Bank overdraft</td><td>(5,537)</td></tr><tr><td colspan="2">Expense payable</td><td>(258)</td></tr><tr><td colspan="2"></td><td>49,266</td></tr></table>			Rs. 000	Non-current assets		41,700	Inventory		9,860	Receivables		7,695	Payables		(4,194)	Bank overdraft		(5,537)	Expense payable		(258)			49,266					
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13.	(b)	<table><tr><th colspan="4">Inventory</th></tr><tr><th>Particulars</th><th>Rs. 000</th><th></th><th>Particulars</th><th>Rs. 000</th></tr><tr><td>Bal. b/d</td><td>15,740</td><td></td><td>COS 91,800/120x100</td><td>76,500</td></tr><tr><td>Purchases</td><td>75,550</td><td></td><td>c/d (bal.)</td><td>14,790</td></tr><tr><td></td><td>91,290</td><td></td><td></td><td>91,290</td></tr></table>	Inventory				Particulars	Rs. 000		Particulars	Rs. 000	Bal. b/d	15,740		COS 91,800/120x100	76,500	Purchases	75,550		c/d (bal.)	14,790		91,290			91,290					
Inventory																															
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Purchases	480,000		Lost by fire (bal.)	185,000																											
			c/d	220,000																											
15.	(b)	<table><tr><th></th><th>Rs.</th><th>Rs.</th></tr><tr><td>Sales 174,825 – 1,146</td><td></td><td>173,679</td></tr><tr><td>Less: Cost of goods sold</td><td></td><td></td></tr><tr><td>Opening inventory</td><td>12,274</td><td></td></tr><tr><td>Purchases 136,527 - 1,084</td><td>135,443</td><td></td></tr><tr><td>Closing inventory (bal.)</td><td>(8,774)</td><td></td></tr><tr><td>Cost of sales (bal.)</td><td></td><td>138,943</td></tr><tr><td>Gross profit 173,679 /125 x 25</td><td></td><td>34,736</td></tr></table>		Rs.	Rs.	Sales 174,825 – 1,146		173,679	Less: Cost of goods sold			Opening inventory	12,274		Purchases 136,527 - 1,084	135,443		Closing inventory (bal.)	(8,774)		Cost of sales (bal.)		138,943	Gross profit 173,679 /125 x 25		34,736					
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16.	Rs. 418,000	Drawings = Opening capital + Profit + capital introduced – Closing capital =1,051,000+100,000- 733,000 = Rs. 418,000																													

17.	Rs. 6,515,500	<table><tr><th colspan="4">Cash a/c</th></tr><tr><th>Particulars</th><th>Rs.</th><th></th><th>Particulars</th><th>Rs.</th></tr><tr><td>Bal. b/d</td><td>240,000</td><td></td><td>Bank 9,300,000 + 2,429,000</td><td>11,729,000</td></tr><tr><td>Cash sales</td><td>9,300,000</td><td></td><td>Expenses</td><td>180,500</td></tr><tr><td>Receivables</td><td>8,885,000</td><td></td><td>Cash stolen (bal.)</td><td>6,515,500</td></tr><tr><td></td><td>18,425,000</td><td></td><td></td><td>18,425,000</td></tr></table> <table><tr><th colspan="4">Accounts receivables</th></tr><tr><th>Particulars</th><th>Rs.</th><th></th><th>Particulars</th><th>Rs.</th></tr><tr><td>Bal. b/d</td><td>2,100,000</td><td></td><td>Cash (bal.)</td><td>8,885,000</td></tr><tr><td></td><td></td><td></td><td>Bank</td><td>24,290,000</td></tr><tr><td>Sales 41,250,000- 9,300,000</td><td>31,950,000</td><td></td><td>c/d</td><td>875,000</td></tr><tr><td></td><td>34,050,000</td><td></td><td></td><td>34,050,000</td></tr></table>	Cash a/c				Particulars	Rs.		Particulars	Rs.	Bal. b/d	240,000		Bank 9,300,000 + 2,429,000	11,729,000	Cash sales	9,300,000		Expenses	180,500	Receivables	8,885,000		Cash stolen (bal.)	6,515,500		18,425,000			18,425,000	Accounts receivables				Particulars	Rs.		Particulars	Rs.	Bal. b/d	2,100,000		Cash (bal.)	8,885,000				Bank	24,290,000	Sales 41,250,000- 9,300,000	31,950,000		c/d	875,000		34,050,000			34,050,000
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18.	Rs. 31.5 million	Purchases = 27,600,000+3,900,000 = Rs. 31,500,000 <table><tr><th colspan="4">Accounts payable</th></tr><tr><th>Particulars</th><th>Rs.</th><th></th><th>Particulars</th><th>Rs.</th></tr><tr><td>Cash</td><td>27,850,000</td><td></td><td>b/d</td><td>970,000</td></tr><tr><td>c/d</td><td>720,000</td><td></td><td>Purchases</td><td>27,600,000</td></tr><tr><td></td><td>28,570,000</td><td></td><td></td><td>28,570,000</td></tr></table>	Accounts payable				Particulars	Rs.		Particulars	Rs.	Cash	27,850,000		b/d	970,000	c/d	720,000		Purchases	27,600,000		28,570,000			28,570,000																																		
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20.	Rs. 87.7 million	<table><tr><th colspan="4">Diesel Fuel</th></tr><tr><th>Particulars</th><th>Rs.</th><th></th><th>Particulars</th><th>Rs.</th></tr><tr><td>b/d</td><td>12,500,000</td><td></td><td>b/d</td><td>1,700,000</td></tr><tr><td>Cash</td><td>85,400,000</td><td></td><td>PL</td><td>87,700,000</td></tr><tr><td>c/d</td><td>1,300,000</td><td></td><td>c/d</td><td>9,800,000</td></tr><tr><td></td><td>99,200,000</td><td></td><td></td><td>99,200,000</td></tr></table>	Diesel Fuel				Particulars	Rs.		Particulars	Rs.	b/d	12,500,000		b/d	1,700,000	Cash	85,400,000		PL	87,700,000	c/d	1,300,000		c/d	9,800,000		99,200,000			99,200,000																													
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21.	(c)	Double entry system																																																										
22.	(b)	Statement of affairs																																																										
23.	(d)	Small businesses																																																										

24.	(c)	Trial balance from ledgers																																					
25.	(d)	Opening statement of affairs																																					
26.	(c)	Closing capital = Opening capital + Net profit – Drawings																																					
27.	(a)	Closing capital + Drawings - Fresh capital injected – Opening capital																																					
28.	(c)	Profit (loss) = Increase (decrease) in capital = Rs. 20m – 10m = Rs. 10m profit																																					
29.	(b)	Creditor account																																					
30.	(a)	Debtor account																																					
31.	(b)	Rs. 5m – Rs. 1m = Rs. 4m																																					
32.	(c)	<table><tr><th colspan="4">Receivables</th></tr><tr><th>Particulars</th><th>Rs.</th><th></th><th>Particulars</th><th>Rs.</th></tr><tr><td>b/d</td><td>412,800</td><td></td><td>Cash</td><td>2,684,500</td></tr><tr><td>Sales</td><td>2,848,360</td><td></td><td>Discount allowed</td><td>17,420</td></tr><tr><td></td><td></td><td></td><td>Bad debts</td><td>34,840</td></tr><tr><td></td><td></td><td></td><td>c/d</td><td>524,400</td></tr><tr><td></td><td>3,261,160</td><td></td><td></td><td>3,261,160</td></tr></table>				Receivables				Particulars	Rs.		Particulars	Rs.	b/d	412,800		Cash	2,684,500	Sales	2,848,360		Discount allowed	17,420				Bad debts	34,840				c/d	524,400		3,261,160			3,261,160
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	4,100,000			4,100,000																																			
34.	(a)	<table><tr><th colspan="4">Salaries</th></tr><tr><th>Particulars</th><th>Rs.</th><th></th><th>Particulars</th><th>Rs.</th></tr><tr><td>Cash</td><td>856,420</td><td></td><td>b/d</td><td>96,720</td></tr><tr><td>c/d</td><td>74,540</td><td></td><td>PL</td><td>834,240</td></tr><tr><td></td><td>930,960</td><td></td><td></td><td>930,960</td></tr></table>				Salaries				Particulars	Rs.		Particulars	Rs.	Cash	856,420		b/d	96,720	c/d	74,540		PL	834,240		930,960			930,960										
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	930,960			930,960																																			

STICKY NOTES

PREPARING LEDGER ACCOUNTS FOR MISSING INFORMATION

Ledger account	Key points																								
Receivables	Mostly used where credit sales or total sales are to be determined unless the same can be calculated using mark-up/margin equations. It is important to consider impact of bad debts information carefully.																								
Payables	Mostly used where credit purchases or total purchases are to be determined unless the same can be calculated using mark-up/margin and cost of sales equations																								
Expenses	The following memorandum expense account based on concepts of accrual and prepayments is useful: <table><tr><th colspan="4">EXPENSES</th></tr><tr><th>Particulars</th><th>Rs.</th><th>Particulars</th><th>Rs.</th></tr><tr><td>b/d (prepaid)</td><td>XX</td><td>b/d (payable)</td><td>XX</td></tr><tr><td>Cash paid</td><td>XX</td><td>Expense (balancing)</td><td>XX</td></tr><tr><td>c/d (payable)</td><td>XX</td><td>c/d (prepaid)</td><td>XX</td></tr><tr><td></td><td>XX</td><td></td><td>XX</td></tr></table>	EXPENSES				Particulars	Rs.	Particulars	Rs.	b/d (prepaid)	XX	b/d (payable)	XX	Cash paid	XX	Expense (balancing)	XX	c/d (payable)	XX	c/d (prepaid)	XX		XX		XX
EXPENSES																									
Particulars	Rs.	Particulars	Rs.																						
b/d (prepaid)	XX	b/d (payable)	XX																						
Cash paid	XX	Expense (balancing)	XX																						
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	XX		XX																						
Income	The following memorandum income account based on concepts of accrual and prepayments is useful: <table><tr><th colspan="4">INCOME</th></tr><tr><th>Particulars</th><th>Rs.</th><th>Particulars</th><th>Rs.</th></tr><tr><td>b/d (receivable)</td><td>XX</td><td>b/d (advance)</td><td>XX</td></tr><tr><td>Income (balancing)</td><td>XX</td><td>Cash received</td><td>XX</td></tr><tr><td>c/d (advance)</td><td>XX</td><td>c/d (receivable)</td><td>XX</td></tr><tr><td></td><td>XX</td><td></td><td>XX</td></tr></table>	INCOME				Particulars	Rs.	Particulars	Rs.	b/d (receivable)	XX	b/d (advance)	XX	Income (balancing)	XX	Cash received	XX	c/d (advance)	XX	c/d (receivable)	XX		XX		XX
INCOME																									
Particulars	Rs.	Particulars	Rs.																						
b/d (receivable)	XX	b/d (advance)	XX																						
Income (balancing)	XX	Cash received	XX																						
c/d (advance)	XX	c/d (receivable)	XX																						
	XX		XX																						
Cash/Bank account	This account is relevant: - To find missing figure of any specific payment or receipt - To find opening or closing balance of cash or bank																								
Bank reconciliation	If bank statement information is given, it may be necessary to prepare reconciliation to determine cash at bank figure.																								

USING EQUATIONS FOR MISSING INFORMATION

Equation	Details
Accounting equation	This is often used to calculate opening equity. $\text{Equity} = \text{Total assets} - \text{Total liabilities}$ Opening statement of financial position prepared on the basis of estimated values is often called “statement of affairs” of the entity.
Business equation	This represents movement in equity. $\text{Closing equity} = \text{Opening equity} + \text{Capital invested} + \text{Profit} - \text{Drawings}$
Cost of sales	$\text{Cost of sales} = \text{Opening inventory} + \text{Purchases (net)} - \text{Closing inventory}$
Property, plant & equipment	Net book value (opening) = NBV at end $\times$ 100 / (100 – Dep%) Depreciation = NBV at end $\times$ Dep% / (100 – Dep%)

MARK UP AND MARGIN PERCENTAGES

Type	Details	
Mark up	Markup is the percentage increase in price above the cost of product. Sometimes, this is incorrectly referred to as margin on cost.	
	$\text{Cost} = \text{Sales} \times \frac{100}{100 + \text{markup}}$	$\text{Sales} = \text{Cost} \times \frac{100 + \text{markup}}{100}$
Margin	Margin is the percentage of profit on the selling price. Sometimes, this is incorrectly referred to as mark-up on selling price.	
	$\text{Cost} = \text{Sales} \times \frac{100 - \text{margin}}{100}$	$\text{Sales} = \text{Cost} \times \frac{100}{100 - \text{margin}}$

AT A GLANCE

SPOTLIGHT

STICKY NOTES

ACCOUNTING FOR NPOs

IN THIS CHAPTER:

AT A GLANCE

SPOTLIGHT

1. Not for profit organisations
2. Income of NPOs
3. Inventories and non-current assets
4. Preparation of financial statements
5. Comprehensive Examples
6. Objective Based Q&A

STICKY NOTES

AT A GLANCE

Not-for-Profit Organisations (NPOs) do not operate with a profit motive. However, they are also required to keep proper records of incomes, expenses, assets, and liabilities to provide relevant information to stakeholders.

The major sources of income of an NPO is donations / contributions, subscriptions, fee for services, government funding, grants, etc. The revenue expenditures related to NPOs are quite similar to profit-oriented organisations e.g. salaries, rent, electricity, repair, maintenance and depreciation etc. These revenue items are presented in the statement of income and expenditure to determine the surplus or deficit for the period.

The statement of financial position is also quite similar to as those of profit-oriented organisations reflecting non-current assets, current assets, non-current liabilities and current liabilities. However, net assets (i.e. equity) is presented using fund accounting instead of share capital and reserves.

Some small NPOs only maintain record of receipt and payments prepared on cash basis and includes both capital items and revenue items for a period. Using additional information and receipt and payment account, amounts for accrual based financial statements may be calculated or estimated.

As NPOs operations and objectives differ significantly from profit-oriented entities, ICAP has issued 'Accounting Standard for NPOs' to prescribe the detailed accounting guidance for general and specific issues relevant to NPOs. This standard is compulsory for NPOs registered as companies as per SECP directives and is recommended to be applied by other NPOs as well to provide relevant and reliable information to donors and other stakeholders of NPOs.

The Accounting standard for NPOs requires use of fund accounting and provides detailed guidance on revenue recognition of contributions received or receivable by an NPO.

1 NOT FOR PROFIT ORGANISATIONS

1.1 Introduction [ASNPO: 1.1]

Not-for-Profit Organisations (NPOs) are organisations, normally without transferable ownership interests, organized and operated exclusively for social, educational, professional, religious, health, charitable or any other not-for-profit purpose. An NPO's members, contributors and other resource providers do not, in such capacity, receive any financial return or dividends directly from the NPO.

NPOs may be:

- companies formed under Section 42 of Companies Act, 2017;
- trusts formed under Trust Act, 1882;
- societies formed under the Societies Registration Act, 1860; or
- any other recognisable form of organisation giving value to the groups of people they administer to.

The primary objective of a profit-oriented entity is to make profit and maximise shareholders' wealth while main objective of NPO is to provide its services effectively by achieving value for money. NPO applies or intends to apply its profits (commonly referred to as surplus), if any, or other income in promoting its objects, and prohibits the distribution of surplus to its members, sponsors, promoters, etc.

NPOs have income which they raise and costs which must be paid just like other organisations and although profit is not their objective but they have to account for their income and costs. NPOs are accountable for their effectiveness, economy and efficiency in utilising the funds.

Revenues of NPOs normally arise from donations, government grants and amount collected through contributions, membership fees, fundraising, the sale of goods, the rendering of services or the use by others of NPO resources yielding rent, interest, royalties or dividends.

Some accounting rules are as relevant to NPOs as to profit-oriented entities, for example, requirements relating to inventory, non-current assets and recognition of revenue. However, some areas might be completely irrelevant, for example, earnings per share.

1.2 Different terminology

NPOs use different accounting and business terminology from profit-oriented entities.

Profit-oriented entities	Not-for-Profit Organisations
Statement of comprehensive income	Statement of income and expenditure
Net profit	Excess of income over expenditure / Surplus
Net loss	Excess of expenditure over income / Deficit
Equity / Share capital and equity reserves	Net assets / Accumulated fund / Accumulated surplus / Accumulated deficit / Fund balance
Statement of changes in equity	Statement of changes in net assets
Specific reserve	Restricted contribution / grant
Fee	Subscription
Owners / Shareholders	Trustees/ sponsors / donors

1.3 Accounting Standard for Not-for Profit Organisations [ASNPO: 1.3 & 1.4]

The Institute of Chartered Accountants of Pakistan (ICAP) issued the 'Accounting Standard for Not-for-Profit Organisations' (hereinafter referred to as 'ASNPO') and as per Securities and Exchange Commission of Pakistan's (SECP) directives, ASNPO is applicable to associations not-for-profit registered under the company law (e.g. Companies Act, 2017).

ASNPO is applicable to NPOs registered under the company law i.e. it is compulsory for such NPOs to comply with requirements of ASNPO in addition to the requirements of applicable reporting framework e.g. IFRSs. In case any requirement of ASNPO is/are inconsistent, the requirements of IFRSs shall prevail.

NPOs, other than companies, are also recommended to prepare financial statements in accordance with ASNPO.

1.4 Measurement [ASNPO: 2.47 & 2.48]

Financial statements of NPOs are prepared primarily using the historical cost basis of measurement whereby transactions and events are recognised in financial statements at the amount of cash or cash equivalents paid or received or the fair value ascribed to them when they took place.

Financial statements are prepared with capital maintenance measured in financial terms and with no adjustment being made for the effect on capital of a change in the general purchasing power of the currency during the period.

1.5 Fund accounting [ASNPO: Definitions, 4.3, 4.16 & 4.19]

Fund accounting comprises the collective accounting procedures resulting in a self-balancing set of accounts for each fund established by legal, contractual or voluntary actions of an NPO. Elements of a fund can include assets, liabilities, net assets, revenues and expenses (and gains and losses, where appropriate). Fund accounting involves an accounting segregation, although not necessarily a physical segregation, of resources.

Net assets or fund balances may be internally or externally restricted. Internally restricted net assets or fund balances are often referred to as reserves or appropriations.

Restrictions are stipulations imposed that specify how resources must be used. External restrictions are imposed from outside the NPO, usually by the contributor of the resources. Internal restrictions are imposed in a formal manner by the NPO itself, usually by resolution of the board of directors/council/board of trustees.

An NPO that uses fund accounting in its financial statements should provide a brief description of the purpose of each fund reported. There are two methods of fund accounting, deferral method (discussed later in this chapter) and restricted fund method (not examinable). In practice, most companies use deferral method.

The funds can be classified into following three categories:

Endowment fund	An endowment fund is a self-balancing set of accounts which reports the accumulation of endowment contributions. Only endowment contributions and investment income subject to restrictions stipulating that it be added to the principal amount of the endowment fund would be reported as revenue of the endowment fund. Allocations of resources to the endowment fund that result from the imposition of internal restrictions are recorded as inter-fund transfers.
Restricted fund	A restricted fund is a self-balancing set of accounts the elements of which are restricted or relate to the use of restricted resources. Only restricted contributions, other than endowment contributions, and other externally restricted revenue would be reported as revenue in a restricted fund. Allocations of resources that result from the imposition of internal restrictions are recorded as inter-fund transfers to the restricted fund.
General fund / unrestricted fund	A general fund is a self-balancing set of accounts which reports all unrestricted revenue and restricted contributions for which no corresponding restricted fund is presented. The fund balance represents net assets that are not subject to externally imposed restrictions.

► *Example 01:*

Consider the following independent circumstances:

- a) A professional body of accountants (the NPO) sets-up a fund for financial support of deserving students. For this purpose, Rs. 100 million have been allocated that will be invested and 80% of the investment income shall be used for student support and 20% of investment income shall be added to fund investments. The fund investments shall not be available for use by the NPO for its operations and the NPO shall preserve the principal amount of fund.
- b) A healthcare NPO has raised money through special marketing drive in which overseas contributors deposited \$100 each in its 'Save a life fund' account. The contributions shall be used for the NPO's routine operations which focuses on providing life-saving drugs to patients who cannot afford the cost.
- c) An educational NPO has set-up a fund for development of new school in nearby rural area. The fund-raising drive has been successful as many people have contributed for the cause. The fund-raising clearly stated that the funds so raised shall only be used for construction and operations of school at that specific location.

Required:

Identify the type of above funds.

► *Answer:*

- a) Endowment fund
- b) General fund
- c) Restricted fund

2 INCOME OF NPOs

2.1 Categories of income

An NPO may have several categories of income to fund its operations, for example:

- Fee for services;
- Contributions and donations;
- Membership fees /subscriptions;
- Government funding;
- Investment income;
- Profit from running a coffee bar, a canteen or a shop; and
- Fundraising events.

2.2 Fee for services

NPOs may charge fee for their service in order to supplement their funding. The fee is usually lower than commercial charges for the same product or services. Examples include:

- A healthcare NPO charges Rs. 100 only for each consultation visit by a patient while commercial hospitals are charging Rs. 1,500 per visit for similar services.
- An educational NPO is charging a fee of Rs. 500 per month per student to provide affordable education in an under-privileged area.

2.3 Contribution/donations [ASNPO: Definitions & 6.2]

Contributions can come from many sources, including individuals, corporations, governments and other NPOs. Contributions include contributions receivable that meet the criteria for recognition in the financial statements.

A **contribution** is a non-reciprocal transfer to an NPO of cash or other assets or a non-reciprocal settlement or cancellation of its liabilities.

Restrictions (explicit or implicit) on contributions may only be externally imposed. However, subsequently internal restrictions may be imposed in a formal manner by the organization itself by directors / trustees.

2.3.1 Types of contribution [ASNPO: Definitions]

Restricted contribution	A restricted contribution is a contribution subject to externally imposed stipulations that specify the purpose for which the contributed asset is to be used.
Endowment contribution	An endowment contribution is a type of restricted contribution subject to externally imposed stipulations specifying that the resources contributed be maintained permanently, although the constituent assets may change from time to time.
Unrestricted contribution	An unrestricted contribution is a contribution that is neither a restricted contribution nor an endowment contribution.

► Example 02:

Consider the following independent circumstances:

- A healthcare NPO received Rs. 10 million from wealthy individuals subject to the condition that this amount shall only be used for acquisition of land for construction of a hospital in a specific village.
- A healthcare NPO received Rs. 25 million contribution from a wealthy individual in the year 20X2. The sole purpose of the amount is to support the NPO's general operations in the year 20X4 and 20X5.

- c) An educational NPO received a plot of land from Mr. Salman subject to the condition that this land shall only be used for construction of a primary education school to be run by that NPO. The fair value of this plot of land is Rs. 12 million.
- d) An educational NPO received a plot of land from Mr. Jamal subject to the condition that this land or sale proceeds from its disposal shall only be used to achieve general objectives of that NPO. The fair value of this plot of land is Rs. 15 million.
- e) An educational NPO received Rs. 50 million from alumni donors subject to the condition that the principal balance shall be invested as per specified investment policy and NPO cannot use the principal balance to fund operations. However, the NPO can utilise the investment earnings to pay for things such as academic programs or building new school facilities.

Required:

Identify the type of contributions in above circumstances.

► **Answer:**

- a) Restricted contribution
- b) Restricted contribution
- c) Restricted contribution
- d) Unrestricted contribution
- e) Endowment contribution

2.3.2 Contributed materials and services [ASNPO: 6.15 to 6.17]

A contribution of materials and services (i.e. assets other than cash) would be measured at fair value only when:

- the fair value can be reasonably estimated; and
- the materials and services are used in the normal course of the NPO's operations and would otherwise have been purchased.

Often these contributions are not recorded because of record-keeping and valuation difficulties. For example, it may be impractical to record the receipt of contributed services where the NPO depends heavily on the use of volunteers to provide services. Where contributed materials and services meet the criteria of fair value measurement, recording their value would provide useful information.

Contributed materials and services that are part of a constructed or developed capital asset (i.e. property, plant and equipment) would be recognised at fair value.

2.3.3 Contribution receivable [ASNPO: 7.2, 7.4 & 7.5]

Contributions include contributions receivable that meet the criteria for recognition in the financial statements. A contribution receivable should be recognised as an asset when it meets the following criteria:

- a) the amount to be received can be reasonably estimated; and
- b) ultimate collection is reasonably assured.

In particular, recognition of pledge and bequest shall be recognised as follows:

- a) A pledge is a promise to contribute cash or other assets to an NPO. Similar to any other contribution receivable, an uncollected pledge would only be recognised:
 - if it meets the above recognition criteria;
 - there is reasonable assurance that the NPO will comply with conditions, if any, attached to the contribution; and
 - contribution is not dependant on any contingent event outside NPO's control.

- b) Bequests are often subject to considerable uncertainty surrounding both the timing of the receipt and the amount that will actually be received. In many cases, the recognition criteria will not be satisfied and the bequest will not be recognised until it is received.

2.3.4 Recognition of contribution revenue [ASNPO: 6.27 to 6.46]

Using the deferral method, the contributions and related income are recognised as follows:

Contribution / income	Recognition
Endowment contributions	Recognise as direct increases in net assets in the current period and excluded from revenue. This is because endowment contributions will never be available to meet expenses associated with the organization's service delivery activities.
Restricted contributions for expenses of current period	Recognise as revenue in current period.
Restricted contributions for expenses of future periods	Defer and recognise as revenue in the same period(s) as the related expenses are recognised. When the only restriction on a contribution is that it cannot be used until a particular future period, the total amount of the contribution would be recognised as revenue in that future period, whether or not it has been spent.
Restricted contributions for the purchase of capital assets	In case of depreciable assets, defer and recognise as revenue on the same basis as the depreciation/amortisation expense related to the acquired capital assets. In case of non-depreciable assets, recognise as direct increase in net assets. In order for a contribution to be accounted for as a contribution restricted for the purchase of a capital asset, the contributor must specify the portion of the contribution that is to be used to purchase capital assets. If the contributor does not so specify, then the contribution would be recognised as revenue when spent for the particular purpose covered by the restriction, regardless of the fact that some of the expenditures may relate to the purchase of capital assets.
Restricted contributions for the repayment of debt	In case debt was incurred to fund expenses of future periods, defer and recognise as revenue in same period(s) as the related expenses are recognised. In case debt was incurred to fund the purchase of capital asset (depreciable), defer and recognise as revenue on the same basis as the depreciation / amortisation expense related to the acquired capital assets. In case debt was incurred to fund the purchase of capital asset (non-depreciable), recognise as direct increase in net assets. Otherwise, recognise as revenue in the current period.
Unrestricted contributions	Recognise as revenue in the current period.

Deferred contributions balances should be presented in the statement of financial position outside net assets as liability.

► Example 03:

Ali has been very successful in business. When he was a young man, he very much enjoyed playing cricket and has very fond memories of his days at the village cricket club.

He has donated Rs. 1,000,000 to the club to fund the building of a new club house which is under construction and expected to be completed by the end of next year.

Required:

How the above amount of Rs. 1 million should be recognised in the books of village cricket club?

► *Answer:*

This is restricted contribution for construction of a capital asset.

Initially, this amount shall be recognised as deferred contribution and presented as liability.

Subsequently, this shall be recognised as revenue on the same basis depreciation expense is charged on the building of new club house.

► *Example 04:*

A social club in a small town has managed to accumulate a significant balance on its accumulated fund over the years.

Its board of trustees have decided that the club should establish a fund to contribute to the school fees of children of high promise from the town. Parents of such children would apply to the club for a grant of Rs. 50,000. A total Rs. 1,500,000 is to be set aside for this purpose.

Required:

How to account for the above when the amount is set-aside and subsequently when the amount is actually paid?

► *Answer:*

This is not restricted contribution because there is no externally imposed stipulation rather an internal restriction has been imposed by the NPO itself.

The transfer of Rs. 1,500,000 shall be presented in statement of changes in net assets (and not in the statement of income and expenditure).

Debit	General fund	Rs. 1,500,000
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Credit	Special education fund	Rs. 1,500,000
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Subsequently, the amount paid will be recognised as reduction from the special fund.

Debit	Special education fund	Rs. 1,500,000
-------	------------------------	---------------

Credit	Cash	Rs. 1,500,000
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► *Example 05:*

A member of cricket club donated Rs. 2 million for repayment of loan obtained by the club in order to finance its general operations.

Required:

How the above donation shall be recognised?

► *Answer:*

This is restricted contribution for repayment of debt. However, since the loan relates neither to expenses of future periods nor to capital assets, the contribution shall be recognised as revenue in the current period.

2.4 Membership fee / subscription [ASNPO: 6.4]

Many NPOs receive membership fees / subscription that entitles the members of the NPO to services provided by the NPO. At each year end there will usually be some members who have paid their subscriptions in advance and some who are in arrears. These are both included as balances brought down and carried down on a single subscription account. Cash received is credited to this account and the balance on the account is transferred to statement of the income and expenditure (as income for the year).

Subscription account			
	Rs.		Rs.
Balance b/d (members in arrears)	X	Balance b/d (members who have prepaid)	X
Income and expenditure	X	Cash	X
Balance c/d (members who have prepaid)	X	Balance c/d (members in arrears)	X
	X		X
Balance b/d (members in arrears)	X	Balance b/d (members who have prepaid)	X

► **Example 06:**

At 31 March 2016 a cricket club had membership subscriptions in arrears amounting to Rs. 48,000 and had received Rs. 12,000 subscriptions in advance.

During the year to 31 March 2017 the club received Rs. 624,000 including 26 memberships for the year to 31 March 2018 at Rs. 1,200 per annum.

At 31 March 2017 16 members owed subscriptions of Rs. 1,200 each.

Required:

How the above transactions would be recorded in the subscription's ledger account for the year to 31 March 2017?

► **Answer:**

Subscriptions			
	Rs.		Rs.
b/d (arrears)	48,000	b/d (advance)	12,000
Income and expenditure	576,000	Cash	624,000
c/d (advance) [26 × 1,200]	31,200	c/d (arrears) [16 × 1,200]	19,200
	655,200		655,200
b/d	19,200	b/d	31,200

The exam questions often include the write off of subscriptions from members who have stopped attending the club. The bad debts expense is charged as expense in statement of income and expenditure and also included in the subscriptions account to determine correct amount of subscription revenue to be recognised in statement of income and expenditure.

► **Example 07:**

At 31 March 2016 a cricket club had membership subscriptions in arrears amounting to Rs. 48,000 and had received Rs. 12,000 subscriptions in advance.

During the year to 31 March 2017 the club received Rs. 624,000 including 26 memberships for the year to 31 March 2018 at Rs. 1,200 per annum.

At 31 March 2017 16 members owed subscriptions of Rs. 1,200 each.

Half of the members who were in arrears at the end of the previous period still had not paid by 31 March 2017. It was decided to write these amounts off.

Required:

How the above transactions would be recorded in the subscription's ledger account for the year to 31 March 2017?

► *Answer:*

Subscriptions			
	Rs.		Rs.
b/d (arrears)	48,000	b/d (advance)	12,000
Income and expenditure	600,000	Cash	624,000
		Bad debts [$1/2 \times 48,000$]	24,000
c/d (advance) [$26 \times 1,200$]	31,200	c/d (arrears) [$16 \times 1,200$]	19,200
	679,200		679,200
b/d	19,200	b/d	31,200

2.4.1 Joining fee and life membership fee

The following membership fees might be recognised over the several years during which the NPO is expected to provide services to the respective members:

- Joining fee i.e. a sum of money that paid by member in order to become a member of the NPO.
- Life membership fee i.e. "once in a life" lump sum amount paid by a member in lieu of periodic regular subscription to the NPO.

However, in some circumstances, it may be appropriate to recognise joining fees or entrance fees in the year in which those fees become due. Therefore, recognition of such fees involves a considerable degree of judgment on the part of the NPO.

► *Example 08:*

Multan Book Reading Club (MBRC) is a newly established NPO. The members of MBRC can pay for membership privileges by either paying Rs. 10,000 per annum or paying lump sum amount of Rs. 80,000 for life-time membership.

During the first month of operations, 20 members have opted for life-time membership.

The management of MBRC has estimated that on average a member will be using MBRC services for 10 years.

Required:

Advise how MBRC should recognise the above life-membership fee in its financial statements prepared at the end of Year 1.

► *Answer:*

The life-membership shall be recognised as income over the years MBRC is expected to provide services i.e. 10 years.

Therefore, Rs. 160,000 (i.e. 20 members $\times$ Rs. 80,000 / 10 years) shall be recognised in statement of income and expenditure. The amount attributable to next year (i.e. Rs. 160,000) shall be presented as current liability, while remaining amount of Rs. 1,280,000 (i.e. 20 members $\times$ Rs. 80,000 – 160,000 – 160,000) shall be presented as non-current liability.

2.4.2 Fee for service and/or contributions [ASNPO: 6.4]

Membership fees are considered fees for services when members receive services having a value commensurate with fees paid. In other cases, membership fees may be in substance contributions.

An NPO would decide whether its membership fees are contributions or fees for services and account for them accordingly on a consistent basis. Some membership fees have characteristics of both fees for services and contributions. Such fees would be divided into the portion that relates to fees for services and the portion that is in substance a contribution.

► **Example 09:**

ABC Golf Club is members only club providing its members with sports facilities in the grounds owned and maintained by it against annual subscription fee.

At 30 June 20X2, the club had membership subscriptions in arrears amounting to Rs. 48,000,000 and had received Rs. 12,000,000 in advance.

During the year to 30 June 20X3, the club received Rs. 650,000,000 from its members. This amount includes:

- Rs. 26,000,000 received as donation from members (no conditions attached).
- Rs. 31,200,000 received for membership fee for the year to 30 June 20X4.

At 30 June 20X3, members owed Rs. 19,200,000 of subscriptions.

Half of the members who were in arrears at the end of the previous period still had not paid by 30 June 20X3. It was decided to write these amounts off.

Required:

How the revenue from above should be reported in financial statements of ABC Golf Club for the year ended on 30 June 20X3?

► **Answer:**

The donation of Rs. 26 million received shall be recognised as contribution revenue separately from fee for services to members.

The subscription income (i.e. fee for services) may be calculated as follows:

Subscription income			
	Rs. m		Rs. m
b/d	48	b/d	12
Income and expenditure	600	Cash (Rs. 650m – 26m)	624
		Bad debts (Rs. 48m x 50%)	24
c/d	31.2	c/d	19.2
	679.2		679.2

The subscription income may be reported in statement of income and expenditure at Rs. 600 million (gross basis) or at Rs. 576 million (net of bad debts expense).

2.5 Government funding [ASNPO: 6.3 & 4.45 to 4.48]

Government funding provided to an NPO is considered to be a contribution. Certain types of government funding are calculated and paid as if they were fees for services. However, because the services being funded are provided to the NPO's community of service, and not directly to the government funder, government funding is considered to be a contribution.

In case the NPO is required to provide goods and services directly to the government, the related government funding shall be treated as fee for services.

► **Example 10:**

Mujahid Healthcare (MH) is a registered NPO. It has received government funding of Rs. 20 million for which it has to provide vaccine (dosage and administration) for a viral disease to general public (8,000 dosages x Rs. 2,500 each) without taking any fee from them.

Required:

Discuss the accounting treatment of above from perspective of MH.

► **Answer:**

The amount of Rs. 20 million is being calculated on dosage basis (i.e. 8,000 dosages x Rs. 2,500) which might indicate that Rs. 20 million should be recognised as fee-for-services in statement of income and expenditure.

However, since the service is not being provided to government but rather to MH's community of service (i.e. general public to whom they provide healthcare services), the government funding of Rs. 20 million shall be considered as contribution.

Further, since the purpose of government funding is specified, it shall be considered as restricted contribution.

2.6 Investment income [ASNPO: 6.47 & 6.48]

Net investment income may be subject to externally imposed restrictions. In order to ensure the appropriate reporting of restricted and unrestricted resources, an organization would account for net investment income in the manner appropriate to the nature of any external restrictions imposed.

Net investment income (including revenue, gains or losses on investments) is recognised in the same way contributions are recognised:

- Externally restricted investment income that must be added to principal resources held for endowment are recognised as direct increase or decrease in net assets.
- Other externally restricted investment income is recognised according to the type of restrictions (same criteria as for contributions discussed above).
- In case there is no external restriction, recognise in the statement of income and expenditure.

2.7 Profit from running an operation

If a club has a coffee bar, canteen or shop the "profit" from these is generally calculated separately (in an account known as a trading account) and presented as a line in the statement of income and expenditure.

Any expenses directly related to the operation of a coffee bar or shop would be deducted from the gross profit of the operation and the net profit would be presented on a separate line in the statement of income and expenditure.

Profit (loss) from running Coffee shop	Rs.
Sales	X
<u>Cost of sales</u>	
Opening inventory	X
Purchases	X
Closing inventory	(X)
	(X)
Gross profit	X
Coffee shop worker's salary (and other relevant expenses)	(X)
Profit (loss)	X / (X)

2.8 Fundraising events [ASNPO: 4.45 & 4.49 to 4.52]

Many special events, such as dinners, galas, auctions, and walk-a-thons, are organized to raise contributions to support the NPO's activities. The participants of these events are offered something of value (a meal, entertainment, interaction with a celebrity) for a sum.

The determination of whether to report the revenues and expenses on a gross or net basis depends on the relative facts and circumstances and requires significant judgment.

► *Example 11:*

An NPO engages in a number of fundraising activities, including a fundraising telethon, a telephone campaign, a direct mail campaign, special events and a lottery. The NPO uses an outside fundraising consultant to conduct the telethon and uses the NPO's own staff and volunteers in the telethon and the other activities. Funds solicited in each of the activities are raised in the name of the NPO.

Required:

Whether the fundraised and related costs be presented on gross basis or net basis?

► *Answer:*

Even though the NPO uses an outside fundraising consultant to conduct the telethon, the NPO is the principal in the relationship with the donors as the funds are raised in its name. The NPO has discretion in selecting the outside fundraiser, in establishing the fees to be paid and in determining the specifications of the telethon. The NPO also has the credit risk if donors to the telethon do not pay according to their pledge. Thus, the NPO should recognise the gross amounts fundraised in each of the activities as revenue of the NPO, and the total expenses of each activity, including the fees charged by any outside party, as expenses of the NPO, separately.

► *Example 12:*

An NPO is actively engaged in helping communities in flood affected area. A group of students organised a music concert, announcing that the net proceeds of the event shall be given to the NPO.

Required:

Whether to report the revenue and costs of the event on gross basis or net basis?

► *Answer:*

The NPO is not the principal in the fundraising event as it was not involved in organizing the event and did not bear any risks in connection with it. The amount received by the NPO is a donation from the organizers of the event. Neither the gross revenues nor the gross expenses of the event are recognised in the NPO's financial statements. The net proceeds received are recognised as a contribution. Disclosure of gross revenues and expenses is not required.

3 INVENTORIES AND NON-CURRENT ASSETS

3.1 Inventories [ASNPO: 5.3 & 5.4]

3.1.1 Contribution of materials

When an NPO recognises contributions of materials and goods, the cost of inventories shall reflect the fair value at the date of contribution.

3.1.2 To be distributed at no charge or for a nominal charge

An NPO shall measure inventories at the lower of cost and current replacement cost when they are held for:

- distribution at no charge or for a nominal charge; or
- consumption in the production process of goods to be distributed at no charge or for a nominal charge.

► **Example 13:**

Medicine-for-All is an NPO which provides medicine to communities living in underdeveloped areas at nominal charge. It has following inventories:

Item	Type	Cost	NRV*	Replacement cost	Fair value
		Rupees			
Panadol	Received in kind	Nil	6,000	26,000	28,000
Neubrol	Purchased for cash	24,000	4,000	24,500	25,000
Imodium		12,000	3,000	12,000	12,500
Motilium		15,000	2,500	14,700	15,200
Rijix		18,000	3,500	18,300	17,900

**provided at nominal charge*

Required:

Calculate the amount of inventory that should be presented in the statement of financial position of Medicine-for-All from above data.

► **Answer:**

Item	Basis	Rupees
Panadol	Cost equal to fair value but replacement cost is lower	26,000
Neubrol	Cost (lower)	24,000
Imodium	Cost / replacement cost (equal)	12,000
Motilium	Replacement cost (lower)	14,700
Rijix	Cost (lower)	18,000
Total		94,700

3.2 Collections [ASNPO: Definitions, 10.2 to 10.4 & 8.8]

Collections are works of art, historical treasures or similar assets that are:

- held for public exhibition, education or research;
- protected, cared for and preserved; and
- subject to an organisational policy that requires any proceeds from their sale to be used to acquire other items to be added to the collection or for the direct care of the existing collection.

Although items meeting the definition of a collection exhibit the characteristics of 'assets' they are excluded from the definition of property, plant & equipment, and intangible assets. Collections are made up of items that are often rare and unique. They have cultural and historical significance.

Although collections are usually held by museums or galleries, other NPOs may also have items that meet the definition of a collection. For example, an NPO's library may include rare books which might be considered to be a collection. The regular library materials, however, would not usually meet the definition of a collection.

Certain works of art and historical treasures may have lives that are so long as to be virtually unlimited. Works of art and historical treasures in this category are those that have cultural, aesthetic, or historical value that is worth preserving perpetually. In addition, the NPO must have the technological and financial ability to continue to protect and preserve them. Works of art and historical treasures of this type would not be depreciated.

3.3 Property, plant and equipment [ASNPO: Definitions, 8.3 to 8.9 & 8.12]

Tangible capital assets are identifiable tangible assets that meet all of the following criteria:

- are held for use in the provision of services, for administrative purposes, for production of goods or for the maintenance, repair, development or construction of other tangible capital assets;
- have been acquired, constructed or developed with the intention of being used on a continuing basis;
- are not intended for sale in the ordinary course of operations; and
- are not held as part of a collection.

3.3.1 Measurement for contributed assets

A contributed asset would be recognised at its fair value at the date of contribution. When an estimate of fair value cannot reasonably be made, both the asset and the related contribution would be recognised at nominal value to ensure monitoring and accountability.

A tangible capital asset purchased by an NPO at a value substantially below fair value would also be recognised at its fair value with the difference between the consideration paid for the tangible capital asset and fair value reported as a contribution.

A tangible moveable capital asset procured from a grant may be recognised at carrying amount deducting the grant. The grant is recognised in profit or loss over the life of the depreciable asset as a reduced depreciation expense.

3.3.2 Depreciation / amortisation (under fund accounting)

Land normally has an unlimited life and would not be depreciated.

When a fund accounting basis of reporting is used, the choice of the fund or funds to which depreciation expense would be charged would be based on providing the most meaningful presentation.

4 PREPARATION OF FINANCIAL STATEMENTS

4.1 General [ASNPO: 3.9]

The accounting and approach for preparation of financial statements of an NPO is similar to general-purpose financial statements of other entities except for the issues specifically addressed in ASNPO.

Financial statements of NPO shall normally include:

- statement of financial position (or balance sheet)
- statement of income and expenditure
- statement of changes in net assets
- statement of cash flows.

Notes to financial statements and supporting schedules to which the financial statements are cross-referenced are an integral part of such statements; the same does not apply to information set out in other material attached to or submitted with financial statements.

4.2 Statement of financial position [ASNPO: 4.18 & 4.25]

Information about the NPO's liquidity is presented by classifying current assets separately from non-current assets and current liabilities separately from non-current liabilities. Cash and other assets subject to external restrictions limiting their use to beyond one year from the date of the statement of financial position would be classified as non-current assets.

Under the deferral method of accounting for contributions:

- endowment contributions are accumulated in the net assets balance; and
- internally restricted balances are reflected as appropriations of unrestricted net assets; and
- externally restricted contributions are accumulated in the statement of financial position as deferred contributions.

A format of statement of financial position of an NPO is given below:

Not-for-Profit Organisation

Statement of financial position as at 31 December 20X2

	20X2	20X1
	Rs. 000	Rs. 000
Non-current assets		
Capital assets (property, plant and equipment)	2,037	XX
Collections	80	XX
Investments	4,157	XX
	6,274	XX
Current assets		
Office supplies stock	55	XX
Prepaid expenses	58	XX
Subscription receivable	17	XX
Cash and cash equivalents	183	XX
	313	XX
	6,587	XXX

	20X2	20X1
Fund balances / Net assets	Rs. 000	Rs. 000
General fund / Unrestricted net assets	2,939	XX
Net assets: restricted for endowments	208	XX
Net assets: internally restricted for special projects	340	XX
	3,487	XX
Non-current liabilities		
Deferred grants/contributions	1,800	XX
Loans	300	XX
	2,100	XX
Current liabilities		
Deferred grants/contributions	500	XX
Subscriptions received in advance	100	XX
Accrued expenses	400	XX
	1,000	XX
	6,587	XX

4.3 Statement of income and expenditure [ASNPO: 4.29, 13.9, 4.31 & 4.35]

Revenues and expenses should be recognised and presented at their gross amounts and this information may be presented in the notes to the financial statements. NPO may classify expenses in the statement of income and expenditure:

- by object (for example, salaries, rent, utilities);
- by function (for example, administrative, research, ancillary operations); or
- by program.

An NPO would classify its expenses in the manner that results in the most meaningful presentation in the circumstances. Whether the NPO prepares its budgets by function or object would be a factor to consider in deciding which method of expense classification would be most appropriate for the NPO's financial statements.

The statement of income and expenditure should present:

- for each financial statement item, a total that includes all funds reported; and
- total excess or deficiency of revenues and gains over expenses and losses for the period.

A format of statement of income and expenditure of an NPO is given below:

Not-for-Profit Organisation

Statement of income and expenditure for the year ended 31 December 20X2

	20X2	20X1
Income	Rs. 000	Rs. 000
Fee-for-services	5,300	XX
Government grants	1,200	XX
Contributions	170	XX
Fundraising events	300	XX
Profit from coffee bar / shop / canteen	50	XX
Investment income	31	XX
Other income	2	X
	7,053	XXX
Expenditures		
Salaries	3,070	XX
Rent	1,320	XX
Office supplies used	610	XX
Utilities	880	XX
Marketing and communications	422	XX
Amortisation of capital assets	153	XX
	(6,455)	(XXX)
Excess of income over expenditure i.e. surplus	598	XX

4.4 Statement of changes in net assets [ASNPO: 4.37, 4.38, 4.9 & 4.12]

The statement of changes in net assets is presented in the similar way a statement of changes in equity is prepared i.e. showing the movements in net assets during the year.

The statement of changes in net assets may be referred to as 'the statement of changes in fund balances' when the NPO uses fund accounting in its financial statements.

Inter-fund transfers should be presented in the statement of changes in net assets. Allocations of revenues and expenses between funds that are made when the NPO first recognises the revenue or expense are not considered to be transfers.

A format of statement of changes in net assets for an NPO is given below:

Not-for-Profit Organisation

Statement of changes in net assets for the year ended 31 December 20X2

	Unrestricted / General fund	Endowment fund	Special (internal) fund	Total
Balance 1 January	2,386	150	315	2,851
Surplus	598			598
Endowment Contributions		20		20
Investment income		18		18
Transfer to special fund	(25)		25	-
Transfer to endowment fund	(20)	20		-
Balance 31 December	2,939	340	208	3,487

► **Example 14:**

The following information relates to Professional Sports Club (PSC), a Not-for-Profit Organisation.

Trial balance as at 30 June 20X4

	Dr. Rs. m	Cr. Rs. M
General fund (1 July 20X3)		1,147
Fund for Supporting the Young-Talent (1 July 20X3)		50
Fund for gymnasium and training centre (1 July 20X3)		115
Fund for franchise (1 July 20X3)		3
Long term assets (net)	428	
Investments	1,204	
Short term bank loan		17
Prepaid and accrued expenses	8	11
Cash at bank	43	
Fee-for-services		340
Fundraising in various tournaments (net proceeds)		15
Contributions		494
Government funding		150
Investment income		144
Salaries	403	
Rent and utilities	354	
Other expenses	46	
	2,486	2,486

Additional information:

- Fund for Supporting the Young-Talent (SYT) has stipulations imposed that require resources contributed to be maintained permanently. The above contribution received include Rs. 15 million contribution related to SYT to be maintained permanently. The investment income of Rs. 144 million includes Rs. 6 million that is externally restricted to be added to principal amount of resources for SYT to be maintained permanently.

There is no other restrictions on investment income. As part of agreement with contributors of SYT, PSC is required to allocate Rs. 5 million from general fund to the SYT fund, annually.

- ii. Fund for gymnasium and training centre has stipulation imposed externally that it shall be used exclusively for building a gymnasium and training centre in Nawabpur Town. The contribution received include contributions of Rs. 14 million to acquire freehold land for the centre, however, no land has been acquired yet.
- iii. Last year, the trustees of PSC imposed stipulations to create a fund for acquiring a franchise in a popular league and approved Rs. 3 million to be transferred this year as well.
- iv. The contribution received also include Rs. 8 million to repay the loan that was obtained to pay expenses incurred during the year.
- v. The government funding was received to support PSC general operations for five years starting from 1st January 20X4.
- vi. Long term assets in the trial balance include freehold land of Rs. 20 million and collections of Rs. 8 million. These collections represent items of such historic value that is worth preserving perpetually and PSC is committed to protect and preserve them as part of its organisation policy.
- vii. Long term assets are depreciated at 20% reducing balance method. All the amortisation is allocated to general operations.

Required:

Prepare the following (under deferral method) for PSC:

- Statement of income and expenditure for the year ended 30 June 20X4.
- Statement of changes in net assets for the year ended 30 June 20X4.
- Statement of financial position as at 30 June 20X4.

► *Answer:*

Professional Sports Club**Statement of income and expenditure for the year ended 30 June 20X4**

Income		Rs. M
Fee-for-services		340
Fundraising proceeds		15
Contributions	[494 – 15 – 14]	465
Government funding	[150 / 5 years x 6/12]	15
Investment income	[144 – 6]	138
		973
Expenditures		
Salaries		403
Rent and utilities		354
Other expenses		46
Amortisation of capital assets	[(428 – 8 – 20) x 20%]	80
		(883)
Surplus i.e. excess of income over expenditure		90

Professional Sports Club

Statement of changes in net assets for the year ended 30 June 20X4

	General fund	Endowment fund (SYT)	Franchise fund	Total
Balance 1 July 20X3	1,147	50	3	1,200
Surplus	90			90
Endowment contributions		15		15
Endowment investment income		6		6
Transfer to franchise fund	(3)		3	-
Transfer to endowment fund	(5)	5		-
Balance 30 June 20X4	1,229	76	6	1,311

Professional Sports Club

Statement of financial position as at 30 June 20X4

Non-current assets	Rs. M
Capital assets [428 – 8 – 80]	340
Collections	8
Investments	1,204
	1,552
Current assets	
Prepaid expenses	8
Cash at bank	43
	51
	1,603
Fund balances / Net assets	
General fund	1,229
Endowment fund: Supporting the young talent	76
Franchise fund (internal)	6
	1,311
Non-current liabilities	
Deferred government funding [150 – 15 – 30]	105
Deferred contributions (gym etc) [115 + 14]	129
	234
Current liabilities	
Deferred government funding [150 / 5]	30
Short term bank loan	17
Accrued expenses	11
	58
	1,603

4.5 Receipt and payment account

Some small NPOs may not have enough resources to maintain proper double entry accounting records and, therefore, record cash receipts and payments only in addition to some records of bills, accruals and prepayments, etc.

When accounts are prepared on cash or disbursement basis rather than accrual basis of accounting, a receipt and payment account is prepared and presented. This is simply a summary of cash receipts and payments during the accounting period. It includes capital items, as well as revenue items.

Receipts and payments account			
	Rs.		Rs.
Balance b/d	X	Donation to Dam Fund	X
Subscriptions	X	Repairs	X
Functions – ticket revenue	X	Telephone	X
Sale of land	X	Extension of building	X
Bank interest	X	Furniture	X
Bequest	X	Electricity expenses	X
Sundry income	X	Salary and wages	X
		Sundry expenses	X
		Balance c/d	X
	X		X
Balance b/d	X		

A receipt and payment account gives far less information than a set of financial statements based on the accruals concept. Therefore, some donors / government might require an NPO to present financial statements on accrual basis, that are prepared using records available relating to receipts, payments and other balances.

► **Example 15:**

The statement of financial position of Peshawar Business Club as at 31 December 2017 is shown as follows:

	Cost	Accumulated depreciation	Carrying amount
Non-current assets:	Rs.000	Rs.000	Rs.000
Furniture and fittings	40,000	10,000	30,000
Games equipment	20,000	7,200	12,800
Motor van	30,000	10,000	20,000
	90,000	27,200	62,800
Current assets: Cash and bank balances			9,200
			72,000
Financed by: Accumulated funds			72,000

The following transactions took place during the year 1 January 2018 to 31 December 2018:

Receipts	Rs. 000
Subscriptions (10,000 members @ Rs. 1,600 each)	16,000
Donations	1,600
Sale of tickets for annual dinner	10,800
	28,400
Payments	
Electricity	4,000
Expenses for annual dinner	6,200
New games equipment	3,200
Cleaners' wages	2,080
Repairs and renewals	1,660
Motor van repairs	2,520
	19,660

Further information:

- An electricity bill of Rs. 900,000 was owed at 31 December 2018.
- Depreciation should be calculated at 10% of cost of the assets.

Required:

Prepare the statement of income and expenditure of Peshawar Business Club for the year ended 31 December 2018 and statement of financial position as at that date.

► *Answer:*

Statement of income and expenditure for the year ended 31 December 2018

Income	Rs. 000
Subscription	16,000
Donations	1,600
Ticket sales for annual dinner	10,800
	28,400
Expenditure	
Electricity [4,000 + 900]	4,900
Expenses for annual dinner	6,200
Cleaners' wages	2,080
Repairs and renewals	1,660
Motor van repairs	2,520
Depreciation:	
Fixture and fittings [40,000 x 10%]	4,000
Games equipment [(20,000 + 3,200) x 10%]	2,320
Motor van [30,000 x 10%]	3,000
	(26,680)
Surplus	1,720

Statement of financial position as at 31 December 2018

Non-current assets		Rs. 000
Fixture and fittings	[30,000 – 4,000]	26,000
Games equipment	[12,800 + 3,200 – 2,320]	13,680
Motor van	[20,000 – 3,000]	17,000
		56,680
Current assets: Cash and bank balances [9,200 + 28,400 – 19,660]		17,940
		74,620
Net assets (accumulated fund)		
Opening balance		72,000
Surplus for the year		1,720
		73,720
Current liabilities: Accrued electricity charges		900
		74,620

► Example 16:

The following were the assets and liabilities of the Nawabshar Youth Movement at 30 April 2017.

	Rs. 000
Fixtures and fittings (net)	16,340
Inventory of refreshment (coffee bar)	4,460
Land	51,600
Subscription received in advance	4,900
Payables for drinks supplied (coffee bar)	6,780
Cash at bank	7,466

The accountant's receipts and payments account for the year to 30 April 2018 shows the following:

Receipts	Rs. 000
Contributions received	500
Rent of hall	5,600
Members' subscription	24,000
Sale of brochure	1,740
Sale of dance tickets	3,400
Sale of refreshments (coffee bar)	10,200
	45,440

Payments	
Repairs and maintenance	3,218
Salaries and wages	6,309
Gifts and charity	600
Dance event expenses	950
Refreshment supplies (coffee bar)	19,415
Sundry expenses	10,000
	40,492

Further information:

- Wages of Rs. 556,000 were due but unpaid at the year-end.
- Inventories of drinks at 30 April 2018 were Rs. 14,210,000
- Provide for depreciation on fixtures and fittings at Rs. 1,900,000
- Subscription due but not paid by members at 30 April 2018 was Rs. 1,900,000

Required:

Prepare the club's statement of income and expenditure for the year ended 30 April 2018 and the statement of financial position as at that date.

► **Answer:****Statement of income and expenditure for the year ended 30 April 2018**

Income		Rs. 000
Contributions		500
Fee for services (rent of hall)		5,600
Members' subscription	W1	30,800
Sales of brochures		1,740
Sale of dance tickets		3,400
Income from coffee bar (net)	W2	7,315
		49,355
Expenditure		
Salaries and wages	[6,309 + 556]	6,865
Repairs and maintenance		3,218
Gift and charity		600
Dance event expenses		950
Sundry expenses		10,000
Depreciation		1,900
		(23,533)
Surplus		25,822

Statement of financial position as at 30 April 2018

Non-current assets		Rs. 000
Land		51,600
Fixtures and fittings	[16,340 – 1,900]	14,440
		66,040
Current assets		
Inventory (refreshments)		14,210
Subscription receivable		1,900
Cash at bank	[7,466 + 45,440 – 40,492]	12,414
		28,524
		94,564

Net assets (fund)		
Opening balance	W4	68,186
Surplus for the year		25,822
		94,008
Current liabilities: accrued wages		556
		94,564

W1:

Subscription				
	Rs. 000			Rs. 000
			b/d	4,900
I&E (balancing)	30,800		Bank	24,000
			c/d	1,900
	30,800			30,800

W2:

Coffee bar operation		Rs. 000
Sales		10,200
<u>Cost of sales</u>		
Opening inventory		4,460
Purchases	W3	12,635
Closing inventory		(14,210)
		(2,885)
Profit		7,315

W3:

Payables (refreshment)				
	Rs. 000			Rs. 000
Bank	19,415		b/d	6,780
c/d	-		Purchases (balancing)	12,635
	19,415			19,415

W4:

Net assets (opening balance)		Rs. 000
Assets	[16,340 + 4,460 + 51,600 + 7,466]	79,866
Liabilities	[4,900 + 6,780]	(11,680)
		68,186

5 COMPREHENSIVE EXAMPLES

► Example 17:

The accountant of Leisure Club was terminated on account of charges of fraud on 31 December 2016 and Mr. Emad has been appointed in his place. Emad has gathered the following information in respect of the year ended 31 December 2016:

- i. The club has 3,300 members and the membership fee is Rs. 10,000 per annum. The fee payable by each member becomes due on the first day of the quarter in which he became a member. The fee received in each quarter was as follows:

Quarter	First	Second	Third	Fourth
Subscription received (Rs.)	9,900,000	8,250,000	5,500,000	9,350,000

Last year the fee was Rs. 9,000 per annum. However, the number of members was the same.

- ii. A summary of the bank account for the year is shown below:

Deposits	Rupees	Withdrawals	Rupees
Balance as at 1 Jan. 2016	3,700,500	Insurance	175,000
Cash deposited into bank	37,848,500	Rent and rates	4,200,000
Written off amount recovered	1,860,000	Utilities	4,365,000
Disposal of fixed assets	750,000	Freehold land purchased	17,000,000
Membership fee received directly in bank account	19,800,000	Cash withdrawals	6,120,000
		Payment to creditors	18,155,000
		Repairs and maintenance	700,000
		Exercise equipment	7,350,000
		Balance as at 31 Dec. 2016	5,894,000
	63,959,000		63,959,000

- iii. Amounts paid from petty cash were as follows:

	Rupees
Salaries	2,300,000
Sundry expenses	640,000

- iv. The club has a tuck shop which earns a profit margin of 20% of sales. All sales of tuck shop are made on cash. During the year, stock costing Rs. 500,000 was destroyed by fire.
- v. The opening WDV of fixed assets was Rs. 28,000,000. Exercise equipment was purchased on 1 October 2016. Fixed assets having opening WDV of Rs. 800,000 were disposed of on 31 March 2016. Fixed assets are depreciated @ 20% under the reducing balance method.
- vi. The opening and closing balances of cash in hand were Rs. 300,000 and Rs. 25,000 respectively.

vii. The following balances have been extracted through a scrutiny of the available records:

	2016	2015
	----- Rupees -----	
Creditors	3,330,000	2,500,000
Prepaid rent	175,000	168,000
Stock- tuck shop	2,500,000	2,300,000

Required:

- Determine the amount of loss incurred by the club due to fraud committed by the previous accountant.
- Statement of income and expenditure for the year ended 31 December 2016.
- Statement of financial position as at 31 December 2016.

► *Answer:*

Part (a)

Amount of loss due to fraud **W2** Rs. 1,662,750

Part (b)

Statement of income and expenditure for the year ended 31 December 2016

Income	Rupees
Subscription income W1	31,817,500
Income from tuck-shop W6	4,571,250
Other income (recovery of write off)	1,860,000
	38,248,750

Expenditure	Rupees
Insurance	175,000
Utilities	4,365,000
Repair and maintenance	700,000
Salaries	2,300,000
Sundry expenses	640,000
Loss of inventory due to fire	500,000
Loss on disposal W4	10,000
Depreciation W4	5,847,500
Rent and rates W3	4,193,000
Loss due to fraud W2	1,662,750
	(20,393,250)
Surplus	17,855,500

Statement of financial position as at 31 December 2016

Non-current assets		Rs. 000
Fixed assets – WDV	W4	45,742,500
Current assets		
Stock		2,500,000
Prepaid rent		175,000
Bank		5,894,000
Cash		25,000
		8,594,000
		54,336,500

Net assets (fund)		
Opening balance	W7	21,326,000
Surplus		17,855,500
		39,181,500
Current liabilities		
Creditors		3,330,000
Unearned subscription		11,825,000
		15,155,000
		54,336,500

W1:

Subscriptions			
	Rupees		Rupees
		b/d 1.3	10,642,500
I&E (balancing)	31,817,500	Bank	19,800,000
c/d 1.2	11,825,000	Cash 1.1	13,200,000
	43,642,500		43,642,500

1.1 Amount received

	Rupees
Total received [9,900,000 + 8,250,000 + 5,500,000 + 9,350,000]	33,000,000
In bank	19,800,000
In cash	13,200,000

1.2 Closing unearned subscription

		Rupees
Quarter 1	[9,900,000 x 0/12]	0
Quarter 2	[8,250,000 x 3/12]	2,062,500
Quarter 3	[5,500,000 x 6/12]	2,750,000
Quarter 4	[9,350,000 x 9/12]	7,012,500
		11,825,000

1.3 Opening unearned subscription Rs. 11,825,000 x 9/10 = Rs. 10,642,500

W2:

Cash			
	Rupees		Rupees
b/d	300,000	Salaries	2,300,000
Subscription	13,200,000	Sundry expenses	640,000
Bank	6,120,000	Bank	37,848,500
Tuck shop receipts	22,856,250	Loss due to fraud (bal.)	1,662,750
		c/d	25,000
	42,476,250		42,476,250

W3:

Rent and rates			
	Rupees		Rupees
b/d	168,000	I&E (balancing)	4,193,000
Bank	4,200,000	c/d	175,000
	4,368,000		4,368,000

W4:

Fixed assets			
	Rupees		Rupees
b/d	28,000,000	Disposal	760,000
Bank (land)	17,000,000	Depreciation	5,847,500
Bank (equipment)	7,350,000	c/d	45,742,500
	52,350,000		52,350,000

4.1 Disposal

	Rupees
Sale proceeds	750,000
Opening WDV	800,000
Depreciation $[800,000 \times 20\% \times 3/12]$	(40,000)
	(760,000)
Loss	(10,000)

4.2 Depreciation for the year

	Rupees
On disposed assets 4.2	40,000
On other opening assets $[(28,000,000 - 800,000) \times 20\%]$	5,440,000
On additions $[7,350,000 \times 20\% \times 3/12]$	367,500
	5,847,500

W5:

Creditors			
	Rupees		Rupees
Bank	18,155,000	b/d	2,500,000
c/d	3,330,000	Purchases	18,985,000
	21,485,000		21,485,000

W6: Tuck shop operations

	Rupees
Sales $[18,285,000 / 80\%]$	22,856,250
<u>Cost of sales</u>	
Opening stock	2,300,000
Purchases $[18,985,000 - 500,000 \text{ loss}]$	18,485,000
Closing stock	(2,500,000)
	(18,285,000)
Profit	4,571,250

W7:

	Rupees
Net assets (opening balance)	
Assets $[28,000,000 + 2,300,000 + 168,000 + 3,700,500 + 300,000]$	34,468,500
Liabilities $[2,500,000 + 10,642,500]$	(13,142,500)
	21,326,000

► **Example 18:**

Seaview Club started its operations on 1 February 2015. Sponsor of the club contributed Rs. 50 million towards general fund for the start of operations and placed the amount in the bank. Following is the receipts and payments summary for the period from 1 February 2015 to 31 December 2015:

Receipts	Rs. in '000	Payments	Rs. in '000
Sponsor's contribution	50,000	Furniture & fixtures	1,200
Joining fees	20,800	Van	1,500
Subscription from members	29,952	Salaries	1,000
Sale of beverages	1,500	Rent	3,600
		Utilities	570
		Insurance	120
		Repairs and maintenance	275
		Purchase of beverages	1,367
		Advance for plot of land	65,000
		Balance	27,620
	102,252		102,252

Additional information:

- i. The joining fee for award of membership is Rs. 50,000. Annual subscription is Rs. 24,000. All new members pay three years' subscription in advance.

The memberships were awarded as follows:

Month	March	June	September	December
No. of members	112	98	101	105

- ii. The club sells beverages at a gross profit margin of 20%. All sales are billed in the first week of the next month and the payment is received in the same month. Sale of beverages during December 2015 amounted to Rs. 150,000.
- iii. 25% of total purchases of beverages made during the year remained unsold at year-end.
- iv. Salaries are paid on the first day of next month. The amount of salaries includes an advance amounting to Rs. 10,000 paid to an employee on 1 December 2015. The advance is repayable on 1 February 2016.
- v. Rent for three years was paid in advance on 1 February 2015.
- vi. Presently the club is operating on rental premises. However, a plot of land has been purchased on which construction would commence shortly. Title of land would be transferred after completion of legal formalities.
- vii. Payments for utilities include security deposit paid to utility companies amounting to Rs. 20,000. Utility bills are paid on the 7th day of the next month.
- viii. Insurance premium was paid on 1 February 2015 covering a period of 12 months.
- ix. Repairs and maintenance include an advance of Rs. 100,000 paid to a contractor for construction of a parking shed. Repair bills amounting to Rs. 7,000 were outstanding at year-end.
- x. Furniture & fixtures and van were purchased on 1 February 2015. Depreciation on these assets is to be charged at 10% and 20% respectively.

Required:

Prepare statement of financial position as at 31 December 2015 and statement of income & expenditure of Seaview Club for the period ended 31 December 2015.

► Answer:

Statement of income and expenditure for the period ended 31 December 2015

Income		Rs. 000
Joining fee		20,800
Subscription income	W1	4,630
Profit from beverages	W2	330
		25,760
Expenditure		
Salaries and wages	[1,000 – 10 + 99]	1,089
Rent	[3,600 / 3 x 11/12]	1,100
Utilities	[570 – 20 + 55]	605
Insurance	[120 – 10]	110
Repair and maintenance	[275 – 100 + 7]	182
Depreciation (F&F)	[1,200 x 10% x 11/12]	110
Depreciation (van)	[1,500 x 20% x 11/12]	275
		(3,471)
Surplus		22,289

Statement of financial position as at 31 December 2015

Non-current assets		Rs. 000
Furniture and fixture	[1,200 – 110]	1,090
Van	[1,500 – 275]	1,225
Advance for land		65,000
Prepaid rent	[3,600 – 1,100 – 1,200]	1,300
Security deposit		20
Advance for parking shed		100
		68,735
Current assets		Rs. 000
Stock	W2	440
Prepaid rent	[3,600 / 3]	1,200
Prepaid insurance	[120 x 1/12]	10
Advance salaries		10
Receivable for beverages		150
Bank		27,620
		29,430
		98,165

Net assets (fund)		Rs. 000
Sponsor's contribution		50,000
Surplus		22,289
		72,289
Non-current liabilities		
Subscription in advance	W1	15,338
Current liabilities		
Subscription in advance	W1	9,984
Salaries payable	[990 / 10 months]	99
Utilities payable	[550 / 10 months]	55
Repairs payable		7
Payable for beverages	W3	393
		10,538
		98,165

W1: Subscription income

Subscription for 3 years is Rs. 72,000 so subscription for 1 year is Rs. 24,000 or Rs. 2,000 per month.

	No. of members	No. of months	Monthly Rs. 000	Subscription Rs. 000
Total received	416	36	2	29,952
Recognised in I&E				
From march	112	10	2	2,240
From June	98	7	2	1,372
From September	101	4	2	808
From December	105	1	2	210
				4,630
Current liability	416	12	2	9,984
Non-current liability				[29,952 - 4,630 - 9,984]
				15,338

W2: Profit from sale of beverages

		Rs. 000
Sales	[1,500 + 150]	1,650
<u>Cost of sales</u>		
Opening stock		-
Purchases	[1,320 / 75 x 100]	1,760
Closing stock	[1,320 / 75 x 25]	(440)
	[1,650 / 100 x 80]	(1,320)
Profit		330

W3:

Payable for beverages			
	Rs. 000		Rs. 000
Bank	1,367	b/d	0
c/d	393	Purchases W2	1,760
	1,760		1,760

► Example 19:

A fire broke out in the office of Moderna Sports Club (MSC) and burnt all the accounting records. The accountant was able to retrieve a burnt copy of financial statements of MSC for the year ended 31 December 2020. However, few information (as indicated by capital alphabets) were unreadable. The retrieved copy is as follows:

Statement of financial position as on 31 December 2020

Funds and liabilities	Rs. in '000		Assets	Rs. in '000	
	2020	2019		2020	2019
General fund:			Fixed assets - net	1,403	1,300
Opening balance	A	1,586	Members' subscription	270	158
Excess of income over expenditure	B	C	Misc. supplies	13	10
			Tuck-shop rent	E	37
Tennis court fund	260	200	Advance salaries	18	15
			Bank	F	530
Liabilities:					
Members' subscription	20	25			
Salaries	52	41			
Utilities	25	D			
Annual sports event	10	-			

Statement of income and expenditure for the year ended 31 December 2020

Expenditure	Rs. in '000	Income	Rs. in '000
Salaries	G	Members' subscriptions	919
Utilities	221	Tuck-shop rent	252
Misc. supplies	H	Donation - sports equipment	70
Members' subscription written off	12	L	M
Annual sports event	I		
J	K		
Disposal of fixed assets	8		
Repair and maintenance	40		
Excess of income over expenditure	B		

Receipts and payments account for the year ended 31 December 2020

Receipts	Rs. in '000	Payments	Rs. in '000
Opening balance	530	Salaries	560
N	O	Fixed assets	92
Tennis court fund	P	Annual sports event	180
Contribution for annual sports event	49	Misc. supplies	132
Entrance fee - annual sports event	86	Utilities	214
Sale of fixed assets	21	Repair and maintenance	Q
Tuck-shop rent	248	Construction of tennis court	131
Scrap sale	15	Closing balance	F

Required: Determine the missing information as indicated by capital alphabets. (*Redrafting of above financial statements is not required*).

► **Answer:**

	Description	Rs. in '000	Working
A	Opening general fund – 2020	1,766	1,586 + 180 (C) / Balancing figure in SFP of 2020
B	Excess of income over expenditure – 2020	62	Balancing figure in SFP / I&E
C	Excess of income over expenditure – 2019	180	198–18(D) Balancing figure in SFP of 2019
D	Utilities payable – 2019	18	(W1)
E	Tuck-shop rent receivable	41	(W2)
F	Bank balance – 2020	450	Balancing figure in receipt and payment account
G	Salaries expense	568	(W3)
H	Misc. supplies expense	129	(W4)
I	Annual sports event expense	55	(W5)
J	Depreciation expense		
K	Depreciation expense	161	(W6)
L	Scrap sale / Other income		
M	Scrap sale / Other income	15	
N	Members' subscriptions received		
O	Members' subscriptions received	790	(W8)
P	Tennis court fund received	60	(W9)
Q	Repair and maintenance paid	40	

W1:

Utilities			
	Rs. in '000		Rs. in '000
Payment	214	b/d (balancing)	18
c/d	25	Expense	221
	239		239

W2:

Tuck shop rent			
	Rs. in '000		Rs. in '000
b/d	37	Receipt	248
Income	252	c/d (balancing)	41
	289		289

W3:

Salaries			
	Rs. in '000		Rs. in '000
b/d	15	b/d	41
Payment	560	Expense (balancing)	568
c/d	52	c/d	18
	627		627

W4:

Misc. Supplies			
	Rs. in '000		Rs. in '000
b/d	10	Expense (balancing)	129
Payment	132	c/d	13
	142		142

W5:

Annual Sports event			
	Rs. in '000		Rs. in '000
Payment	180	Members 'contribution	49
		Entrance fee	86
c/d	10	Expense (balancing)	55
	190		190

W6:

Fixed Assets – Net			
	Rs. in '000		Rs. in '000
b/d	1,300	Disposal (W7)	29
Donation	70	Depreciation (bal.)	161
Payment	92		
Tennis court	131	c/d	1,403
	1,593		1,593

W7:

Disposal			
	Rs. in '000		Rs. in '000
Fixed assets (balancing)	29	Sale proceeds	21
		Loss on disposal	8
	29		29

W8:

Members' subscription			
	Rs. in '000		Rs. in '000
b/d	158	b/d	25
Income	919	Receipt (balancing)	790
		Write off	12
c/d	20	c/d	270
	1,097		1,097

W9:

Tennis court fund			
	Rs. in '000		Rs. in '000
		b/d	200
c/d	260	Receipt (balancing)	60
	260		260

► **Example 20:**

Following is the trial balance of Mahtab Welfare Hospital (MWH) as on 31 December 2021:

	Debit	Credit
	---- Rs. in million ----	
Capital work in progress – hospital building	335	
Cash at bank	60	
Closing inventory – medicines and supplies	14	
Contributions received		281
General fund as at 1 January 2021		332
Medical equipment	320	100
Medicines and supplies used	76	
Other expenditures	19	
Payables		17
Research cost	33	
Restricted fund as at 1 January 2021		180
Salaries	53	
Total	910	910

Additional information:

- i. The break-up of restricted fund balance is as follows:

Fund	Description	Rs. in million
Hospital building fund	Contributions received for the construction of hospital building.	120
Research fund	As per the resolution of board of trustees, MWH is required to allocate 20% of surplus of each year to the research fund.	60

- ii. Contributions received include Rs. 55 million received for construction of hospital.
- iii. During the year, MWH also received construction materials having fair value of Rs. 65 million for the hospital building which has not been recorded in books.
- iv. MWH has completed the construction of hospital building on 1 April 2021.
- v. Depreciation is to be charged as follows:

Hospital building	5% – straight line
Other fixed assets	10% – reducing balance

Required:

Prepare the following using deferral method:

- a) Statement of income and expenditure for the year ended 31 December 2021.
- b) Statement of financial position as at 31 December 2021.

► Answer:

Part (a)

Statement of income and expenditure for the year ended 31 December 2021

Income:		Rs. in million
General Contributions	[281 – 55]	226
Hospital contributions	W1	9
		235
Expenditure:		
Medicine and supplies used		76
Salaries		53
Other expense		19
Depreciation – Hospital	$[(335+65) \times 5\% \times 9/12]$	15
Depreciation – Other fixed assets	$[(320-100) \times 10\%]$	22
		(185)
Surplus i.e. excess of income over expenditure		50

Part (b)

Statement of financial position as at 31 December 2021

Non-current assets:		Rs. in million
Hospital building	[335 + 65 – 15]	385
Medical equipment	[320 – 100 – 22]	198
		583
Current assets:		
Medicines and supplies		14
Cash at bank		60
		74
		657
Funds:		
General fund	$[332 + 50 - (50 \times 20\%)]$	372
Research fund	$[60 - 33 + (50 \times 20\%)]$	37
		409
Non-current liabilities:		
Hospital deferred contribution	W1	219

Current liabilities:		Rs. in million
Payables		17
Hospital deferred contribution	W1	12
		29
		657

W1:

Contributions for hospital buildings		Rs. in million
Opening balance		120
Received in cash		55
Received in kind	(at fair value)	65
		240
Transferred to income	$[240 \times 5\% \times 9/12]$	(9)
		231
Presented as current liability	$[240 \times 5\%]$	(12)
Presented as non-current liability		219

► **Example 21:**

Oracle Family Club (OFC) was formed in January 2021. The following information is available in respect of the first year of operations:

Receipt and payment account for the year ended 31 December 2021

Receipts	Rs. in '000	Payments	Rs. in '000
Subscriptions for:		Salaries	640
2021	2,800	Rent	990
2022	1,360	Equipment	2,560
Joining fees	2,100	10% Fixed deposit	2,020
Canteen sales	720	Construction of building	1,500
Life-time memberships	1,840	Canteen purchases	700
		Closing balance	410
	8,820		8,820

Statement of income and expenditure for the year ended 31 December 2021

Expenditures	Rs. in '000	Incomes	Rs. in '000
Salaries	700	Subscription	3,450
Rent	760	Interest on fixed deposit	150
Depreciation of equipment	200	Life-time memberships	360
Surplus	2,330	Profit from canteen	30
	3,990		3,990

Additional information:

- i. OFC also operates a canteen. All sales and purchases of canteen are made for cash.
- ii. Salary of canteen's salesman amounted to Rs. 90,000 is included in payments.

Required:

Prepare OFC's statement of financial position as on 31 December 2021.

► *Answer:*

Statement of financial position as on 31 December 2021

Non-current assets:		Rs. in '000
Equipment	[2,560 – 200]	2,360
Capital work in progress – Building		1,500
		3,860
Current assets:		
Canteen inventory	W1	100
Subscription in arrears	[3,450 – 2,800]	650
Prepaid rent	[990 – 760]	230
Fixed deposit		2,020
Interest receivable		150
Cash		410
		3,560
		7,420
General funds:		
Opening balance		-
Excess of income over expenditure		2,330
		2,330
Joining fees fund (or deferred joining fees)		2,100
Liabilities:		
Deferred life membership	[1,840 – 360]	1,480
Salaries payable	[700 + 90 – 640]	150
Subscription in advance		1,360
		7,420

W1: Canteen profit statement

	Rs. in '000
Sales	720
<u>Cost of sales</u>	
Opening inventory	0
Purchases	700
Closing inventory (balancing)	(100)
	[720 sales – 120 gross profit]
	(600)
Gross profit	120
	[30 profit + 90 salary]
Salary of salesman	(90)
Profit	30

► **Example 22:**

Gemini Club (GC) prepared its complete financial statements for 2023; however, the excel sheet containing statement of income and expenditure was inadvertently deleted. The following comparative balance sheet, along with the receipts and payments account, is available:

Balance sheet as on 31 December 2023

Funds and liabilities	Rs. in '000		Assets	Rs. in '000	
	2023	2022		2023	2022
General fund:			Fixed assets – net	1,403	1,300
Opening balance	1,766	1,586	Members' subscription	270	158
Excess of income over expenditure	62	180	Miscellaneous supplies	13	10
	1,828	1766	Tuck-shop rent	41	37
Tennis court fund	260	200	Advance salaries	18	15
			Bank	450	530
Liabilities:					
Members' subscription	20	25			
Salaries	52	41			
Utilities	25	18			
Annual sports event	10	-			
	2,195	2,050		2,195	2,050

Receipts and payments account for the year ended 31 December 2023

Receipts	Rs. in '000	Payments	Rs. in '000
Opening balance	530	Salaries	560
Members' subscription received	790	Fixed assets	92
Tennis court fund	60	Annual sports event	180
Contribution for annual sports event	49	Miscellaneous supplies	132
Entrance fee - annual sports event	86	Utilities	214
Tuck-shop rent	248	Repair and maintenance	40
Scrap sale	15	Construction of tennis court	110
		Closing balance	450
	1,778		1,778

Required:

Prepare GC's statement of income and expenditure for the year ended 31 December 2023. (Comparative figures are not required)

► **Answer:****Gemini Club**

Statement of income and expenditure for the year ended 31 December 2023

Income		Rs. in '000
Members' subscription	790+270-158+25-20	907
Tuck shop rent	248+41-37	252
Scrap sale/other income		15
		1,174
Expenditures		
Salaries	560+52-41+15-18	568
Utilities	214+25-18	221
Annual sports event - net	(180+10)-(49+86)	55
Depreciation	1,300+92+110-1,403	99
Repairs and maintenance		40
Miscellaneous supplies expense	10+132-13	129
		(1,112)
Excess of income over expenditure		62

► **Example 23:**

Aztec Sports Club (ASC) was formed on 1 January 2021 when a founding member sold a piece of land to ASC having fair value of Rs. 4,000,000 for the purpose of establishing a sports club, for Rs. 1,000,000 only. The following information is available for the preparation of financial statements of ASC for the year ended 31 December 2022:

- i. Balances of some assets and liabilities as on 1 January 2022:

	Rs. in '000
Cash and bank balances	223
Fixed assets (other than land)	6,450
Prepaid insurance	274
Accrued other expenditures	865

- ii. Payments made during the year:

	Rs. in '000
Fixed assets (on 1 May 2022)	6,000
Annual insurance (valid till 31 March 2023)	1,404
Other expenditures	2,788

- iii. Annual membership fee for the years 2021, 2022 and 2023 was Rs. 8,000, Rs. 10,000 and Rs. 12,000 respectively. However, members joining in second half of year are charged only half fee for that year. Each member is required to pay the membership fee for the current year and the next year at the time of admission. The numbers of members admitted during the years 2021 and 2022 are as follows:

2021		2022	
1 st half	2 nd half	1 st half	2 nd half
150	270	220	105

- iv. Contributions received during the year:

- A member contributed Rs. 1,400,000 for the purchase of a tractor for ground's maintenance. The tractor will be purchased in the year 2023.
- Another member contributed Rs. 1,100,000 without specifying any restriction.

- v. On 1 April 2021, an area was given on rent for operating a canteen in the club at an annual rent of Rs. 840,000. However, to facilitate the tenant for setting up the canteen, it was agreed that the rent for 2 years will be paid in 2023.
- vi. On 1 September 2022, some fixed assets having book value of Rs. 3,000,000 on 1 January 2022 were disposed of for Rs. 3,300,000.
- vii. Depreciation is charged on all fixed assets (other than land) using reducing balance method at a rate of 20% per annum.

Required:

Prepare the following using the deferral method:

- Statement of income and expenditure for the year ended 31 December 2022
- Statement of financial position as at 31 December 2022

► Answer:

(a)

Aztec Sports Club**Statement of income and expenditure for the year ended 31 December 2022**

Income		Rs. in '000
Membership	(W-1)	6,925
Canteen rent		840
Gain on disposal	3,300–2,600	700
Unrestricted contribution		1,100
		9,565
Expenditure		
Depreciation	(W-3)	1,890
Insurance	1,404+274–351(1,404×3/12)	1,327
Other expenditures	2,788–865	1,923
		(5,140)
Surplus of income over expenditure		4,425

(b)

Aztec Sports Club**Statement of financial position as on 31 December 2022**

		Rs. in '000
Non-current assets		
Land		4,000
Other fixed assets	(W-3)	7,960
		11,960
Current assets		
Rent receivable	840(IE)+630(W-4)	1,470
Prepaid insurance		351
Cash	(W-2)	2,456
		4,277
		16,237
Funds		
Opening general fund	(W-4)	3,512
Surplus of income over expenditure		4,425
		7,937
Land fund		3,000
		10,937
Liabilities		
Advance membership	(W-1)	3,900
Deferred contribution - tractor		1,400
		5,300
		16,237

W-1:	Membership		Rs. in '000
Income (bal.)	6,925	Opening advance $150 \times 10 + 270 \times 10$	4,200
		Receipts - 1 st half $220 \times 10 + 220 \times 12$	4,840
Closing advance $220 \times 12 + 105 \times 12$	3,900	- 2 nd half $105 \times 5 + 105 \times 12$	1,785
	10,825		10,825

W-2:

	Cash		Rs. in '000
Opening	223	Fixed assets	6,000
Subscription (4,840+1,785)	6,625	Insurance	1,404
Fixed assets disposal	3,300	Other expenditures	2,788
Contribution (1,100+1,400)	2,500	Closing	2,456
	12,648		12,648

W-3:

	Other fixed assets		Rs. in '000
Opening	6,450	Asset disposed of (3,000-400)	2,600
Purchase	6,000	Depreciation expense	1,890
		- Disposal $3,000 \times 8/12 \times 20\% = 400$	
		- Addition $6,000 \times 8/12 \times 20\% = 800$	
		- Remaining $(6,450 - 3,000) \times 20\% = 690$	
		Closing	7,960
	12,450		12,450

W-4:

Opening fund		
Cash		223
Other fixed assets		6,450
Prepaid insurance		274
Land		4,000
Land fund	4,000-1,000	(3,000)
		1,000
Rent receivable	$840 \times 9 \div 12$	630
Accrued other expenditures		(865)
Advance membership	(W-1)	(4,200)
General fund		3,512

► **Example 24:**

Following is the trial balance of Sagala Sports Club (SSC) as at 30 June 2024:

	Debit	Credit
	---- Rs. in million ----	
Accrued expenditures		17
Cash at bank	12	
Contribution for pavilion building		20
Depreciation expense	11	
General fund as at 1 July 2023		102
Other expenditures	38	
Fixed assets	96	
Pavilion building	27	
Payments for schools fee	7	
Players' subscription receivable as at 1 July 2023	8	
Players' subscription received during the year		45
Players' subscription received during the year in advance		15
Total	199	199

Additional information:

- A contribution of Rs. 20 million for the pavilion was received last year. The pavilion was completed this year at a cost of Rs. 30 million and has been depreciated by Rs. 3 million.
- Players' subscription of Rs. 16 million were outstanding as at 30 June 2024. Of this amount, Rs. 3 million should be written off as it was also outstanding on 1 July 2023.
- During the year, some players started paying subscriptions in advance for the whole year, receiving a 20% discount. 40% of these subscriptions should be considered as advances as at 30 June 2024.
- Due to a significant balance in the general fund, SSC's board of trustees has decided to establish a fund with Rs. 24 million to contribute to the school fees of promising children from the town. Parents can apply for a grant up to Rs. 50,000.

Required:

Prepare the following using deferral method:

- Statement of income and expenditure for the year ended 30 June 2024
- Statement of financial position as at 30 June 2024

► Answer:

Part (a)**Statement of income and expenditure for the year ended 30 June 2024**

		Rs. in million
Income:		
Players' subscription	(W-1)	62
Pavilion contributions	$20 \times (3 \div 30)$	2
		64
Expenditures:		
Depreciation		11
Other expenditures		38
Players' subscription written off		3
		(52)
Excess of income over expenditure		12

Part (b)**Statement of financial position as at 30 June 2024**

		Rs. in million
Non-current assets:		
Fixed assets		96
Pavilion building		27
		123
Current assets:		
Players' subscription receivable	(W-1)	13
Cash at bank		12
		25
		148
Funds:		
General fund	$102 + 12 - 24$	90
School fee fund	$24 - 7$	17
		107
Pavilion deferred contribution	$20 - 2$	18
Liabilities:		
Accrued expenditures		17
Players' subscription received in advance	(W-1)	6
		23
		148

W1: Players' Subscription

	Rs. m		Rs. M
b/d (receivable)	8	Receipts $45 + 15$	60
Income and expenditure	62	Write offs	3
c/d (advance) $15 \times 40\%$	6	c/d (receivable) $16 - 3$	13
	<u>76</u>		<u>76</u>

6. OBJECTIVE BASED Q&A

1. Which of the following is generally considered an NPO?
 - a) Charitable organisation
 - b) Trading companies
 - c) Audit firms
 - d) Insurance companies
2. Expenditures greater than incomes of an NPO give rise to a:
 - a) Loss
 - b) Profit
 - c) Surplus
 - d) Deficit
3. An advance receipt of subscription from a member of the NPO is considered as:
 - a) an expense
 - b) a liability
 - c) an equity item
 - d) an asset
4. Statement of income and expenditure is based on;
 - a) Cash accounting
 - b) Accrual accounting
 - c) Government accounting
 - d) Management accounting
5. When cash is received for life membership, which one of the following double entries is passed?
 - a) Cash Debit and capital Credit
 - b) Life membership Debit and cash Credit
 - c) Investment Debit and cash Credit
 - d) Cash Debit and deferred life-membership fee Credit
6. XYZ club has a bar that maintains a separate trading account for its trading activities. Which of the following is the treatment of profit or loss on bar trading activities?
 - a) Profit or loss is directly shown in the statement of financial position
 - b) Profit or loss is to be presented in statement of income and expenditure
 - c) Profit or loss is credited in statement of profit or loss
 - d) Profit or loss is added to accumulated fund
7. An NPO has provided services to one of its members, however, subscription has not been received yet. It is considered as:
 - a) an asset
 - b) a liability
 - c) an income
 - d) an expenditure

8. Rs. 1,000,000 received as the annual membership subscription. Out of this, Rs. 200,000 is pertaining to the previous accounting period whereas Rs. 100,000 is receivable at the end of the current accounting period.

Calculate the amount of subscription that will be shown in the statement of income and expenditure.

- a) Rs. 100,000
 - b) Rs. 900,000
 - c) Rs. 1,200,000
 - d) Rs. 800,000
9. Statement of income and expenditure shows:
- a) Cash available to an organization
 - b) Closing capital of an organization
 - c) Cash available in the bank account
 - d) Surplus or deficit for the current accounting period
10. On what basis the 'receipts and payments account' is prepared?
- a) Cash basis
 - b) Accrual basis
 - c) Both accrual and cash basis
 - d) None of the two
11. Statement of income and expenditure includes:
- a) Capital items
 - b) Revenue items
 - c) Both capital items and revenue items
 - d) None of these
12. A club has 500 members. Annual membership fees are Rs. 1,000. Therefore, membership fees for the year should be Rs. 500,000.

The club's subscription records for the year ended 31 December 2013 show the following:

	At 31 December 2012	At 31 December 2013
Subscriptions in advance	10,000	6,000
Subscriptions in arrears	18,000	22,000

Calculate the amount of cash received during the year.

- a) Rs. 492,000
 - b) Rs. 496,000
 - c) Rs. 504,000
 - d) Rs. 508,000
13. At 31 March 2012 a cricket club had membership subscriptions in arrears amounting to Rs. 48,000 and had received Rs. 12,000 subscriptions in advance.

During the year to 31 March 2013 the club received Rs. 624,000 including 26 memberships for the year to 31 March 2014 at Rs. 1,200 per annum in advance.

At 31 March 2013 16 members owed subscriptions of Rs. 1,200 each.

Calculate the amount of subscription income during the year.

- a) Rs. 552,000
- b) Rs. 576,000
- c) Rs. 600,000
- d) Rs. 648,000

14. At 31 March 2012 a cricket club had membership subscriptions in arrears amounting to Rs. 48,000 and had received Rs. 12,000 subscriptions in advance.

During the year to 31 March 2013 the club received Rs. 624,000 including 26 memberships for the year to 31 March 2014 at Rs. 1,200 per annum.

At 31 March 2013 16 members owed subscriptions of Rs. 1,200 each.

Half of the members who were in arrears at the end of the previous period still had not paid by 31 March 2013. It was decided to write these amounts off.

Required:

Calculate the amount of subscription income during the year.

- a) Rs. 552,000
- b) Rs. 576,000
- c) Rs. 600,000
- d) Rs. 648,000

15. Seaview Club started its operations on 1 February 2015. Total subscription received for the period ended 31 December 2015 was Rs. 29,952,000

Annual subscription is Rs. 24,000. All new members pay three years' subscription in advance. The memberships were awarded as follows:

Month	March	June	September	December
No. of member	112	98	101	105

What amount of subscription income should be included in statement of income and expenditure for the period ended 31 December 2015?

- a) Rs. 4,630,000
- b) Rs. 9,984,000
- c) Rs. 15,338,000
- d) None of above

16. Seaview Club started its operations on 1 February 2015. Total subscription received for the period ended 31 December 2015 was Rs. 29,952,000

Annual subscription is Rs. 24,000. All new members pay three years' subscription in advance. The memberships were awarded as follows:

Month	March	June	September	December
No. of member	112	98	101	105

What amount of advance subscription should be included in non-current liabilities as at 31 December 2015?

- a) Rs. 4,630,000
- b) Rs. 9,984,000
- c) Rs. 15,338,000
- d) None of above

17. The main objective of an NPO is;
- To earn profits
 - To create monopoly
 - Welfare of the society or service to its members
 - To provide for owner's dividends
18. Receipt and payment account include:
- Revenue items
 - Capital items
 - Both capital and revenue items
 - None of above
19. The 'Accounting Standard for NPOs' has been issued by:
- The Institute of Chartered Accountants of Pakistan
 - The Securities and Exchange Commission of Pakistan
 - International Accounting Standards Board
 - All Pakistan Association of NPOs
20. According to ASNPO, the financial statements of an NPO use the following concept of capital maintenance:
- Physical capital maintenance
 - Welfare capital maintenance
 - Financial capital maintenance (real terms)
 - Financial capital maintenance (money terms)
21. An NPO has a fund that is subject to externally imposed stipulations specifying the resources contributed be maintained permanently, although the constituent assets may change from time to time. Which type of fund it is?
- Unrestricted fund
 - Capital assets fund
 - Restricted fund
 - Endowment fund
22. Which of the following statement is incorrect with respect to restrictions on contribution revenue of an NPO?
- Restrictions may be externally imposed
 - Restrictions may be internally imposed
 - Restrictions may be explicit
 - Restrictions may be implicit
23. An NPO received endowment contributions of Rs. 2 million. How should the receipt be recognised under deferral method?
- Recognise as revenue in statement of income and expenditure in endowment fund of the current period
 - Recognise as revenue in statement of income and expenditure in general fund of the current period
 - Recognise as direct increase in statement of changes in net assets in endowment fund of the current period
 - Recognise as direct increase in statement of changes in net assets in general fund of the current period

24. An NPO received restricted contribution for the repayment of debt. The related debt was incurred for the payment of expenses expected to be incurred in next three years. How should the receipt be recognised under deferral method?
- Recognise as revenue in statement of income and expenditures of the current period
 - Defer and recognise as revenue in relevant periods applying the matching concept
 - Recognise as direct increase in net assets in the statement of changes in net assets
 - Recognise as deduction from related capital asset or related expenses
25. An NPO received restricted contribution for the repayment of debt. The related debt was taken to fund purchase of school's furniture. How should the receipt be recognised under deferral method?
- Recognise as revenue in statement of income and expenditures of the current period
 - Defer and recognise as revenue on the same basis as related depreciation expense is charged
 - Recognise as direct increase in net assets in the statement of changes in net assets
 - Recognise as deduction from related capital asset or related expenses
26. An NPO received restricted contribution for the repayment of debt. The related debt was taken neither to fund expenses of future periods nor to fund purchase of any capital assets. How should the receipt be recognised under deferral method?
- Recognise as revenue in statement of income and expenditures of the current period
 - Defer and recognise as revenue in relevant period applying the matching concept
 - Recognise as direct increase in net assets in the statement of changes in net assets
 - Recognise as deduction from related capital asset or related expenses
27. An NPO earned investment income that is externally restricted to be held for endowment. How should it be recognised under deferral method?
- Recognise as revenue in statement of income and expenditures of the current period
 - Defer and recognise as revenue in relevant period applying the matching concept
 - Recognise as direct increase in net assets in the statement of changes in net assets
 - Recognise as deduction from related capital asset or related expenses
28. An NPO has of 16,000 bags of rice to be sold only to members of an underprivileged community. The cost of rice to the NPO is Rs. 600 per bag. However, the NPO sells one bag to the underprivileged persons for Rs. 50 only. How should these 16,000 bags be measured?
- At cost
 - At lower of cost and NRV
 - At lower of current replacement cost and NRV
 - At lower of cost and current replacement cost
29. Morning Football Club has a monthly subscription fee of Rs. 800 per member. The club has 240 members on 31 December 2018. No fresh members were admitted during 2018 but 30 members left the club on 1 July 2018. As at 31 December 2018, the club has received subscription in advance amounting to Rs. 60,000. The club's subscription income for 2018 would be:
- Rs. 2,448,000
 - Rs. 2,388,000
 - Rs. 2,160,000
 - Rs. 2,100,000

30. Alpha Club's financial year ends on 31 December. Following information pertain to its members' subscription:

	Rupees
Subscription received in 2018 for 2019	180,000
Subscription received in 2019 for 2018	90,000
Subscription received in 2019 for 2019	1,400,000
Subscription received in 2019 for 2020	200,000
Subscription for 2018 outstanding as on 31 December 2018	150,000
Subscription for 2019 outstanding as on 31 December 2019	325,000

Subscription income for the year ended 31 December 2019 is:

- Rs. 1,845,000
 - Rs. 1,705,000
 - Rs. 1,905,000
 - Rs. 1,665,000
31. Which of the following is a self-balancing set of accounts that reports all unrestricted revenue and restricted contributions for which no corresponding restricted fund is presented?
- General fund
 - Restricted fund
 - Endowment fund
 - Balancing fund
32. Annual membership subscription income of Rs. 1,800,000 was shown in the statement of income and expenditure. Out of this, Rs. 300,000 was receivable at the year-end. During the year, an amount of Rs. 400,000 was received pertaining to the previous year. Calculate the total amount of subscription received during the year.
- Rs. 1,100,000
 - Rs. 1,700,000
 - Rs. 1,900,000
 - Rs. 2,500,000
33. A non-profit organisation earns income on funds that are externally restricted to be held for endowment. How should such income be recognised under the deferral method?
- Recognise revenue in the current year immediately
 - Defer and recognise revenue over the years
 - Recognise direct increase in the statement of changes in net assets
 - Deduct from the related capital asset

ANSWERS

01.	(a)	Trading companies, audit firms and insurance companies are profit oriented. A charitable organisation is an NPO.																															
02.	(d)	Excess of expenditure over income of an NPO is called ‘deficit’.																															
03.	(b)	The subscription received in advance is unearned and shall be presented as a liability.																															
04.	(b)	Statement of income and expenditure is prepared on accrual basis while receipt and payment account is prepared on cash basis.																															
05.	(d)	Cash Debit and Deferred life-membership fee Credit																															
06.	(b)	Profit or loss from running an operation shall be presented in statement of income and expenditure.																															
07.	(a)	Subscription receivable is presented as a current asset.																															
08.	(b)	<table><tr><th colspan="4">Subscription a/c</th></tr><tr><th>Particulars</th><th>Rs.</th><th></th><th>Particulars</th><th>Rs.</th></tr><tr><td>b/d</td><td>200,000</td><td></td><td>Cash received</td><td>1,000,000</td></tr><tr><td>I & E</td><td>900,000</td><td></td><td>c/d</td><td>100,000</td></tr><tr><td></td><td>1,100,000</td><td></td><td></td><td>1,100,000</td></tr></table>				Subscription a/c				Particulars	Rs.		Particulars	Rs.	b/d	200,000		Cash received	1,000,000	I & E	900,000		c/d	100,000		1,100,000			1,100,000				
Subscription a/c																																	
Particulars	Rs.		Particulars	Rs.																													
b/d	200,000		Cash received	1,000,000																													
I & E	900,000		c/d	100,000																													
	1,100,000			1,100,000																													
09.	(d)	Statement of income and expenditure shows surplus or deficit for the current accounting period.																															
10.	(a)	Statement of income and expenditure is prepared on accrual basis while receipt and payment account is prepared on cash basis.																															
11.	(b)	Statement of income and expenditure includes only revenue items.																															
12.	(a)	<table><tr><th colspan="4">Subscriptions</th></tr><tr><th></th><th>Rs.</th><th></th><th>Rs.</th></tr><tr><td>Balance b/d</td><td>18,000</td><td>Balance b/d</td><td>10,000</td></tr><tr><td>I&E</td><td>500,000</td><td>Cash</td><td>492,000</td></tr><tr><td>Balance c/d</td><td>6,000</td><td>Balance c/d</td><td>22,000</td></tr><tr><td></td><td>524,000</td><td></td><td>524,000</td></tr></table>				Subscriptions					Rs.		Rs.	Balance b/d	18,000	Balance b/d	10,000	I&E	500,000	Cash	492,000	Balance c/d	6,000	Balance c/d	22,000		524,000		524,000				
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17.	(c)	Welfare of the society or service to its members																																																
18.	(c)	Both capital and revenue items are included in receipt and payment account.																																																
19.	(a)	ASNPO has been issued by ICAP.																																																

20.	(d)	Financial statements of an NPO are prepared with capital maintenance measured in financial terms and with no adjustment being made for the effect on capital of a change in the general purchasing power of the currency during the period.																											
21.	(d)	Such stipulations relate to endowment contribution and related fund would be endowment fund.																											
22.	(b)	Restrictions (explicit or implicit) on contributions may only be externally imposed.																											
23.	(c)	Endowment contributions are recognised ad direct increase in statement of changes in net assets.																											
24.	(b)	As debt relates to expenses of future periods, the contribution for repayment thereof shall be deferred and recognised as revenue in future relevant periods.																											
25.	(b)	Defer and recognise as revenue on the same basis as related depreciation expense is charged																											
26.	(a)	Recognise as revenue in statement of income and expenditures of the current period																											
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31.	(a)	General fund																											
32.	(c)	<table><tr><td colspan="4">Subscription</td></tr><tr><td>Particulars</td><td>Rs. 000</td><td></td><td>Particulars</td><td>Rs. 000</td></tr><tr><td>b/d</td><td>400</td><td></td><td>Cash (balancing)</td><td>1,900</td></tr><tr><td>I & E</td><td>1,800</td><td></td><td>c/d</td><td>300</td></tr><tr><td></td><td>2,200</td><td></td><td></td><td>2,200</td></tr></table> Cash received Rs. 1,900,000				Subscription				Particulars	Rs. 000		Particulars	Rs. 000	b/d	400		Cash (balancing)	1,900	I & E	1,800		c/d	300		2,200			2,200
Subscription																													
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33.	(c)	Recognise direct increase in the statement of changes in net assets																											

STICKY NOTES

Different terminology

Profit-oriented entities	Not-for-Profit Organisations
Statement of comprehensive income	Statement of income and expenditure
Net profit	Excess of income over expenditure / Surplus
Net loss	Excess of expenditure over income / Deficit
Equity / Share capital and equity reserves	Net assets / Accumulated fund / Accumulated surplus / Accumulated deficit / Fund balance
Statement of changes in equity	Statement of changes in net assets
Specific reserve	Restricted contribution / grant
Fee	Subscription
Owners / Shareholders	Trustees/ sponsors / donors

Types of contributions

Restricted contribution	A restricted contribution is a contribution subject to externally imposed stipulations that specify the purpose for which the contributed asset is to be used.
Endowment contribution	An endowment contribution is a type of restricted contribution subject to externally imposed stipulations specifying that the resources contributed be maintained permanently, although the constituent assets may change from time to time.
Unrestricted contribution	An unrestricted contribution is a contribution that is neither a restricted contribution nor an endowment contribution.

Subscription account

	Rs.		Rs.
Balance b/d		Balance b/d	
(members in arrears)	X	(members who have prepaid)	X
Income and expenditure	X	Cash	X
Balance c/d		Balance c/d	
(members who have prepaid)	X	(members in arrears)	X
	<u>X</u>		<u>X</u>
Balance b/d		Balance b/d	
(members in arrears)	X	(members who have prepaid)	X

Profit (loss) from running an operation	Rs.
Sales	X
<u>Cost of sales</u>	
Opening inventory	X
Purchases	X
Closing inventory	(X)
	(X)
Gross profit	X
Coffee shop worker's salary (and other relevant expenses)	(X)
Profit (loss)	X / (X)

Not-for-Profit Organisation	
Statement of financial position as at _____	
	Rs. 000
Non-current assets	
Capital assets (property, plant and equipment)	XX
Collections	XX
Investments	XX
	XX
Current assets	
Office supplies stock	XX
Prepaid expenses	XX
Subscription receivable	XX
Cash and cash equivalents	XX
	XX
	XXX
Fund balances / Net assets	
General fund / Unrestricted net assets	XX
Net assets: restricted for endowments	XX
Net assets: internally restricted for special projects	XX
	XX
Non-current liabilities	
Deferred grants/contributions	XX
Loans	XX
	XX
Current liabilities	
Deferred grants/contributions	XX
Subscriptions received in advance	XX
Accrued expenses	XX
	XX
	XX

Not-for-Profit Organisation
Statement of income and expenditure for the year ended _____

Income	Rs. 000
Fee-for-services	XX
Government grants	XX
Contributions	XX
Fundraising events	XX
Profit from coffee bar / shop / canteen	XX
Investment income	XX
Other income	XX
Expenditures	
Salaries	XX
Rent	XX
Office supplies used	XX
Utilities	XX
Marketing and communications	XX
Amortisation of capital assets	XX
	(XX)
Excess of income over expenditure i.e. surplus	XX

Not-for-Profit Organisation
Statement of changes in net assets for the year ended _____

	Unrestricted / General fund	Endowment fund	Special (internal) fund	Total
	Rs. 000	Rs. 000	Rs. 000	Rs. 000
Balance 1 January	XXX	XX	XXX	XXX
Surplus	XX			XX
Endowment		XX		XX
Contributions		XX		X
Investment income		XX		-
Transfer to special fund	(X)		XX	-
Transfer to endowment	(X)	XX		-
Balance 31 December	XXX	XX	XX	XXX

IAS 7 STATEMENT OF CASH FLOWS

IN THIS CHAPTER:

AT A GLANCE

SPOTLIGHT

1. Introduction
2. Presentation
3. Reporting operating cash flows
4. Reporting investing and financing cash flows
5. Usefulness of cash flow information
6. Comprehensive Examples
7. Objective Based Q&A

STICKY NOTES

AT A GLANCE

IAS 7 prescribes how to present information in a statement of cash flows to reflect changes in an entity's cash and cash equivalents during the period. Cash comprises cash on hand and demand deposits. Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and that are subject to an insignificant risk of changes in value.

The statement classifies cash flows during a period into cash flows from operating, investing and financing activities:

- a) operating activities are the principal revenue-producing activities of the entity and other activities that are not investing or financing activities. An entity reports cash flows from operating activities using either:
 - the direct method, whereby major classes of gross cash receipts and gross cash payments are disclosed; or
 - the indirect method, whereby profit or loss is adjusted for the effects of transactions of a non-cash nature, any deferrals or accruals of past or future operating cash receipts or payments and items of income or expense associated with investing or financing cash flows.
- b) investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents. The aggregate cash flows arising from obtaining and losing control of subsidiaries or other businesses are presented as investing activities.
- c) financing activities are activities that result in changes in the size and composition of the contributed equity and borrowings of the entity.

Investing and financing transactions that do not require the use of cash or cash equivalents are excluded from a statement of cash flows but separately disclosed. IAS 7 requires an entity to disclose the components of cash and cash equivalents and to present a reconciliation of the amounts in its statement of cash flows with the equivalent items reported in the statement of financial position.

1 INTRODUCTION

1.1 Scope [IAS 7: 1 & 3]

IAS 7 requires all entities to prepare a statement of cash flows as an integral component of financial statements for each period for which financial statements are presented.

All entities need cash, regardless of how different their principal revenue-producing activities might be, to conduct their operations, to pay their obligations, and to provide returns to their investors. Users of an entity's financial statements are interested in how the entity generates and uses cash and cash equivalents. Therefore, understanding cash inflows and outflows is important

1.2 Key definitions [IAS 7: 6 to 9]

Cash comprises cash on hand and demand deposits.

Bank overdraft, which are repayable on demand, is included as a component of cash and cash equivalent.

Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.

Not all investments are cash equivalents. An investment normally qualifies as a cash equivalent only when it has a short maturity of, say, three months or less from the date of acquisition. Equity investments are excluded from cash equivalents unless they are, in substance, cash equivalents, for example, redeemable preference shares acquired within a short period of their specified maturity date.

► Example 01:

Which of the following items are cash equivalents:

- i. Investment in ordinary shares of another entity. The shares are traded on Pakistan Stock Exchange.
- ii. Prize bonds issued by Government of Pakistan
- iii. Government treasury bills with specified two months' maturity (to be encashed into specified amount)
- iv. Trade receivables
- v. Plant and machinery
- vi. Inventory

► Answer:

- i. Not cash equivalent. Although these shares are readily convertible into cash yet there is significant risk of changes in value.
- ii. Cash equivalent.
- iii. Cash equivalent.
- iv. Not cash equivalent. These are not investments.
- v. Not cash equivalent. Not readily convertible into known amount of cash.
- vi. Not cash equivalent. Not readily convertible into known amount of cash.

Cash flows are inflows and outflows of cash and cash equivalents.

Cash flows exclude movements between items that constitute cash or cash equivalents, for example, deposit of cash on hand into bank account or vice versa.

► *Example 02:*

Whether the following transactions shall be reported as cash flows?

- Cash in hand deposited in bank account
- Cash withdrawn from bank to be held as cash in hand
- Sale or purchase of prize bonds
- Investment in government treasury bills with 60 days' maturity

► *Answer:*

None of the transactions shall be reported because cash flows exclude movements between items that constitute cash or cash equivalents.

► *Example 03:*

Calculate the total amount of cash and cash equivalents from the following data:

	Rs.
Cash in hand	200,000
Cash at bank (demand deposit)	400,000
Cash at bank (term deposit 3 months)	100,000
Cash at bank (term deposit 2 years)	300,000
Short term investment in T bills (1 month)	50,000
Investment in prize bonds	30,000
Trade receivables	80,000
Prepaid rent	60,000
Bank overdraft	8,000

► *Answer:*

Cash and cash equivalents	Rs.
Cash in hand	200,000
Cash at bank (demand deposit)	400,000
Cash at bank (term deposit 3 months)	100,000
Short term investment in T bills (1 month)	50,000
Investment in prize bonds	30,000
Bank overdraft	(8,000)
	772,000

1.3 Disclosure [IAS 7: 45 to 48]

An entity shall disclose the components of cash and cash equivalents and shall present a reconciliation of the amounts in its statement of cash flows with the equivalent items reported in the statement of financial position.

► *Example 04:*

The following data has been extracted from statement of financial position of Kashif Software Limited (KSL):

	2023	2022		2023	2022
<i>Current assets</i>	Rs. m	Rs. m	<i>Current liabilities</i>	Rs. m	Rs. m
Inventory	145	140	Short term loan	190	180
Trade receivables	195	180	Trade payables	185	170
Marketable securities*	5	8	Accrued expenses	13	17
Cash at bank	7	-	Bank overdraft	-	9
Cash in hand	2	3			

**Cash equivalents*

Required:

Prepare the disclosure note of components of cash and cash equivalents along with reconciliation with equivalent items presented in statement of financial position for KSL.

► *Answer:*

	Rs.m
Net increase in cash and cash equivalents	12
Cash and cash equivalent at beginning of period	2
Cash and cash equivalent at end of period	14

	2023	2022
Cash and cash equivalents	Rs. m	Rs. m
Marketable securities*	5	8
Cash at bank	7	-
Cash in hand	2	3
Bank overdraft	-	(9)
	14	2

**Cash equivalents*

An entity shall also disclose, together with a commentary by management, the amount of significant cash and cash equivalent balances held by the entity that are not available for use. For example, cash and cash equivalent balances held at a branch that operates in a country where exchange controls or other legal restrictions are such that the balances are not available for general use by the entity in Pakistan.

2 PRESENTATION

2.1 Presentation of statement of cash flows [IAS 7: 6, 10, 12, 14, 16 & 17]

The statement of cash flows shall report cash flows during the period classified by operating, investing and financing activities.

	Rs.
Cash generated from (used in) operating activities	X/(X)
Cash generated from (used in) investing activities	X/(X)
Cash generated from (used in) financing activities	X/(X)
Net increase (decrease) in cash and cash equivalents	X/(X)
Cash and cash equivalent at beginning of period	X/(X)
Cash and cash equivalent at end of period	X/(X)

Operating activities are the principal revenue-producing activities of the entity and other activities that are not investing or financing activities.

Examples of cash flows from operating activities are:

- cash receipts from the sale of goods and the rendering of services;
- cash receipts from royalties, fees, commissions and other revenue;
- cash payments to suppliers for goods and services;
- cash payments to and on behalf of employees; and
- cash payments or refunds of income taxes unless they can be specifically identified with financing and investing activities.

Some transactions, such as the sale of an item of plant, may give rise to a gain or loss that is included in recognised profit or loss. The cash flows relating to such transactions are cash flows from investing activities.

Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.

Examples of cash flows arising from investing activities are:

- cash payments to acquire or construct property, plant and equipment, intangibles and other long-term assets;
- cash receipts from sales of property, plant and equipment, intangibles and other long-term assets;
- cash payments to acquire equity or debt instruments of other entities (other than cash equivalents or those held for trading purposes);
- cash receipts from sales of equity or debt instruments of other entities (other than cash equivalents or those held for trading purposes);
- cash advances and loans made to other parties; and
- cash receipts from the repayments of advances and loans made to other parties.

Financing activities are activities that result in changes in the size and composition of the contributed equity and borrowings of the entity.

Examples of cash flows arising from financing activities are:

- a) cash proceeds from issuing shares;
- b) cash proceeds from issuing debentures, loans, bonds, mortgages and other short-term or long-term borrowings; and
- c) cash repayments of amounts borrowed.

A single transaction may include cash flows that are classified differently. For example, when the cash repayment of a loan includes both interest and capital, the interest element may be classified as an operating activity and the capital element is classified as a financing activity.

2.2 Interest, dividend and taxation [IAS 7: 31 to 34]

Cash flows from interest and dividends received and paid shall each be disclosed separately. Each shall be classified in a consistent manner from period to period as either operating, investing or financing activities.

Each of these items may be classified in either of the following two ways:

Item	Suggested classification*	Alternative classification
Interest paid (expensed or capitalised in accordance with IAS 23)	Operating because it is deducted in determining profit or loss.	Financing because they are costs of obtaining financial resources.
Interest received	Investing because they represent returns on investment.	Operating because it is added in determining profit or loss.
Dividend received	Investing because they represent returns on investment.	Operating because it is added in determining profit or loss.
Dividend paid	Financing because they are costs of obtaining financial resources.	Operating in order to assist users to determine the ability of entity to pay dividends out cash generated from operations.

**Based on illustrative example accompanying IAS 7.*

Cash flows arising from taxes on income shall be separately disclosed and shall be classified as cash flows from operating activities unless they can be specifically identified with financing and investing activities.

2.3 Non-cash transactions [IAS 7: 43]

Investing and financing transactions that do not require the use of cash or cash equivalents shall be excluded from a statement of cash flows. Examples include conversion of debt to equity, bonus issue of shares and revaluation and/or impairment of non-current assets.

Such transactions shall be disclosed elsewhere in the financial statements in a way that provides all the relevant information about these investing and financing activities.

► Example 05:

Identify the following transactions as operating, investing, financing activity or otherwise for the purpose of preparing statement of cash flows:

- i. Cash received from customers
- ii. Cash sales
- iii. Cash proceeds from disposal of PPE

- iv. Right issue of shares
- v. Dividend paid
- vi. Salaries paid to employees
- vii. Interest paid
- viii. Interest received by a trading entity on some investment
- ix. Repayment of loan
- x. Taxes paid
- xi. Purchase of a patent and software
- xii. Advance paid to supplier
- xiii. Depreciation
- xiv. Bonus issue of shares
- xv. Impairment loss on a plant

► *Answer:*

- i. Operating
- ii. Operating
- iii. Investing
- iv. Financing
- v. Financing or operating
- vi. Operating
- vii. Operating or financing
- viii. Investing
- ix. Financing
- x. Operating
- xi. Investing
- xii. Operating
- xiii. Non-cash transaction
- xiv. Non-cash transaction
- xv. Non-cash transaction

3 REPORTING OPERATING CASH FLOWS

3.1 Reporting cash flows from operating activities [IAS 7: 18, 31 & 35]

An entity is required to report cash flows from operating activities using either the direct method or indirect method.

Whichever method is used, IAS 7 requires interest paid and tax paid to be separately disclosed. Therefore, cash flows from operating activities are usually presented in the following manner:

Cash flows from operating activities	Rs. m
Cash generated from (used in) operations (Note 1)	XX/(XX)
Interest paid	(X)
Income taxes paid	(X)
Net cash from (used in) operating activities	X/(X)

The amount of 'interest paid' and 'tax paid' may be calculated by preparing relevant T account. Alternatively, it may be simply calculated as:

Amount paid = expense + opening accrual – closing accrual

► **Example 06:**

A company had liabilities in its statement of financial position at the beginning and at the end of 2017, as follows:

Interest payable	Rs.
Beginning of 2017	4,000
End of 2017	6,000

During the year, interest charges in profit or loss were Rs. 22,500.

Required:

Calculate the amount of interest paid during 2017.

► **Answer:**

Interest payable			
	Rs.		Rs.
Cash (balancing)	20,500	b/d	4,000
c/d	6,000	Profit or loss	22,500
	26,500		26,500

Alternatively, Rs. 22,500 expense + 4,000 opening accrual – 6,000 closing accrual = Rs. 20,500

► **Example 07:**

A company had liabilities in its statement of financial position at the beginning and at the end of 2017, as follows:

Income tax payable	Rs.
Beginning of 2017	53,000
End of 2017	61,000

During the year, taxation expense charged on profits was Rs. 77,000.

Required:

Calculate the amount of tax paid during 2017.

► *Answer:*

Tax payable			
	Rs.		Rs.
Cash (balancing)	69,000	b/d	53,000
c/d	61,000	Profit or loss	77,000
	130,000		130,000

Alternatively, Rs. 77,000 expense + 53,000 opening accrual – 61,000 closing accrual = Rs. 69,000

3.2 Cash generated from operations: indirect method [IAS 7: 18 & 20]

An entity may report cash flows from operating activities using indirect method whereby profit or loss is adjusted for the effects of transactions of a non-cash nature, any deferrals or accruals of past or future operating cash receipts or payments, and items of income or expense associated with investing or financing cash flows.

The cash generated from operations may be determined by making certain adjustments and taking account of working capital changes in “profit before tax”.

Profit before tax may be calculated by adding back tax expense to profit after tax determined as balancing amount by preparing retained earnings account.

► *Example 08:*

A company had retained earnings in its statement of financial position at the beginning and at the end of 2017, as follows:

Retained earnings	Rs.
Beginning of 2017	4,000
End of 2017	6,000

During the year, dividend of Rs. 20,000 was declared and paid and tax expense of Rs. 3,000 was included in profit or loss

Required:

Calculate the amount of profit before tax for the year ended 31 December 2017.

► *Answer:*

Retained earnings			
	Rs.		Rs.
Cash (dividend)	20,000	b/d	4,000
c/d	6,000	Profit after tax (bal.)	22,000
	26,000		26,000

Profit before tax = Rs. 22,000 + 3,000 = Rs. 25,000

The adjustments are to reverse the effect (by adding back expenses and deducting back income) of following items included in determination of profit or loss:

- non-cash items of income and expenses (e.g. depreciation, bad debts, etc.);
- income or expense associated with investing or financing activities (e.g. gain or loss on disposal, dividend received, etc.); and
- interest expense or finance cost because separate disclosure of interest paid is required.

The working capital changes (e.g. increase or decrease in inventory, trade receivables, trade payables, etc.) are included as follows:

- Increase in assets: cash outflow (e.g. cash paid to purchase inventory)
- Decrease in assets: cash inflow (e.g. cash received from receivables)
- Increase in liabilities: cash inflow (e.g. advance from customers obtained)
- Decrease in liabilities: cash outflow (e.g. cash paid to suppliers)

The following working capital changes are not included:

- Cash and cash equivalents i.e. to avoid duplication of cash flows.
- Other receivables relating to non-current assets because they relate to investing activity.
- Other payables relating to non-current assets because they relate to investing activity.
- Short term investments because they relate to investing activity.
- Short term borrowings because they relate to financing activity.
- Interest payable because this is used in separate disclosure of interest paid.
- Tax payable because this is used in separate disclosure of tax paid

3.3 Cash generated from operations: direct method [IAS 7: 18 & 19]

An entity may report cash flows from operating activities using direct method whereby major classes of gross cash receipts and gross cash payments are disclosed.

The cash generated from operations may be determined as follows based on illustrative examples accompanying IAS 7. However, presentation of more classes of receipts and payments is also acceptable.

Note 1: Cash generated from operations (direct method)	Rs.
Cash received from customers	XXX
Cash paid to suppliers and employees	(XXX)
	XX

The cash received from customers may be calculated by taking revenue and other income (only if related to customers) and including related working capital changes (e.g. trade receivables, unearned income, etc).

The cash paid to suppliers and employees may be determined by taking expenses (other than finance cost) and other income (not related to customers) and including all adjustments and working capital changes as included in indirect method (excluding those included in calculation of cash received from customers).

► Example 09:

The following information has been extracted from the financial statements of Hopper Limited for the year ended 31 December 2017:

	Rs.
Sales	1,280,000
Cost of sales	(400,000)
Gross profit	880,000
Distribution costs	(290,000)
Administrative expenses	(350,000)
Interest charges	(50,000)
Profit before tax	190,000
Taxation	(40,000)
Profit after tax	150,000

Extracts from the statement of financial position:

	At 1 January 2017	At 31 December 2017
	Rs.	Rs.
Inventory	118,000	124,000
Trade receivables	233,000	219,000
Trade payables	102,000	125,000
Accrued salaries	8,000	5,000
Accrued interest charges	30,000	45,000
Tax payable	52,000	43,000

Depreciation expense of Rs. 25,000 is included in profit or loss.

Required:

Using the above information, prepare cash flows from operating activities section of statement of cash flows for Hopper Limited using:

- indirect method
- direct method

► *Answer:*

Part (a) Indirect method

Hopper Limited

Statement of cash flows for the year ended 31 December 2017

Cash flows from operating activities	Rs.
Cash generated from operations (Note 1)	293,000
Interest paid [50,000 + 30,000 – 45,000]	(35,000)
Income taxes paid [40,000 + 52,000 – 43,000]	(49,000)
Net cash from (used in) operating activities	209,000

Note 1: Cash generated from operations (indirect method)	Rs.
Profit before tax	190,000
Adjustments:	
Depreciation	25,000
Finance costs	50,000
Operating profit	265,000
Working capital changes:	
Inventories [124,000 – 118,000]	(6,000)
Trade receivables [233,000 – 219,000]	14,000
Trade payables [102,000 – 125,000]	23,000
Accrued salaries [8,000 – 5,000]	(3,000)
	293,000

Part (b) Direct method**Hopper Limited****Statement of cash flows for the year ended 31 December 2017**

Cash flows from operating activities		Rs.
Cash generated from operations	(Note 1)	293,000
Interest paid	[50,000 + 30,000 – 45,000]	(35,000)
Income taxes paid	[40,000 + 52,000 – 43,000]	(49,000)
Net cash from (used in) operating activities		209,000

Note 1: Cash generated from operations (direct method)		Rs.
Cash received from customers	(1.1)	1,294,000
Cash paid to suppliers and employees	(1.2)	(1,001,000)
		293,000

1.1: Cash received from customers		Rs.
Revenue		1,280,000
(Increase) decrease in receivables	[233,000 – 219,000]	14,000
		1,294,000

1.2: Cash paid to suppliers and employees		Rs.
Cost of sales		(400,000)
Distribution costs		(290,000)
Administrative expenses		(350,000)
<i>Adjustments:</i>		
Depreciation		25,000
<i>Working capital changes:</i>		
Inventories	[124,000 – 118,000]	(6,000)
Trade payables	[102,000 – 125,000]	23,000
Accrued salaries	[8,000 – 5,000]	(3,000)
		(1,001,000)

► **Example 10:**

The following information has been extracted from the financial statements of Trango Limited for the year ended 31 December 2015:

Statement of comprehensive income for the year ended 31 December 2015

	Rs.
Sales	905,000
Cost of sales	(311,000)
Gross profit	594,000
Distribution costs	(275,000)
Administrative expenses	(193,000)
Interest charges	(24,000)
Profit before tax	102,000
Tax on profit	(38,000)
Profit after tax	64,000

Following items are included in profit or loss:

- Depreciation expense of Rs. 46,000
- Loss on disposal of non-current assets of Rs. 9,000. The asset disposed of had a carrying amount of Rs. 31,000 at the time of the sale.

Extracts from the statement of financial position:	At 1 Jan 2015	At 31 Dec 2015
	Rs.	
Inventory	42,000	38,000
Trade receivables	157,000	173,000
Trade payables	43,600	35,700
Accrued salaries	4,000	4,600
Accrued interest charges	11,200	10,000
Tax payable	45,000	41,000

Required:

Present the cash flows from operating activities as they would be presented in a statement of cash flows using:

- indirect method
- direct method

► Answer:

Part (a) Indirect method**Trango Limited****Statement of cash flows for the year ended 31 December 2015**

Cash flows from operating activities		Rs.
Cash generated from operations	(Note 1)	161,700
Interest paid	[24,000 + 11,200 – 10,000]	(25,200)
Income taxes paid	[38,000 + 45,000 – 41,000]	(42,000)
Net cash from (used in) operating activities		94,500

Note 1: Cash generated from operations (indirect method)		Rs.
Profit before tax		102,000
Adjustments:		
Depreciation		46,000
Loss on disposal of non-current assets		9,000
Finance costs		24,000
Operating profit		181,000
Working capital changes:		
Inventories	[42,000 – 38,000]	4,000
Trade receivables	[157,000 – 173,000]	(16,000)
Trade payables	[43,600 – 35,700]	(7,900)
Accrued salaries	[4,000 – 4,600]	600
		161,700

Part (b) Direct method**Trango Limited****Statement of cash flows for the year ended 31 December 2015**

Cash flows from operating activities		Rs.
Cash generated from operations	(Note 1)	161,700
Interest paid	[24,000 + 11,200 – 10,000]	(25,200)
Income taxes paid	[38,000 + 45,000 – 41,000]	(42,000)
Net cash from (used in) operating activities		94,500

Note 1: Cash generated from operations (direct method)		Rs.
Cash received from customers	(1.1)	889,000
Cash paid to suppliers and employees	(1.2)	(727,300)
		161,700

1.1: Cash received from customers		Rs.
Revenue		905,000
(Increase) decrease in receivables	[157,000 – 173,000]	(16,000)
		889,000

1.2: Cash paid to suppliers and employees		Rs.
Cost of sales		(311,000)
Distribution costs		(275,000)
Administrative expenses		(193,000)
Adjustments:		
Depreciation		46,000
Loss on disposal of non-current assets		9,000
Working capital changes:		
Inventories	[42,000 – 38,000]	4,000
Trade payables	[43,600 – 35,700]	(7,900)
Accrued salaries	[4,000 – 4,600]	600
		(727,300)

3.4 Presentation of bad and doubtful debts

A common exam issue is how to deal with receivables, bad debts and allowance for doubtful debts. There are two ways of dealing with this:

- Adjust the profit for bad and doubtful debts expense (i.e. non-cash item) and in working capital changes include the change in gross receivables (before deducting bad debts and allowance for doubtful debts); or
- Make no adjustments for bad and doubtful debts expense and in working capital changes include the change in net receivables (after deducting bad debts and allowance for doubtful debts).

The first method (i.e. change in gross receivables) must be used in exams whenever relevant information is available in the question.

► Example 11:

The following data relates to Adeel Software Limited (ASL):

	2021	2020
	Rs. m	Rs. m
Gross Receivables	500	480
Less: Allowance	(15)	(12)
Net Receivables	485	468

Bad debts of Rs. 8 million were also written off during the year.

Required:

Present the relevant information in statement of cash flows of ASL for the year ended 31 December 2021 using indirect method by:

- Presenting change in gross receivables
- Presenting change in net receivables

► Answer:

Part (a) presenting change in gross receivables

Note 1: Cash generated from operations (indirect method)		Rs. m
Profit before tax		XXX
Adjustments:		
Bad debts expense		8
Doubtful debts expense	[15 - 12]	3
Operating profit		XXX
Working capital changes:		
Trade receivables	[(500+8) - 480]	(28)
		XXX

Part (b) presenting change in net receivables

Note 1: Cash generated from operations (indirect method)		Rs. m
Profit before tax		XXX
Adjustments:		
Bad debts expense		-
Doubtful debts expense		-
Operating profit		XXX
Working capital changes:		
Trade receivables	[485 - 468]	(17)
		XXX

4 REPORTING INVESTING AND FINANCING CASH FLOWS

4.1 Separate reporting [IAS 7: 21 and IAS 20: 28]

An entity shall report separately major classes of gross cash receipts and gross cash payments arising from investing and financing activities except in certain circumstances when IAS 7 requires reporting on net basis.

The purchase of assets and the receipt of related grants can cause major movements in the cash flow of an entity. For this reason and to show the gross investment in assets, such movements are often disclosed as separate items in the statement of cash flows regardless of whether or not the grant is deducted from the related asset for presentation purposes in the statement of financial position.

4.2 Calculation tips: investing activities

The following tips might be handy for relevant calculations for presenting cash flows from investing activities in the exam:

- Focus on non-current assets e.g. PPE, capital work in progress, investment property, long term investments and short-term investments (excluding those held for trading and cash equivalents);
- Make sure receipt of income relating to non-current assets is included, for example, rental income of investment property and dividend received on investments;
- Prepare following T accounts to determine missing amounts:
 - “PPE account” may give amount of cash additions, disposal, or depreciation.
 - “Accumulated depreciation” account may be used to find depreciation.
 - “Disposal” account may be used to find gain/loss or disposal proceeds;
- Make sure effect of non-cash items has been accounted for e.g. gain on revaluation, assets acquired for non-cash consideration and purchase and disposal of assets on credit;
- PPE account may be prepared on net basis when detailed data is not available. However, if separate cost and accumulated depreciation information is available in exam question, it is advised to prepare both accounts separately; and
- Combine items classified into current and non-current to save time e.g. deferred government grant.

► Example 12:

The following data relates to plant and machinery of KM Limited as at 31 December:

	2023	2022
	Rs. m	Rs. m
Non-current assets		
Cost	180	150
Accumulated depreciation	(88)	(105)
	92	45
Non-current liabilities		
Deferred government grant	80	60
Current liabilities		
Deferred government grant	24	20

During the year a vehicle was disposed of for a gain of Rs. 3 million. The original cost of this asset was Rs. 60 million and accumulated depreciation till the date of disposal was Rs. 45 million. The government grant income of Rs. 25 million has been recognised in profit or loss.

Required:

Calculate the amount of depreciation and prepare the cash flows from investing activities section of the statement of cash flows for KM Limited for the year ended 31 December 2023.

► Answer:

Depreciation charge on plant and machinery

Accumulated depreciation			
	Rs. m		Rs. m
Disposal	45	b/d	105
c/d	88	Depreciation (PL)	28
	133		133

Cash flows from investing activities		Rs. m
Purchase of plant and machinery	W1	(90)
Sale proceeds from disposal of plant	W2	18
Receipts from government grant	W3	49
Net cash (used in) investing activities		(23)

W1: Plant & machinery			
	Rs. m		Rs. m
b/d	150	Disposal	60
Cash (balancing)	90	c/d	180
	240		240

W2: Disposal account			
	Rs. m		Rs. m
Plant and machinery	60	Accumulated depreciation	45
Gain	3	Cash (balancing)	18
	63		63

W3: Deferred government grant			
	Rs. m		Rs. m
Profit or loss	25	b/d	60
c/d	80	b/d	20
c/d	24	Cash (balancing)	49
	129		129

► **Example 13:**

The statements of financial position of Grand Company at the beginning and end of 2017 include the following information:

Property, plant and equipment	2016	2017
	Rs.	Rs.
At cost/revalued amount	1,400,000	1,900,000
Accumulated depreciation	350,000	375,000
Carrying value	1,050,000	1,525,000

During the year, the land was revalued upwards by Rs. 200,000. An item of equipment was disposed of during the year at a profit of Rs. 25,000. This equipment had an original cost of Rs. 260,000 and accumulated depreciation of Rs. 240,000 at the date of disposal.

Depreciation charged in the year was Rs. 265,000.

Required:

Calculate the cash paid for acquisition and sale proceeds from disposal of property, plant and equipment.

► **Answer:**

Property, plant and equipment (net book value)			
	Rs. 000		Rs. 000
b/d	1,050	Disposal [260 – 240]	20
Gain on revaluation	200	Depreciation	265
Cash (balancing)	560	c/d	1,525
	1,810		1,810

Sale proceeds from disposal = Rs. 20,000 net book value + Rs. 25,000 gain = Rs. 45,000

Alternatively, it may be calculated as follows:

Property, plant and equipment (cost)			
	Rs. 000		Rs. 000
b/d	1,400	Disposal	260
Gain on revaluation	200		
Cash (balancing)	560	c/d	1,900
	2,160		2,160

Sale proceeds from disposal = Rs. [260,000 – 240,000] + Rs. 25,000 gain = Rs. 45,000

► *Example 14:*

The statements of financial position of Grand Company at the beginning and end of 2017 include the following information:

	2016	2017
Property, plant and equipment	Rs.	Rs.
At cost/re-valued amount	1,400,000	1,900,000
Accumulated depreciation	(350,000)	(375,000)
Carrying value	1,050,000	1,525,000
Capital work in progress	600,000	620,000

During the year:

- Property was revalued upwards by Rs. 200,000.
- An item of equipment was disposed of at a profit of Rs. 25,000. This equipment had an original cost of Rs. 260,000 and accumulated depreciation of Rs. 240,000 at the date of disposal.
- Depreciation charged in the year was Rs. 265,000.
- The company capitalised Rs. 200,000 as capital work in progress.

Required:

Calculate the cash paid for acquisition (additions) of property, plant and equipment.

► *Answer:*

Property, plant and equipment (net book value)			
	Rs. 000		Rs. 000
b/d	1,050	Disposal [260 – 240]	20
Gain on revaluation	200	Depreciation	265
Transfer from CWIP	180		
Cash (balancing)	380	c/d	1,525
	1,810		1,810

Capital work in progress			
	Rs. 000		Rs. 000
b/d	600	Transfer to PPE (bal.)	180
Cash	200	c/d	620
	800		800

4.3 Calculation tips: financing activities

The following tips might be handy for relevant calculations for presenting cash flows from financing activities in the exam:

- Focus on equity and borrowing (long-term as well as short-term);
- Make sure dividend paid has been included if relevant. The information may be determined by preparing retained earnings account;
- Combine share capital and share premium accounts to save time while calculating cash proceeds from issue of shares;
- Make sure effect of non-cash items has been accounted for e.g. bonus issue of shares, shares issued for non-cash consideration and conversion of debt into equity;
- Combine items classified into current and non-current to save time e.g. long-term loans and their portion classified as current liability; and
- Present proceeds from loan obtained and repayment of loan separately.

► **Example 15:**

From the following information, calculate the cash flows from financing activities for Company X in 2017.

	Beginning of 2017	End of 2017
	Rs.	Rs.
Share capital (ordinary shares of Rs. 10 each)	400,000	500,000
Share premium	275,000	615,000
Retained earnings	390,000	570,000
	1,065,000	1,685,000
Non-current liabilities: Long-term loans	600,000	520,000
Current liabilities: Current portion of long-term loans	80,000	55,000

During the year an additional loan of Rs. 30,000 was obtained.

The company made a profit of Rs. 400,000 for the year after taxation and issued 2,000 bonus shares out of retained earnings.

Required:

Prepare the cash flows from financing activities section of the statement of cash flows for Company X for the year ended 31 December 2017.

► **Answer:**

Cash flows from financing activities	Rs.
Proceeds from issue of shares W1	420,000
Receipt of loan	30,000
Repayment of loans W2	(135,000)
Dividends paid W3	(200,000)
Net cash from financing activities	115,000

W1: Share capital + Share premium

	Rs.		Rs.
		b/d	400,000
		b/d	275,000
c/d	500,000	Retained earnings	20,000
c/d	615,000	Cash	420,000
	<u>1,115,000</u>		<u>1,115,000</u>

W2: Long term loan (including current portion)

	Rs.		Rs.
Cash (balancing)	135,000	b/d	600,000
c/d	520,000	b/d	80,000
c/d	55,000	Cash	30,000
	<u>710,000</u>		<u>710,000</u>

W3: Retained earnings

	Rs.		Rs.
Share capital [2,000 x 10]	20,000	b/d	390,000
Cash/dividend (bal.)	200,000	Profit after tax	400,000
c/d	570,000		
	<u>790,000</u>		<u>790,000</u>

5 USEFULNESS OF CASH FLOW INFORMATION

5.1 Benefits of cash flow information [IAS 7: 4 & 5]

A statement of cash flows (alongwith other financial statements) enables users to evaluate:

- the changes in net assets of an entity,
- its financial structure (including its liquidity and solvency); and
- its ability to affect the amounts; and
- timing of cash flows in order to adapt to changing circumstances and opportunities.

Historical cash flow information is used as an indicator of the amount, timing and certainty of future cash flows

- in checking the accuracy of past assessments of future cash flows;
- in examining the relationship between profitability and net cash flow and the impact of changing prices; and
- in comparability of the reporting of operating performance by different entities because it eliminates the effects of using different accounting treatments for the same transactions and events.

5.2 Classification wise usefulness [IAS 7: 13, 16 & 17]

Cash flows are classified by operating, investing and financing activities as each of these classifications provide useful information from different perspective:

Cash flows arising from	Usefulness
Operating activities	It is a key indicator of the extent to which the operations of the entity have generated sufficient cash flows to repay loans, maintain the operating capability of the entity, pay dividends and make new investments without recourse to external sources of financing. Information about the specific components of historical operating cash flows is useful, in conjunction with other information, in forecasting future operating cash flows.
Investing activities	These cash flows represent the extent to which expenditures have been made for resources intended to generate future income and cash flows.
Financing activities	It is useful in predicting claims on future cash flows by providers of capital to the entity.

5.3 Comparison of usefulness of cash flow information with profit or loss

Businesses must have sufficient cash; otherwise they cannot survive.

- A business may be incurring losses but may still survive if it has sufficient cash or has access to other liquid assets.
- A profitable business may not survive if it is unable to pay its obligations when they fall due, because it does not have enough cash or access to other liquid assets.

The fundamental purpose of being in business is to generate profit, as this will increase the owners' wealth. Profitability relates to the long-term performance of the business and indicates that over the long term a business will generate cash. In the short term, the business' viability is determined by its ability to generate cash. However, as a statement of profit or loss is prepared on an accrual basis, the profit for the year is unlikely to correlate with the movement in the company's bank balance. Therefore, understanding cash inflows and outflows is important.

Each financial statement, individually and in combination with other financial statements and other information, provides useful information that helps users of financial statements to make informed decisions. A balance between profitability and liquidity (cash balance) is required, a huge cash balance does not usually indicate good management as this could have been invested to earn more profits. In particular, following points should be considered:

- The amount and composition of net assets of an entity changes due to income and expenses (statement of profit or loss) and cash flows (statement of cash flows). Both statements are relevant but provide different aspects of information.
- Many decision-making models and valuation models rely on present value of the future cash flows generated by an entity e.g. NPV and IRR. Historical cash flow information can be useful to check the accuracy of past assessments and development of future assessments.
- Profitability is an important performance measure, and this information is provided by statement of profit or loss, liquidity information is also important, and this information is provided by statement of cash flows in conjunction with statement of financial position.
- Cash flows are necessary to survive in short term but in long term business must be profitable to survive. Entities often forego short term benefits for long term major benefits e.g. sales on credit usually earns higher profit margin as compared to cash sales.
- The cash flow is not affected by different accounting policies and estimates, and this makes cash flow information more comparable, and consequently, less vulnerable to manipulation.

6 COMPREHENSIVE EXAMPLES

► Example 16:

You are working as Finance Manager in Broad Peak Limited (BPL). Faraz has recently joined BPL as an internee for three months. You have asked him to develop an understanding of the statement of cash flows. After going through few statements, he has raised the following queries:

- Depreciation is not a cash flow but was still appearing as an addition in the statement of cash flows.
- In the statement of cash flows of a competitor, interest paid was shown as a financing activity, but BPL showed it in operating activities.
- BPL purchased inventories throughout the year, but total purchases of inventory were not shown in the statement. However, only decrease in inventory was added.
- Cash and bank balance in the statement of financial position was not in agreement with the opening and closing balances at the end of statement of cash flows.

Required:

Briefly answer the queries raised by Faraz.

► Answer:

- A statement of cash flows begins with net profit which is arrived after deducting depreciation expense. So to convert the net profit into net cash flow the deduction of depreciation being non-cash expense is reversed (i.e. added).
- As per IAS 7, interest paid can be shown as either cash flow from financing activities or cash flow from operating activities. Both classifications are correct as long as they are consistently applied by an entity.
- A statement of cash flows begins with net profit which is arrived after deducting cost of sales. So to convert the effect of cost of goods sold into outflow for purchases of inventory, change in inventory is adjusted i.e. increase is deducted and decrease is added.
- Statement of financial position shows cash and bank balances while the statement of cash flows ends with cash and cash equivalents which may differ from cash and bank balances due to existence of bank overdraft and short-term investments.

► Example 17:

Parveen made a net profit of Rs. 256,800 for the year ended June 30, 2015 after charging depreciation of Rs. 17,500 and loss on disposal of furniture of Rs. 6,800. The sale proceeds of the furniture were Rs. 12,000.

During the year, the net book value of non-current assets decreased by Rs. 7,400; receivables increased by Rs. 11,700; inventories decreased by Rs. 21,600 and creditors increased by Rs. 8,900. A long-term loan of Rs. 75,000 was repaid during the year and Parveen withdrew Rs. 120,000 for his own use.

Her bank balance was Rs. 98,000 and Rs. 10,000 on June 30, 2015 and June 30, 2014 respectively.

Required:

Prepare the statement of cash flows for the year ended June 30, 2015.

► Answer:

Parveen

Statement of cash flows for the year ended 30 June 2015

Cash flows from operating activities	Rs.
Cash generated from operations (Note 1)	299,900
Interest paid	-
Net cash from (used in) operating activities	299,900

Cash flows from investing activities	Rs.
Purchase of non-current assets W1	(28,900)
Proceeds from disposal of PPE	12,000
Net cash from (used in) investing activities	(16,900)
Cash flows from financing activities	
Repayment of loans	(75,000)
Drawings	(120,000)
Net cash from (used in) financing activities	(195,000)
Net increase in cash and cash equivalents	88,000
Cash and cash equivalent at the beginning of the year	10,000
Cash and cash equivalent at the end of the year	98,000

Note 1: Cash generated from operations (indirect method)	Rs.
Profit before tax	256,800
Adjustments:	
Depreciation	17,500
Loss on sale of furniture	6,800
Operating profit	281,100
Working capital changes:	
Inventories	21,600
Trade receivables	(11,700)
Trade payables	8,900
	299,900

W1: Non-current assets			
	Rs.		Rs.
b/d	7,400	Disposal [12,000 + 6,800]	18,800
Cash (balancing)	28,900	Depreciation	17,500
		c/d	0
	36,300		36,300

► **Example 18:**

Following information pertains to Dahl Limited (DL):

Summarised statement of financial position as at 31 December 2021

	2021	2020		2021	2020
	Rs. in million			Rs. in million	
Share capital	11.0	10.0	Property, plant and equipment	18.7	10.6
Retained earnings	32.9	33.8	Working capital other than cash	24.5	17.8
Revaluation surplus	4.0	-	Cash	4.7	15.4
	47.9	43.8		47.9	43.8

Additional information:

- Final dividend was paid in respect of year 2020 amounting to Rs. 3.4 million.
- Additions to property, plant and equipment during the year amounted to Rs. 14 million.
- Tax expense for the year amounted to Rs. 2.4 million. Tax payable as at 31 December 2021 amounted to Rs. 1 million (2020: Rs. 0.2 million)

Required:

Prepare DL's statement of cash flows for the year ended 31 December 2021.

► **Answer:**

Dahl Limited

Statement of cash flows for the year ended 31 December 2021

Cash flows from operating activities		Rs. m
Cash generated from operations	(Note 1)	7.3
Income taxes paid	[2.4 + 0.2 – 1.0]	(1.6)
Net cash from (used in) operating activities		5.7
Cash flows from investing activities		
Purchase of property, plant & equipment		(14)
Net cash from (used in) investing activities		(14)
Cash flows from financing activities		
Proceeds from issue of shares	[11 – 10]	1.0
Dividend paid		(3.4)
Net cash from (used in) financing activities		(2.4)
Net decrease in cash and cash equivalents		(10.7)
Cash and cash equivalent at the beginning of the year		15.4
Cash and cash equivalent at the end of the year		4.7

Note 1: Cash generated from operations (indirect method)		Rs. m
Profit before tax	[2.5 W1 + 2.4 tax]	4.9
Adjustments:		
Depreciation	W2	9.9
Operating profit		14.8
Working capital changes:	[(24.5 + 1) – (17.8 + 0.2)]	(7.5)
		7.3

W1: Retained earnings

	Rs. m		Rs. M
Dividend	3.4	b/d	33.8
c/d	32.9	Profit after tax (bal.)	2.5
	36.3		36.3

W2: Property, plant and equipment

	Rs. m		Rs. m
b/d	10.6		
Gain on revaluation	4	Depreciation (bal.)	9.9
Cash (additions)	14	c/d	18.7
	28.6		28.6

► **Example 19:**

Following information pertains to Nadir Limited:

Extract from statement of profit or loss for the year ended 31 December 2017

	Rs. in '000
Profit before taxation	8,955
Taxation	(2,945)
Profit after taxation	6,010

Extract from statement of financial position as on 31 December 2017

Equity and liabilities	2017	2016	Assets	2017	2016
	-- Rs. in '000 --			-- Rs. in '000 --	
Share capital	12,400	10,000	Property plant & equipment (net)	21,400	15,800
Share premium	1,400	-			
Retained earnings	13,450	12,440	Current assets:		
Surplus on revaluation	4,000	-	Stock-in-trade	5,600	5,750
Non-current liabilities:			Trade receivables – net	6,840	4,446
Long-term loans	4,100	5,000	Other receivables	2,385	800
Current liabilities:			Cash & bank	2,355	3,204
Trade payables	1,900	1,400			
Accruals & other payables	680	660			
Tax liability	650	500			
	38,580	30,000		38,580	30,000

Other information:

- i. Shares issued during the year were as follows:
 - 10% bonus shares in March 2017.
 - Right shares in July 2017.
- ii. During the year, a plant costing Rs. 9,500,000 and having a book value of Rs. 5,200,000 was disposed of for Rs. 4,800,000 of which Rs. 1,800,000 are still outstanding.
- iii. Depreciation for the year amounted to Rs. 7,350,000.
- iv. Financial charges for the year amounted to Rs. 1,100,000. Accrued financial charges as on 31 December 2017 amounted to Rs. 112,000 (2016: Rs. 48,000).
- v. Provision for doubtful trade receivables is maintained at 5%.

Required:

Prepare statement of cash flows for the year ended 31 December 2017, in accordance with IAS 7 'Statement of Cash Flows' using indirect method.

► **Answer:**

Nadir Limited

Statement of cash flows for the year ended 31 December 2017

Cash flows from operating activities		Rs. 000
Cash generated from operations	(Note 1)	16,232
Interest paid	[1,100 + 48 - 112]	(1,036)
Income taxes paid	[2,945 + 500 - 650]	(2,795)
Net cash from (used in) operating activities		12,401
Cash flows from investing activities		Rs. 000
Purchase of property, plant & equipment	W1	(14,150)
Proceeds from disposal of PPE	[4,800 - 1,800 receivable]	3,000
Net cash from (used in) investing activities		(11,150)
Cash flows from financing activities		
Proceeds from issue of shares	W2	2,800
Dividend paid	W3	(4,000)
Repayment of loans	[4,100 - 5,000]	(900)
Net cash from (used in) financing activities		(2,100)
Net decrease in cash and cash equivalents		(849)
Cash and cash equivalent at the beginning of the year		3,204
Cash and cash equivalent at the end of the year		2,355

Note 1: Cash generated from operations (indirect method)		Rs. 000
Profit before tax		8,955
Adjustments:		
Depreciation		7,350
Doubtful debts	$[(6,840/95 \times 5) - (4,446 / 95 \times 5)]$	126
Loss on disposal	$[5,200 - 4,800]$	400
Finance costs		1,100
Operating profit		17,931
Working capital changes:		
Inventories	$[5,750 - 5,600]$	150
Trade receivables	$[(6,840/95\%) - (4,446 / 95\%)]$	(2,520)
Other receivables	$[(2,385 - 1,800) - 800]$	215
Trade payables	$[1,900 - 1,400]$	500
Accruals and other payables	$[(680 - 112) - (660 - 48)]$	(44)
		16,232

W1: Property, plant and equipment

	Rs. 000		Rs. 000
b/d	15,800	Disposal	7,350
Revaluation surplus	4,000	Depreciation	5,200
Cash (balancing)	14,150	c/d	21,400
	33,950		33,950

W2: Share capital and share premium

	Rs. 000		Rs. 000
		b/d	10,000
		b/d	0
c/d	12,400	Retained earnings (10%)	1,000
c/d	1,400	Cash (balancing)	2,800
	13,800		13,800

W3: Retained earnings

	Rs. 000		Rs. 000
Share capital	1,000	b/d	12,440
Cash dividend (bal.)	4,000	Profit after tax	6,010
c/d	13,450		
	18,450		18,450

► **Example 20:**

Following are the extracts from the financial statements of Universal Limited (UL) for the year ended 30 June 2017:

Statement of financial position as on 30 June 2017

Assets	2017	2016	Equity & liabilities	2017	2016
	Rs. in '000			Rs. in '000	
Property, plant and equipment	158,500	120,000	Share capital (Rs. 10 each)	175,000	150,000
Stock in trade	58,000	45,000	Retained earnings	54,434	21,500
Receivables	68,000	56,000	Revaluation surplus	10,000	-
Cash	39,434	48,000	Debentures (Rs. 100 each)	18,000	20,000
			Interest payable	1,000	2,500
			Trade payables	42,000	39,000
			Accrued liabilities	20,000	18,000
			Unearned maintenance	2,000	4,000
			Income tax payable	1,500	14,000
	323,934	269,000		323,934	269,000

Statement of profit or loss for the year ended 30 June 2017

	Rs. in '000
Sales	273,000
Cost of sales	(187,500)
Gross profit	85,500
Operating expenses	(46,766)
Other income	11,200
Profit before interest and tax	49,934
Interest expense	(2,000)
Profit before tax	47,934
Tax expense	(15,000)
Profit after tax	32,934

Additional information:

- 60% of sales were made on credit.
- UL maintains a provision for doubtful receivables at 6%. During the year, trade receivables of Rs. 7 million were written off.
- Depreciation expense for the year was Rs. 22.5 million. 70% of the depreciation was charged to cost of sales.
- Other income comprises of:
 - gain of Rs. 3 million on disposal of vehicles for Rs. 12 million;
 - maintenance income of Rs. 8 million; and
 - discount of Rs. 10 per debenture which were redeemed during the year.

Required:

Prepare UL's statement of cash flows for the year ended 30 June 2017 using direct method and indirect method.

► Answer:

Universal Limited**Statement of cash flows for the year ended 30 June 2017**

Cash flows from operating activities		Rs. 000
Cash generated from operations	(Note 1)	47,234
Interest paid	[2,000 + 2,500 – 1,000]	(3,500)
Income taxes paid	[15,000 + 14,000 – 1,500]	(27,500)
Net cash from (used in) operating activities		16,234
Cash flows from investing activities		
Purchase of property, plant & equipment W1		(60,000)
Proceeds from disposal of PPE		12,000
Net cash from (used in) investing activities		(48,000)
Cash flows from financing activities		
Proceeds from issue of shares	[175,000 – 150,000]	25,000
Redemption of debentures	[20,000 – 18,000 = 2,000 x 90%]	(1,800)
Net cash from (used in) financing activities		23,200
Net decrease in cash and cash equivalents		(8,566)
Cash and cash equivalent at the beginning of the year		48,000
Cash and cash equivalent at the end of the year		39,434

Note 1: Cash generated from operations (indirect method)		Rs. 000
Profit before tax		47,934
<i>Adjustments:</i>		
Depreciation		22,500
Bad debts expense		7,000
Doubtful debts expense	[(68,000/94 x 6) – (56,000/94 x 6)]	766
Gain on disposal		(3,000)
Discount on debentures		(200)
Interest expense		2,000
Operating profit		77,000
Working capital changes:		
Inventories	[58,000 – 45,000]	(13,000)
(Increase) in receivables	[(68,000/94% + 7,000) – 56,000/94%]	(19,766)
Trade payables	[42,000 – 39,000]	3,000
Accrued liabilities	[20,000 – 18,000]	2,000
(Decrease) in unearned income	[2,000 – 4,000]	(2,000)
		47,234

Note 1: Cash generated from operations (direct method)		Rs. 000
Cash received from customers	(1.1)	259,234
Cash paid to suppliers and employees	(1.2)	(212,000)
		47,234
1.1: Cash received from customers		Rs. 000
Revenue		273,000
Maintenance service income		8,000
(Increase) in receivables	$[(68,000/94\% + 7,000) - 56,000/94\%]$	(19,766)
(Decrease) in unearned income	$[2,000 - 4,000]$	(2,000)
		259,234
		Rs. 000
1.2: Cash paid to suppliers and employees		Rs. 000
Cost of sales		(187,500)
Operating expenses		(46,766)
Other income	$[11,200 - 8,000 \text{ maintenance income}]$	3,200
Adjustments:		
Depreciation		22,500
Bad debts expense		7,000
Doubtful debts expense	$[(68,000/94 \times 6) - (56,000/94 \times 6)]$	766
Gain on disposal		(3,000)
Discount on debentures		(200)
Working capital changes:		
Inventories	$[58,000 - 45,000]$	(13,000)
Trade payables	$[42,000 - 39,000]$	3,000
Accrued liabilities	$[20,000 - 18,000]$	2,000
		(212,000)

W1: Property, plant and equipment

	Rs. 000		Rs. 000
b/d	120,000	Disposal $[12,000 - 3,000]$	9,000
Revaluation surplus	10,000	Depreciation	22,500
Cash (balancing)	60,000	c/d	158,500
	190,000		190,000

► **Example 21:**

Following is the statement of financial position of Quicken Limited (QL) as at 30 June 2022:

	2022	2021		2022	2021
	Rs. in million			Rs. in million	
Share capital	480	400	Land and building	748	526
Revaluation surplus	135	-	Vehicles	118	96
Retained earnings	337	325	Inventories	365	444
Long-term loan	335	460	Trade and other receivables	212	185
Trade and other payables	160	142	Cash and bank balances	73	111
Advance from customers	69	35			
	1,516	1,362		1,516	1,362

Additional information:

- During the year, land and building were revalued for the first time, resulting in a surplus of Rs. 150 million and incremental depreciation of Rs. 15 million.
- Depreciation on building charged to profit or loss amounted to Rs. 72 million.
- During the year, vehicles having book value of Rs. 8 million were sold for Rs. 11 million received in cash. Further, sale proceeds of Rs. 6 million of another vehicle (book value Rs. 7 million) disposed of in May 2021 were received in August 2021.
- Vehicles costing Rs. 51 million were purchased during the year of which Rs. 12 million is still unpaid.
- Inventories as at 30 June 2022 included work in process inventories of Rs. 96 million (2021: Rs. 80 million) which are not available for sale.
- Interest on loan for the year amounted to Rs. 48 million of which Rs. 14 million was capitalised in the cost of a building constructed during the year.
- Following dividends were announced for the year ended 30 June 2022 and 2021:

2022	20% interim bonus shares and 15% final cash dividend
2021	5% interim bonus shares and 10% final cash dividend

Required:

Prepare QL's statement of cash flows for the year ended 30 June 2022.

► **Answer:****Quicken Limited****Statement of cash flows for the year ended 30 June 2022**

Cash flows from operating activities	Rs. m
Cash generated from operations (Note 1)	327
Interest paid	(34)
Net cash from (used in) operating activities	293

	Rs. m
Cash flows from investing activities	
Purchase of land and building W2	(144)
Purchase of vehicles [51 – 12]	(39)
Sale proceeds from disposal [11 + 6]	17
Net cash from (used in) investing activities	(166)
Cash flows from financing activities	
Repayment of loan [335 – 460]	(125)
Dividend paid [400 x 10%]	(40)
Net cash from (used in) financing activities	(165)
Net decrease in cash and cash equivalents	(38)
Cash and cash equivalent at the beginning of the year	111
Cash and cash equivalent at the end of the year	73

Note 1: Cash generated from operations (indirect method)	Rs. m
Profit before tax W1	117
<i>Adjustments:</i>	
Depreciation of building	72
Depreciation of vehicle W3	21
Gain on disposal of vehicle [11 – 8]	(3)
Interest expense [48 – 14]	34
Operating profit	241
Working capital changes:	Rs. m
Inventories [365 – 444]	79
Trade receivables [212 – (185 – 6)]	(33)
Trade payables [(160 – 12) – 142]	6
Advance from customers [69 – 35]	34
	327

W1: Retained earnings			
	Rs. m		Rs. m
Cash dividend (400 x 10%)	40	b/d	325
Bonus dividend (400 x 20%)	80	Revaluation surplus	15
c/d	337	Profit (balancing)	117
	457		457

W2: Land and building

	Rs. m		Rs. m
b/d	526	Depreciation	72
Gain on revaluation	150		
Bank (balancing)	144	c/d	748
	820		820

W3: Vehicles

	Rs. m		Rs. m
b/d	96	Disposal	8
Bank	39	Depreciation (balancing)	21
Other payable	12	c/d	118
	147		147

► **Example 22:**

The following is the statement of financial position of Dolphin Limited (DL) as at 30 June 2023:

Equity & liabilities	2023	2022	Assets	2023	2022
	Rs. in million			Rs. in million	
Share capital	16,000	13,000	Property, plant and equipment	13,835	14,300
Share premium	1,120	-	Capital work-in-progress	3,485	2,500
Retained earnings	10,150	10,800	Investment properties	1,820	1,950
Long-term loan	3,275	3,540	Inventories	7,450	5,000
Trade and other payables	1,485	935	Trade receivables – net	3,588	4,085
Accrued interest	140	195	Advance tax	36	-
Dividend payable	260	140	Cash and bank balances	2,216	1,010
Tax payable	-	235			
	32,430	28,845		32,430	28,845

Additional information:

- The interest payment for the year amounted to Rs. 700 million, of which Rs. 300 million has been capitalised in capital work-in-progress.
- The transfer from capital work-in-progress to property, plant and equipment amounted to Rs. 550 million.
- An old machine costing Rs. 520 million with a book value of Rs. 350 million was traded-in for a new machine costing Rs. 600 million on payment of Rs. 200 million.
- DL acquired an investment property costing Rs. 300 million, of which Rs. 125 million is still unpaid. DL applies fair value model for subsequent measurement of its investment properties.
- The provision for doubtful trade receivables at 30 June 2023 was estimated at 8% (2022: 5%).
- During the year, DL issued 10% bonus shares. Subsequently, a right issue was also made.
- The tax charge for the year amounted to Rs. 750 million at 30% of profit before tax.
- DL classifies dividends and interest payments in a way that keeps 'cash flows from operating activities' higher.

Required:

Prepare DL's statement of cash flows for the year ended 30 June 2023.

► Answer:

Dolphin Limited**Statement of cash flows****For the year ended 30 June 2023**

Cash flows from operating activities:		Rs. m
Cash generated from operations (N1)		2,962
Tax paid	W5	(1,021)
Net cash from (used in) operating activities		1,941
Cash flows from investing activities:		
Purchase of property, plant and equipment		(200)
Additions to capital work in progress	W2	(1,535)
Cash paid for investment property	W3	(175)
Net cash from (used in) investing activities		(1,910)
Cash flows from financing activities:		
Issue of shares	W6	2,820
Repayment of loan	[3,275 - 3,540]	(265)
Interest paid	[700 - 300 for CWIP]	(400)
Dividend paid	W8	(980)
Net cash from (used in) financing activities		1,175
Net increase in cash & cash equivalents		1,206
Cash and cash equivalents at beginning		1,010
Cash and cash equivalents at end		2,216

N1: Cash generated from operations (Indirect method)		Rs. m
Profit before tax	[Rs. 750 tax / 30 x 100]	2,500
Adjustments:		
Depreciation	W1	1,265
Doubtful debts expense	[working below]	97
Gain on disposal (exchange)	[600 new asset - 200 paid - 350 old asset]	(50)
Loss on investment property	W3	430
Interest expense (in PL)	W4	345
Working capital changes:		
Increase in inventories	[7,450 - 5,000]	(2,450)
Decrease in trade receivables	[working below]	400
Increase in trade payables (trade & other)	[(1,485 - 125 Inv. property) - 935]	425
		2,962

Trade receivables (gross)		Rs. m
Opening	[4,085 / 95 x 100]	4,300
Closing	[3,588 / 92 x 100]	3,900
Decrease		400
Provision for doubtful receivable		
Opening	[4,300 x 5%]	215
Closing	[3,900 x 8%]	312
Increase		97

W1 - Property, plant and equipment

	Rs. m		Rs. m
b/d	14,300	Disposal	350
Transfer from CWIP	550		
New asset (against exchange)	400	Depreciation	1,265
New asset (cash paid)	200	c/d	13,835
	15,450		15,450

W2 - Capital work in progress

	Rs. m		Rs. m
b/d	2,500	Transfer to PPE	550
Cash (including interest paid)	1,535	c/d	3,485
	4,035		4,035

W3 - Investment property

	Rs. m		Rs. m
b/d	1,950		
Cash	175	Loss (PL)	430
Payable	125	c/d	1,820
	2,250		2,250

W4 - Accrued interest

	Rs. m		Rs. m
Cash [700 - 300 CWIP]	400	b/d	195
c/d	140	Expense (PL)	345
	540		540

W5 - Advance tax + Tax payable

	Rs. m		Rs. m
		b/d	235
Cash	1,021	Tax expense (PL)	750
		c/d	36
	1,021		1,021

W6 - Share capital and share premium

	Rs. m			Rs. m
			b/d	13,000
			b/d	0
c/d	16,000		Retained earnings (bonus issue)	1,300
c/d	1,120		Cash (right issue)	2,820
	17,120			17,120

W7 - Retained earnings

	Rs. m			Rs. m
Share capital (bonus issue)	1,300		b/d	10,800
Dividend payable	1,100		Profit after tax [2,500 - 750]	1,750
c/d	10,150			
	12,550			12,550

W8 - Dividend payable

	Rs. m			Rs. m
Cash	980		b/d	140
c/d	260		Retained earnings	1,100
	1,240			1,240

► **Example 23:**

Following is the draft balance sheet of XYZ Limited as at 31 December 2014 which was prepared by its accountant:

Assets	Rs. in million	Equities and liabilities	Rs. in million
Leasehold land – cost	250	Capital	1,000
Leasehold land – accumulated amortisation	(200)	Accumulated profit	1,816
Building – cost	1,000	Long term bank loan	200
Building – accumulated depreciation	(500)	Trade payables	228
Machinery – cost	1,750	Income tax payable	85
Machinery – accumulated depreciation	(1,150)	Accrued interest	13
Long term deposit	70		
Stocks	910		
Account receivables – net of provision	361		
Cash and bank	851		
	3,342		3,342

Additional information:

- i. Profit before tax and income tax expenses for the year amounted to Rs. 275 million and Rs. 13 million respectively.
- ii. Balances as at 31 December 2013 were as under:

	Rs. in million
Stock	703
Account receivables – net of provision	418
Cash and bank	243
Trade payables	150
Income tax payable	80
Long term deposit	70

The company follows a policy of maintaining provision for bad debts equal to 5% of account receivables.

- i. The bank loan was obtained on 1 January 2014 and carries interest @ 9% per annum.
- ii. XYZ uses straight line method for depreciation. Rates of depreciation are as under:

Leasehold land	2%
Building	5%
Machinery	10%

Depreciation for the year 2014 has already been provided.

On review the CFO has discovered the following:

- A machine with list price of Rs. 50 million was purchased on 1 January 2014. An amount of Rs. 30 million had been paid in cash whereas Rs. 20 million were adjusted against trade-in of a machine costing Rs. 40 million and having a book value of Rs. 25 million. The transaction was recorded by debiting the plant and machinery account by Rs. 30 million i.e. the net amount paid to the supplier.
- One of the company's customers became bankrupt during the year. Rs. 5 million out of total debt of Rs. 25 million were recovered from him. Balance has to be written off.

Required:

Prepare a statement of cash flow as at 31 December 2014.

► **Answer:**

XYZ Limited**Statement of cash flows for the year ended 31 December 2014**

Cash flows from operating activities	Rs. m
Cash generated from operations (Note 1)	451
Interest paid [18 + 0 – 13]	(5)
Income taxes paid [13 + 80 – 85]	(8)
Net cash from (used in) operating activities	438

Cash flows from operating activities	Rs. m
Cash flows from investing activities	
Cash paid in exchange of machines	(30)
Net cash from (used in) investing activities	(30)
Cash flows from financing activities	
Loans obtained	200
Net cash from (used in) financing activities	200
Net increase in cash and cash equivalents	608
Cash and cash equivalent at the beginning of the year	243
Cash and cash equivalent at the end of the year	851

Note 1: Cash generated from operations (indirect method)	Rs. m
Profit before tax W1	253
Adjustments:	
Depreciation W2	228
Loss on disposal [25 - 20 trade-in value]	5
Bad debts	20
Reversal of doubtful debts expense W3	(4)
Finance costs	18
Operating profit	520
Working capital changes:	
Inventories [910 - 703]	(207)
Trade receivables [(361 + 19 W3) - (418 + 22 W3)]	60
Trade payables [228 - 150]	78
	451

W1: Corrected profit before tax	Rs. m
Profit as given	275
Loss on disposal [25 book value - 20 Trade-in value]	(5)
Depreciation reversal [(20 Addition - 40 Disposal) x 10%]	2
Bad debts to be written off [25 - 5]	(20)
Decrease in doubtful debt allowance [20 x 5%]	1
	253

W2: Depreciation		Rs. m
On leasehold land	[250 x 2%]	5
On Building	[1,000 x 5%]	50
On Machinery	[1,750 x 10%]	175
Reversal of depreciation	[(20 Addition - 40 Disposal) x 10%]	(2)
		228

W3: Doubtful debts expense (reversal)		Rs. m
Closing provision	[361 / 95 x 5]	19
Opening provision	[418 / 95 x 5]	(22)
Decrease		(3)
Further decrease due to adjustment	W1	(1)
Total reversal in PL		(4)

► **Example 24:**

Following are the extracts from income statement of Quality Enterprises (QE) for the year ended 31 December 2015 and its statement of financial position as at that date, together with some additional information:

Income statement for the year ended 31 December 2015

	Rs. in '000
Profit from operations	6,402
Other income	1,357
Interest expense	(100)
Profit before tax	7,659
Income tax expense	(1,376)
Profit for the year	6,283

Statement of financial position as at 31 December 2015

Equity and liabilities	2015	2014	Assets	2015	2014
	--- Rs. in '000 ---			--- Rs. in '000 ---	
			Non-current assets		
Owner's capital	14,219	10,703	Property, plant and equipment	19,628	11,845
Unappropriated profit	10,652	6,697	Investments	7,645	6,498
Revaluation surplus	2,676	1,911		27,273	18,343
10% bank loan	6,000	-			
Current liabilities			Current assets		
Trade and other payables	3,337	4,953	Inventories	4,642	3,073
Income tax payable	1,300	994	Trade and other receivables	2,273	3,865
Bank overdraft	-	27	Cash and bank	3,996	4
	4,637	5,974		10,911	6,942
	38,184	25,285		38,184	25,285

Additional information:

- i. During the year, movements in property, plant and equipment include:
 - Depreciation amounting to Rs. 5,280,000.
 - Machinery having a carrying amount of Rs. 2,481,000 was sold for Rs. 3,440,000.
 - Factory building was revalued from a carrying amount of Rs. 5,963,000 to Rs. 8,000,000.
 - An office building which had previously been revalued, was sold at its carrying amount of Rs. 2,599,000.
- ii. The owner of QE withdrew Rs. 300,000 per month. The amounts were debited to unappropriated profit.
- iii. Trade debts written off during the year amounted to Rs. 200,000. The provision for bad debts as at 31 December 2015 was Rs. 400,000 (2014: Rs. 550,000)
- iv. The interest on bank loan is payable on 30th June every year. The bank loan was received on 1 November 2015. Interest for two months has been accrued and included in trade and other payables.
- v. Other income includes investment income of Rs. 398,000. As at 31 December 2015, trade and other receivables included investment income receivable amounting to Rs. 96,000 (2014: Rs. 80,000).

Required:

Prepare a statement of cash flows for Quality Enterprises for the year ended 31 December 2015, using the indirect method.

► *Answer:*

Quality Enterprises**Statement of cash flows for the year ended 31 December 2015**

Cash flows from operating activities		Rs. 000
Cash generated from operations	(Note 1)	10,005
Income taxes paid	[1,376 + 994 - 1,300]	(1,070)
Net cash from (used in) operating activities		8,935
Cash flows from investing activities		
Purchase of property, plant & equipment W2		(16,106)
Proceeds from disposal of machinery		3,440
Proceeds from disposal of office building		2,599
Purchase of investments	[7,645 - 6,498]	(1,147)
Receipt of investment income	[398 + 80 - 96]	382
Net cash from (used in) investing activities		(10,832)
Cash flows from financing activities		
Additional capital invested	[14,219 - 10,703]	3,516
Drawings	[300 x 12 months]	(3,600)
Bank loan obtained		6,000
Net cash from (used in) financing activities		5,916
Net increase in cash and cash equivalents		4,019
Cash and cash equivalent at the beginning of the year	[4 - 27]	(23)
Cash and cash equivalent at the end of the year		3,996

Note 1: Cash generated from operations (indirect method)		Rs. 000
Profit before tax		7,659
Adjustments:		
Depreciation		5,280
Bad debts		200
Reversal of doubtful debts expense	[400 – 550]	(150)
Gain on disposal	[3,440 – 2,481]	(959)
Investment income		(398)
Finance costs		100
Operating profit		11,732
Working capital changes:		
Inventories	[4,642 – 3,073]	(1,569)
Trade receivables	[(2,577 + 200) – 4,335] W1	1,558
Trade payables	[(3,337 – 100) – 4,953]	(1,716)
		10,005

W1: Trade receivables	2015	2014
	Rs. 000	Rs. 000
Trade and other receivables (as given)	2,273	3,865
Less: Investment income receivable	(96)	(80)
Trade receivables (net)	2,177	3,785
Add back: Provision for bad debts	400	550
Trade receivables (gross)	2,577	4,335

W2: Property, plant & equipment			
	Rs. 000		Rs. 000
b/d	11,845	Disposal: machinery	2,481
Gain on revaluation		Disposal: building	2,599
[8,000 – 5,963]	2,037	Depreciation	5,280
Cash (balancing)	16,106	c/d	19,628
	29,988		29,988

► **Example 25:**

Statement of financial position of Taxila Limited (TL) as on 30 June 2020 is as follows:

Assets	2020	2019	Equity & liabilities	2020	2019
	Rs. in million			Rs. in million	
Property, plant and equipment	1,619	1,200	Share capital (Rs. 100 each)	1,200	800
Investment property	290	120	Share premium	290	150
Inventories	205	180	Retained earnings	260	90
Trade receivables	342	291	Revaluation surplus	215	200
Prepayments & other receivables	14	20	Long-term loans	367	445
Short-term investments	60	48	Trade and other payables	144	120
Cash and bank balances	24	6	Current portion of long-term loans	78	60
	2,554	1,865		2,554	1,865

Additional information:

- Equipment having fair value of Rs. 240 million was acquired by issuing 2 million shares.
- As a result of revaluation carried out on 30 June 2020, property, plant and equipment was increased by Rs. 80 million out of which Rs. 35 million was credited to profit and loss account.
- During the year, fully depreciated items of property, plant and equipment costing Rs. 36 million were sold for Rs. 8 million out of which Rs. 3 million is still outstanding.
- Depreciation on property, plant and equipment for the year amounted to Rs. 290 million.
- An investment property was acquired for Rs. 180 million. TL applies cost model for subsequent measurement of its investment property.
- Financial charges for the year amounted to Rs. 45 million. Trade and other payables include accrued financial charges of Rs. 12 million (2019: Rs. 17 million).
- Short-term investments amounting to Rs. 35 million are readily convertible to cash (2019: Rs. 20 million). Investment income for the year amounted to Rs. 6 million.

Required:

Prepare TL's statement of cash flows for the year ended 30 June 2020 in accordance with the requirements of IFRSs.

► **Answer:****Taxila Limited****Statement of cash flows for the year ended 30 June 2020**

Cash flows from operating activities		Rs. m
Cash generated from operations	(Note 1)	398
Interest paid	[45 + 17 – 12]	(50)
Net cash from (used in) operating activities		348

Cash flows from investing activities		Rs. m
Purchase of PPE	W4	(389)
Proceeds from disposal of PPE	[8 – 3 receivable]	5
Purchase of investment property		(180)
Proceeds from short term investments	W5	9
Net cash from (used in) investing activities		(555)
Cash flows from financing activities		
Proceeds from issue of shares	W6	300
Repayment of loans	[(367 + 78) – (445 + 60)]	(60)
Net cash from (used in) financing activities		240
Net increase in cash and cash equivalents		33
Cash and cash equivalent at the beginning of the year	[6 + 20]	26
Cash and cash equivalent at the end of the year	[24 + 35]	59

Note 1: Cash generated from operations (indirect method)		Rs. m
Profit before tax	W1	140
Adjustments:		
Depreciation (PPE)		290
Depreciation (investment property)	W3	10
Gain on disposal	[8 – 0]	(8)
Reversal of revaluation loss in PL		(35)
Investment income		(6)
Finance costs		45
Operating profit		436
Working capital changes:		
Inventories	[205 – 180]	(25)
Trade receivables	[342 – 291]	(51)
Prepayment and other receivables	[(14 – 3) – 20]	9
Trade payables	[(144 – 12) – (120 – 17)]	29
		398

W1: Retained earnings

	Rs. m		Rs. m
Cash (dividend)	0	b/d	90
		Revaluation surplus W2	30
c/d	260	Profit (balancing)	140
	260		260

W2: Revaluation surplus

	Rs. m		Rs. m
Retained earnings (bal.)	30	b/d	200
c/d	215	Gain [80 – 35 PL]	45
	245		245

W3: Investment property

	Rs. m		Rs. m
b/d	120	Depreciation (bal.)	10
Cash	180	c/d	290
	300		300

W4: Property, plant and equipment

	Rs. m		Rs. m
b/d	1,200	Depreciation	290
Gain on revaluation	80	Disposal	-
Share capital & premium	240		
Cash (balancing)	389	c/d	1,619
	1,909		1,909

W5: Short term investments

	Rs. m		Rs. m
b/d [48 – 20]	28	Cash (balancing)	9
Profit or loss (income)	6	c/d [60 – 35]	25
	34		34

W6: Share capital and share premium

	Rs. m		Rs. m
		b/d	800
		b/d	150
c/d	1,200	PPE (equipment)	240
c/d	290	Cash (balancing)	300
	1,490		1,490

► **Example 26:**

The statement of financial position of Liaquat Industries as at 31 December 2016 is as follows:

Equity and liabilities	2016	2015	Assets	2016	2015
	----- Rupees -----			----- Rupees -----	
Owner’s capital	13,938,060	13,665,280	Freehold land	4,778,400	6,600,000
Long-term loan	1,000,000	1,000,000	Building – WDV	5,057,600	4,171,200
Short term loan	1,331,200	1,531,200	Vehicle – WDV	600,000	800,000
Accounts payable	417,120	694,320	Equipment – WDV	1,643,100	2,112,000
Accrued interest	105,600	63,360	Capital work in progress	1,478,400	1,821,600
			Long-term deposits	580,800	448,800
			Inventory	685,608	320,628
			Accounts receivable	1,273,272	595,452
			Cash	694,800	84,480
	16,791,980	16,954,160		16,791,980	16,954,160

The following information has been extracted from income statement:

	Rupees
Depreciation expenses	932,500
Finance cost	141,872
Gain on sale of fixed assets (net)	98,960
Net profit	1,525,948

Additional information:

- i. Details of gain on sale of fixed assets are as follows:

	Rupees
Gain on sale of freehold land	168,960
Loss on disposal of equipment due to fire	(70,000)
	98,960

The loss on disposal of equipment represents the WDV of the equipment. The amount of insurance claim received, amounting to Rs. 30,000 was erroneously credited to accumulated depreciation.

- ii. Repairs to building amounting to Rs. 50,000 were erroneously debited to building account on 31 December 2016.
- iii. Transfers from capital work in progress to building amounted to Rs. 1,200,000.
- iv. The owner withdrew Rs. 150,000 per month.

Required:

Prepare statement of cash flows for the year ended 31 December 2016, in accordance with IAS – 7 using indirect method.

► Answer:

Liaquat Industries**Statement of cash flows for the year ended 31 December 2016**

Cash flows from operating activities	Rupees
Cash generated from operations (Note 1)	1,131,360
Interest paid [141,872 + 63,360 – 105,600]	(99,632)
Net cash from (used in) operating activities	1,031,728
Cash flows from investing activities	
Cash expenditure on capital work in progress W4	(856,800)
Proceeds from disposal of land [1,821,600 W2 + 168,960]	1,990,560
Insurance claim on loss of equipment	30,000
Payment for long term deposits [580,800 – 448,800]	(132,000)
Net cash from (used in) investing activities	1,031,760
Cash flows from financing activities	
Capital invested by owner W5	546,832
Drawings [150,000 x 12]	(1,800,000)
Repayment of short-term loan [1,331,200 – 1,531,200]	(200,000)
Net cash from (used in) financing activities	(1,453,168)
Net increase in cash and cash equivalents	610,320
Cash and cash equivalent at the beginning of the year	84,480
Cash and cash equivalent at the end of the year	694,800

Note 1: Cash generated from operations (indirect method)	Rupees
Profit before tax W1	1,505,948
Adjustments:	
Depreciation	932,500
Gain on disposal of land	(168,960)
Loss on disposal of equipment [70,000 – 30,000 insurance]	40,000
Finance costs	141,872
Operating profit	2,451,360
Working capital changes:	
Inventories [685,608 – 320,628]	(364,980)
Trade receivables [1,273,272 – 595,452]	(677,820)
Trade payables [417,120 – 694,320]	(277,200)
	1,131,360

W1: Corrected profit		Rupees
Net profit as given		1,525,948
Add: Reduction in loss (insurance claim)		30,000
Less: Repair expense		(50,000)
		(20,000)
		1,505,948

W2: Land			
	Rupees		Rupees
b/d	6,600,000	Disposal (bal.)	1,821,600
		c/d	4,778,400
	6,600,000		6,600,000

W3: Depreciable non-current assets			
	Rupees		Rupees
b/d (building)	4,171,200	Disposal (equipment)	70,000
b/d (vehicle)	800,000	Depreciation (total)	932,500
b/d (equipment)	2,112,000	c/d (5,057,600 – 50,000)	5,007,600
Capital work in progress	1,200,000	c/d	600,000
		c/d (1,643,100 + 30,000)	1,673,100
	8,283,200		8,283,200

W4: Capital work in progress			
	Rupees		Rupees
b/d	1,821,600	Building	1,200,00
Cash (balancing)	856,800	c/d	1,478,400
	2,678,400		2,678,400

W5: Owner's capital			
	Rupees		Rupees
Drawings [150,000 x 12]	1,800,000	b/d	13,665,280
		Profit W1	1,505,948
c/d (13,938,060 – 20,000)	13,918,060	Cash (balancing)	546,832
	15,718,060		15,718,060

► **Example 27:**

Junior Accountant of Drum Limited has prepared the following statement of cash flows for the year ended 31 December 2018:

Statement of cash flows

	Rs. in '000
Cash flows from operating activities	
Increase in retained earnings	1,360
Increase in dividend payable	200
Increase in net trade receivables	(100)
Increase in interest accrued	50
	1,510
Cash flows from investing activities	
Increase in land and building	(2,600)
Increase in equipment	(1,550)
Decrease in inventory	400
Decrease in tax payable	(60)
	(3,810)
Cash flows from financing activities	
Increase in share capital and premium	2,350
Decrease in long term loan	(1,000)
Increase in trade and other payables	600
	1,950
Decrease in cash balance during the year	(350)
Opening cash balance	450
Closing cash balance	100

Junior Accountant informed you that he has taken the difference of opening and closing balances of each balance sheet item and classified each difference as either operating, investing or financing cash flows. He further informed that the statement is tied up with the cash balances appearing in the balance sheet. He has ignored the following information:

- Depreciation on building and equipment amounted to Rs. 480,000 and Rs. 810,000 respectively.
- During the year, an equipment costing Rs. 560,000 and having a book value of Rs. 310,000 was sold for Rs. 440,000.
- Provision for doubtful debts was increased by Rs. 140,000.
- Dividend amounting to Rs. 700,000 was paid during the year.
- Interest and tax expenses for the year amounted to Rs. 378,000 and Rs. 650,000 respectively.
- Trade and other payables as at 31 December 2018 included Rs. 950,000 for purchase of land and building.

Required:

Prepare statement of cash flows for the year ended 31 December 2018, in accordance with IAS 7 'Statement of Cash Flows' using indirect method.

► Answer:

Drum Limited**Statement of cash flows for the year ended 31 December 2018**

Cash flows from operating activities		Rs. 000
Cash generated from operations	(Note 1)	4,398
Interest paid	[378 – 50]	(328)
Income taxes paid	[650 + 60]	(710)
Net cash from (used in) operating activities		3,360
Cash flows from investing activities		
Purchase of land and building	W3	(2,130)
Purchase of equipment	W4	(2,670)
Proceeds from disposal of equipment		440
Net cash from (used in) investing activities		(4,360)
Cash flows from financing activities		
Proceeds from issue of shares		2,350
Dividend paid		(700)
Repayment of loans		(1,000)
Net cash from (used in) financing activities		650
Net decrease in cash and cash equivalents		(350)
Cash and cash equivalent at the beginning of the year		450
Cash and cash equivalent at the end of the year		100

Note 1: Cash generated from operations (indirect method)		Rs. 000
Profit before tax	[2,260 W1 + 650]	2,910
Adjustments:		
Depreciation	[480 + 810]	1,290
Doubtful debts expense		140
Gain on disposal	[440 – 310]	(130)
Interest expense		378
Operating profit		4,588
Working capital changes:		
Inventories		400
Trade receivables	[100 + 140 provision]	(240)
Trade payables	[600 increase – 950 PPE]	(350)
		4,398

W1: Retained earnings			
	Rs. 000		Rs. 000
Dividend W2	900	b/d	-
c/d	1,360	Profit after tax (bal.)	2,260
	2,260		2,260
W2: Dividend payable			
	Rs. 000		Rs. 000
Cash	700	b/d	0
c/d	200	Retained earnings (bal.)	900
	900		900
W3: Land and building			
	Rs. 000		Rs. 000
b/d	0	Depreciation	480
Payables	950		
Cash (balancing)	2,130	c/d	2,600
	3,080		3,080
W4: Equipment			
	Rs. 000		Rs. 000
b/d	0	Disposal	310
Cash (balancing)	2,670	Depreciation	810
		c/d	1,550
	2,670		2,670

► **Example 28:**

Following are the extracts from the financial statements of Sunday Traders Limited (STL) for the year ended 30 June 2019:

Statement of financial position as on 30 June 2019

Assets	2019	2018	Equity & liabilities	2019	2018
	Rs. in million			Rs. in million	
Property, plant & equipment	8,555	7,240	Share capital (Rs. 100 each)	4,650	3,450
Investment property	1,800	1,120	Share premium	1,600	1,240
Stock in trade	4,800	4,500	Retained earnings	1,652	(655)
Prepayments	184	268	Long term loans	6,024	6,523
Trade receivables	3,800	3,600	Trade payables	3,422	5,390
Cash	194	480	Advance from customers	250	40
			Accrued liabilities	310	180
			Interest payable	135	110
			Current maturity of long-term loans	850	700
			Provision for taxation	440	230
	19,333	17,208		19,333	17,208

Statement of profit or loss for the year ended 30 June 2019

	Rs. in million
Sales	29,700
Cost of sales	(15,750)
Gross profit	13,950
Distribution cost	(6,185)
Administrative cost	(2,302)
Other income	404
Profit before interest and tax	5,867
Interest expense	(1,210)
Profit before tax	4,657
Tax expense	(1,150)
Profit after tax	3,507

Additional information:

- 72% of sales were made on credit.
- Depreciation expense for the year amounted to Rs. 750 million which was charged to distribution and administrative cost in the ratio of 3:1.
- Distribution cost includes:
 - Rs. 40 million in respect of loss on disposal of equipment. The written down value at the time of disposal was Rs. 152 million.
 - impairment loss on vehicles amounting to Rs. 24 million.
- Loan instalments (including interest) of Rs. 1,984 million were paid during the year.
- Other income comprises of:
 - increase in fair value of investment property amounting to Rs. 220 million.
 - rent received from investment property amounting to Rs. 184 million.
- During the year, STL issued right shares at premium.

Required:

Prepare STL's statement of cash flows for the year ended 30 June 2019 using direct method and indirect method.

► *Answer:*

Sunday Traders Limited**Statement of cash flows for the year ended 30 June 2019**

Cash flows from operating activities	Rs. m
Cash generated from operations (Note 1)	4,233
Interest paid [1,210 + 110 – 135]	(1,185)
Income taxes paid [1,150 + 230 – 440]	(940)
Net cash from (used in) operating activities	2,108

Cash flows from investing activities	Rs. m
Purchase of property, plant & equipment W1	(2,241)
Proceeds from disposal of PPE [152 – 40]	112
Purchase of investment property W2	(460)
Rent received from investment property	184
Net cash from (used in) investing activities	(2,405)
Cash flows from financing activities	
Proceeds from issue of shares W3	1,560
Dividend paid W4	(1,200)
Repayment of loans [1,984 – 1,185 interest]	(799)
Loan obtained W5	450
Net cash from (used in) financing activities	11
Net decrease in cash and cash equivalents	(286)
Cash and cash equivalent at the beginning of the year	480
Cash and cash equivalent at the end of the year	194

Note 1: Cash generated from operations (direct method)	Rs. m
Cash received from customers (1.1)	29,710
Cash paid to suppliers and employees (1.2)	(25,477)
	4,233

1.1: Cash received from customers	Rs. m
Revenue	29,700
(Increase) in trade receivables [3,800 – 3,600]	(200)
Increase in advance from customers [250 – 40]	210
	29,710

1.2: Cash paid to suppliers and employees	Rs. m
Cost of sales	(15,750)
Distribution costs	(6,185)
Administrative expenses	(2,302)
Other income	404

Adjustments:		
Depreciation		750
Loss on disposal		40
Impairment loss		24
Gain on investment property		(220)
Rent income on investment property		(184)
Working capital changes:		
Inventories	[4,800 – 4,500]	(300)
Prepayments	[184 – 268]	84
Trade payables	[3,422 – 5,390]	(1,968)
Accrued liabilities	[310 – 180]	130
		(25,477)

Note 1: Cash generated from operations (indirect method)		Rs. m
Profit before tax		4,657
Adjustments:		
Depreciation		750
Loss on disposal		40
Impairment loss		24
Gain on investment property		(220)
Rent income on investment property		(184)
Finance costs		1,210
Operating profit		6,277
Working capital changes:		
Inventories	[4,800 – 4,500]	(300)
Prepayments	[184 – 268]	84
Trade receivables	[3,800 – 3,600]	(200)
Trade payables	[3,422 – 5,390]	(1,968)
Advance from customers	[250 – 40]	210
Accrued liabilities	[310 – 180]	130
		4,233

W1: Property, plant and equipment

	Rs. m		Rs. m
b/d	7,240	Depreciation	750
Cash (balancing)	2,241	Disposal	152
		Impairment	24
		c/d	8,555
	<u>9,481</u>		<u>9,481</u>

W2: Investment property

	Rs. m		Rs. m
b/d	1,120		
Profit or loss (gain)	220		
Cash (balancing)	460	c/d	1,800
	<u>1,800</u>		<u>1,800</u>

W3: Share capital and share premium

	Rs. m		Rs. m
		b/d	3,450
c/d	4,650	b/d	1,240
c/d	1,600	Cash (right issue)	1,560
	<u>6,250</u>		<u>6,250</u>

W4: Retained earnings

	Rs. m		Rs. m
b/d	655	Profit after tax	3,507
Cash (dividend)	1,200		
c/d	1,652		
	<u>3,507</u>		<u>3,507</u>

W5: Long term loans (current and non-current)

	Rs. m		Rs. m
Cash [1,984 – 1,185]	799	b/d	6,523
c/d	6,024	b/d	700
c/d	850	Cash (balancing)	450
	<u>7,673</u>		<u>7,673</u>

► **Example 29:**

Following are the extracts from the financial statements of Saguaro Limited (SL) for the year ended 30 June 2021:

Statement of financial position as on 30 June 2021

Assets	2021	2020	Equity & liabilities	2021	2020
	Rs. in million			Rs. in million	
Operating fixed assets	820	848	Share capital (Rs. 10 each)	700	500
Accumulated depreciation	(300)	(262)	Share discount	(40)	-
Capital work in progress	84	-	Retained earnings	220	315
Inventories	274	245	Long-term loans	175	210
Trade receivables	177	204	Trade payables	180	130
Insurance claim	-	31	Accrued expenses	48	43
Advance to supplier	78	60	Current portion of long-term loans	43	40
Cash and bank balances	193	112			
	1,326	1,238		1,326	1,238

Statement of profit or loss for the year ended 30 June 2021

	Rs. in million
Sales	757
Cost of sales	(485)
Gross profit	272
Operating expenses	(310)
Gain on disposal of equipment	17
Loss before interest	(21)

Other information:

- SL declared a final dividend of 10% on 30 September 2020 which was paid in December 2020.
- 20 million shares were issued in May 2021.
- Insurance claim was related to plant and machinery destroyed in April 2020. The plant had cost and book value of Rs. 63 million and Rs. 42 million respectively.
- During the year, SL disposed of equipment having cost and net book value of Rs. 75 million and Rs. 35 million respectively.
- Current portion of long-term loans include accrued interest of Rs. 5 million. (2020: Rs. 1 million)
- Trade payables include an amount of Rs. 14 million payable against capital work in progress.

Required:

Prepare SL's statement of cash flows for the year ended 30 June 2021 using indirect method and direct method.

► Answer:

Saguaro Limited**Statement of cash flows for the year ended 30 June 2021**

Cash flows from operating activities		Rs. m
Cash generated from operations	(Note 1)	61
Interest paid	[24 + 1 – 5]	(20)
Net cash from (used in) operating activities		41
Cash flows from investing activities		
Cash expenditure on CWIP	[84 – 14 payable]	(70)
Proceeds from disposal of PPE	[35 NBV + 17 gain]	52
Cash paid to acquire PPE	W3	(47)
Insurance claim on plant received		31
Net cash from (used in) investing activities		(34)
Cash flows from financing activities		Rs. m
Proceeds from issue of shares	[(700 – 40) – 500]	160
Dividend paid	[500 x 10%]	(50)
Repayment of loans	W4	(36)
Net cash from (used in) financing activities		74
Net increase in cash and cash equivalents		81
Cash and cash equivalent at the beginning of the year		112
Cash and cash equivalent at the end of the year		193

Note 1: Cash generated from operations (indirect method)		Rs. m
Net loss	W1	(45)
Adjustments:		
Depreciation	W2	78
Gain on disposal of equipment		(17)
Finance costs	[45 W1 – 21 PL]	24
Operating profit		40
Working capital changes:		
Inventories	[274 – 245]	(29)
Trade receivables	[177 – 204]	27
Advance to suppliers	[78 – 60]	(18)
Trade payables	[(180 – 14 CWIP) – 130]	36
Accrued expenses	[48 – 43]	5
		61

Note 1: Cash generated from operations (direct method)		Rs. m
Cash received from customers	(1.1)	784
Cash paid to suppliers and employees	(1.2)	(723)
		61
1.1: Cash received from customers		Rs. m
Revenue		757
Decrease in receivables	[177 – 204]	27
		784
1.2: Cash paid to suppliers and employees		Rs. m
Cost of sales		(485)
Operating expenses		(310)
Gain on disposal of equipment		17
Adjustments:		
Depreciation	W2	78
Gain on disposal of equipment		(17)
Working capital changes:		
Inventories	[274 – 245]	(29)
Advance to suppliers	[78 – 60]	(18)
Trade payables	[(180 – 14 CWIP) – 130]	36
Accrued expenses	[48 – 43]	5
		(723)

W1: Retained earnings			
	Rs. m		Rs. m
Cash dividend [500 x 10%]	50	b/d	315
Net loss (balancing)	45		
c/d	220		
	315		315

W2: Accumulated depreciation			
	Rs. m		Rs. m
Disposal [75 – 35]	40	b/d	262
c/d	300	Depreciation (bal.)	78
	340		340

W3: Operating fixed assets

	Rs. m		Rs. m
b/d	848	Disposal	75
Cash (balancing)	47	c/d	820
	895		895

W4: Long term loan (including current portion)

	Rs. m		Rs. m
Cash (balancing)	36	b/d	210
c/d	175	b/d [40 – 1]	39
c/d [43 – 5]	38		
	249		249

► *Example 30:*

The draft financial statements of Lyallpur Limited (LL) are presented below:

Statement of financial position as at 31 December 2023

Assets	2023	2022	Equity and liabilities	2023	2022
	-- Rs. in million --			-- Rs. in million --	
Property, plant and equipment	555	218	Share capital (Rs. 10 each)	681	410
Accumulated depreciation	(148)	(92)	Share premium	120	50
Investment property	310	210	Retained earnings	130	90
Inventories	275	261	Long-term loans	220	150
Trade receivables	255	230	Trade payables	109	60
Allowance for doubtful debts	(17)	(11)	Accrued expenses	25	21
Prepayments	12	4	Accrued interest	4	6
Cash and bank balances	47	9	Bank overdraft	-	42
	1,289	829		1,289	829

Statement of profit or loss for the year ended 31 December 2023

	Rs. in million
Sales	1,450
Cost of sales	(860)
Gross profit	590
Selling and administrative expenses	(450)
Other income	30
Financial charges	(16)
Net profit	154

Additional information:

- 10 million shares were issued in consideration for the purchase of machinery having a fair value of Rs. 150 million.
- Equipment with a cost of Rs. 35 million and accumulated depreciation of Rs. 21 million was sold at a gain of Rs. 5 million.
- The fair value model was applied for the subsequent measurement of investment property. During the year, the fair value of the investment property was decreased by Rs. 40 million, and rent amounting to Rs. 25 million was received from the investment property.
- Bad debts amounting to Rs. 36 million were written off, while bad debts previously written off, amounting to Rs. 15 million, were recovered.

Required:

Prepare LL's statement of cash flows for the year ended 31 December 2023 using the direct method and indirect method.

► Answer:

Lyallpur Limited**Statement of cash flows****For the year ended 31 December 2023**

Cash flows from operating activities:		Rs. m
Cash generated from operations (N1)		269
Interest paid	[16 expense + 6 opening - 4 closing]	(18)
Net cash from (used in) operating activities		251
Cash flows from investing activities:		
Purchase of property, plant and equipment	W2	(222)
Sale proceeds from disposal	[35 - 21] + 5 gain	19
Rent income received		25
Purchase of investment property	W3	(140)
Net cash from (used in) investing activities		(318)
Cash flows from financing activities:		
Issue of shares	W4	191
Dividend paid	W5	(114)
Loan obtained	[220 - 150]	70
Net cash from (used in) financing activities		147
Net increase in cash & cash equivalents		80
Cash and cash equivalents at beginning	[+9 - 42]	(33)
Cash and cash equivalents at end		47

N1: Cash generated from operations (direct method)		Rs. m
Cash received from customers	N1.1	1,404
Cash paid to suppliers and for expenses	N1.2	(1,135)
		269

N1.1: Cash received from customers		
Sales		1,450
Increase in receivables	[(255 + 36 bad debts) - 230]	(61)
Bad debts recovered of prior years		15
		1,404

N1.2: Cash paid to suppliers and for expenses		
Cost of sales		(860)
Selling and admin expenses		(450)
Other income		30
Financial charges		(16)
<i>Adjustments:</i>		
Depreciation	W1	77
Bad debt written off		36
Bad debts recovered	(because relates to N1.1)	(15)
Doubtful debts	[17 - 11]	6
Gain on disposal		(5)
Rent of investment property		(25)
Fair value loss on investment property		40
Financial charges		16
<i>Working capital changes:</i>		
Increase in inventories	[275 - 261]	(14)
Increase in prepayments	[12 - 4]	(8)
Increase in payables	[109 - 60]	49
Increase in accrued expenses	[25 - 21]	4
		(1,135)

N1: Cash generated from operations (Indirect method)		Rs. m
Profit before tax		154
<i>Adjustments:</i>		
Depreciation	W1	77
Bad debt written off		36
Doubtful debts	[17 - 11]	6
Gain on disposal		(5)
Rent of investment property		(25)
Fair value loss on investment property		40
Financial charges		16
<i>Working capital changes:</i>		
Increase in inventories	[275 - 261]	(14)
Increase in receivables	[(255 + 36 Bad debts) - 230]	(61)
Increase in prepayments	[12 - 4]	(8)
Increase in payables	[109 - 60]	49
Increase in accrued expenses	[25 - 21]	4
		269

W1 - Accumulated depreciation

	Rs. m			Rs. m
Disposal (equipment)	21		b/d	92
c/d	148		Depreciation (PL)	77
	169			169

W2 - Property, plant and equipment

	Rs. m			Rs. m
b/d	218		Disposal	35
Share capital + Premium	150			
Cash	222		c/d	555
	590			590

W3 - Investment property

	Rs. m			Rs. m
b/d	210		Fair value loss	40
Cash	140		c/d	310
	350			350

W4 - Share capital + Share premium

	Rs. m			Rs. m
			b/d	410
			b/d	50
c/d	681		Issue against PPE	150
c/d	120		Cash	191
	801			801

W5 - Retained earnings

	Rs. m			Rs. m
Cash (dividend)	114		b/d	90
c/d	130		Net profit	154
	244			244

1. OBJECTIVE BASED Q&A

1. Faria Limited is involved in the business of furniture. At 1 January 2018 the company's issued share capital consists of 50,000 Re. 1 shares. During the year 2018 company has made a bonus issue of 1 for 5 shares.

What is impact of bonus issue on cash flows of the business?

- a) Decrease in cash flows from operating activities
- b) Increase in cash flows from financing activities
- c) No impact
- d) Increase in cash generated from operations

2. A company has incurred a loss of Rs. 40,000 during the year 2018; however, the balance in the bank account at end of the year is more than the balance at start of the year.

What does this mean?

- a) Company has allowed a longer credit period to the credit customers
- b) Company has purchased more stock
- c) Company has made a right issue during the year
- d) Company has purchased fixed assets during the year

3. A company has provided the following information:

	2018 Rs.	2017 Rs.
Share capital	110,000	100,000
Share premium	30,000	40,000

A bonus issue of 1 for every 10 shares held has been made during the year.

What is the amount to be reported in cash flow from financing activities for the year 2018?

- a) Rs. 10,000 Inflow
- b) 0
- c) Rs. 10,000 outflow
- d) Cannot be determined

4. A company has provided following balances

	Rs.
Non-current asset – 31 December 2018	125,000
Accumulated depreciation 1 January 2018	25,000
Accumulated depreciation 31 December 2018	38,000

During the year an asset having cost Rs. 10,000 was sold for Rs. 6,000 and gain on disposal was Rs. 3,000.

What is the charge for depreciation for the year to be adjusted in statement of cash flows?

- a) Rs. 13,000
- b) Rs. 19,000
- c) Rs. 20,000
- d) Rs. 38,000

5. A company has provided following information as at 31 March 2019:

	2019 Rs.	2018 Rs.
Retained earnings	50,000	38,000

Following adjustments were made during the year 2019:

Dividends paid	Rs. 5,000
Transfer to general reserves	Rs. 12,000
Tax charge	Rs. 4,000

What is the amount of profit before tax for the year 2019 for the purposes of preparing statement of cash flows?

- Rs. 29,000
 - Rs. 33,000
 - Rs. 24,000
 - Rs. 25,000
6. A company has provided the following data:

	Rs.
Receivables at 1 April 2018	12,000
Receivables at 31 March 2019	25,000
Credit sales during the year	75,000
Discount allowed during the year	3,000

What is the amount to be shown as cash received from customers in statement of cash flows using direct method?

- Rs. 62,000
 - Rs. 75,000
 - Rs. 59,000
 - Rs. 65,000
7. Which TWO of the following are considered as inflows in a company's statement of cash flows?
- Bonus shares issued
 - Decrease in accounts receivables
 - Increase in inventory
 - Increase in accounts payables
8. Which of the following item will appear in cash flows from financing activities section of statement of cash flows?
- Cash paid to acquire non-current assets
 - Dividends paid
 - Bonus shares issued
 - Depreciation for the year

9. Following data is available for a company for the year ended 31 December 2018:

	Rs.
Operating profit before working capital changes	30,000
Increase in accounts receivables	5,000
Increase in inventory	3,000
Increase in accounts payable	2,000
Interest paid	500

What is the net cash generated from cash flows from operating activities for the year ended 31 December 2018?

- a) Rs. 23,500
- b) Rs. 24,500
- c) Rs. 29,500
- d) Rs. 19,500

10. Which of the following is an advantage of statement of cash flows?

- a) It determines the profitability of a business
- b) It helps users to estimate the future expected cash flows of the business
- c) It determines the ratio of business debts and equity
- d) It helps in determining the net assets of a business

11. A company has made following investments during the year:

	Rs.
6 months Advance rent paid to landlord	30,000
Short term investments bond (highly liquid)	25,000
Debentures purchased- redeemable after 7 years	50,000
Non-current assets purchased	45,000

What is the amount to be shown in investing activities for the year?

- a) Rs. 45,000
- b) Rs. 150,000
- c) Rs. 95,000
- d) Rs. 100,000

12. A company has provided following data at the end of year 2017:

	2017 Rs.
Share capital Re. 1 each	100,000
Share premium	3,000

The company has made a right issue of 1 for 5 shares during the year 2018 at Rs. 1.2 per share.

What is the amount to be shown in the cash flows from financing activities?

- a) Rs. 24,000 outflow
- b) Rs. 24,000 inflow
- c) Rs. 20,000 inflow
- d) Rs. 4000 inflow

13. How should gain on sale of used equipment be reported in a cash flow statement, using indirect approach?
- In operating activities as deduction from Profit before tax
 - In investing activities as a reduction in cash inflow
 - In investing activities as an increase in cash inflows
 - In operating activities as addition to profit before tax
14. Which TWO of the following are added as non-cash adjustments to the profit before tax in the cash flow from operating activities section of statement of cash flows?
- Interest expense
 - Interest income
 - Loss on sale of non-current assets
 - Tax charge for the year
15. Where, in a company are financial statements complying with international accounting standards, should you find the proceeds of non-current assets sold during the period?
- Statement of cash flows and statement of financial position
 - Statement of changes in equity and statement of financial position
 - Statement of profit or loss and statement of cash flows
 - Statement of cash flows only
16. Zahid & Co. reported a profit Rs. 40,000 for the year, after charging the following:

	Rs.
Depreciation	4,000
Loss on sale of assets	3,000

During the year there was a decrease in accounts receivables of Rs. 1,000.

What was the net cash flow generated from operations based on above data?

- Rs. 49,000
 - Rs. 48,000
 - Rs. 47,000
 - Rs. 46,000
17. Asmat Limited made a profit for the year of Rs. 320,500, after accounting for depreciation Rs. 32,500. During the year following transactions took place:

	Rs.
Purchase of machinery	125,000
Increase in accounts receivables	45,000
Increase in inventory	28,000
Increase in accounts payable	12,600

What is the net increase in cash and bank balance during the year?

- Rs. 292,600
- Rs. 167,600
- Rs. 353,000
- None of above

18. A company has provided following information:

	Rs.
4% Loan notes	1,000,000
Interest payable 1 January 2018	10,000
Interest payable 31 December 2018	20,000

What is the amount to be reported as interest paid during the year 2018 in the Statement of Cash Flows?

- a) Rs. 30,000
- b) Rs. 40,000
- c) Rs. 50,000
- d) None of above

19. Furqan Limited has provided following information about non-current assets:

	Rs.
Cost as at 1 January 2018	350,000
Cost as at 31 December 2018	450,000

During the year an asset costing Rs. 100,000 and having net book value of Rs. 40,000 was sold at a profit of Rs. 30,000.

What is the net to be shown as outflow in the "Cash flow from investing activities" section in Statement of Cash Flows?

- a) Rs. 130,000
- b) Rs. 140,000
- c) Rs. 270,000
- d) Rs. 340,000

20. The following amounts have been calculated for inclusion in the statement of cash flow of House Limited:

	Rs.
Net cash inflow from financing activities	145,000
Net cash outflow from investing activities	160,000
Increase in cash and cash equivalents	24,000
Income taxes paid	65,000
Interest paid	12,000

How much cash has been generated from operations?

- a) Rs. 39,000
- b) Rs. 63,000
- c) Rs. 104,000
- d) Rs. 116,000

21. A cash flow statement provides information that enables users to evaluate the changes in:
- Solvency
 - Net assets
 - Its financial structure
 - Its liquidity
22. Daily sales and purchases and employee costs comprise:
- Operating activities
 - Investing activities
 - Financing activity
 - Component of cash and cash equivalent
23. Which of the following involves a movement of cash?
- A rights issue
 - Depreciation of fixed assets
 - Creation of a provision for doubtful debts
 - A bonus issue
24. Activities that result in changes in the size and composition of the equity capital and borrowings of an entity are called:
- Operating activities
 - Investing activities
 - Financing activity
 - None of these
25. Which of the following are not the operating activities?
- Interest paid
 - Cash payments of income taxes
 - Collections from customers
 - Payment of dividends
26. Amplifier Limited had sales of Rs.120 million during the year. Trade and other receivables increased from Rs.12 million to Rs.16 million, an increase of Rs. 4 million. What amount of cash was received from customers during the year?
- Rs.124 million
 - Rs.116 million
 - Rs.120 million
 - None of these
27. Cost of sales for Shah Textile Limited during the year was Rs.100 million. Opening inventory was Rs.20 million and closing inventory was Rs. 28 million. Opening trade payables were Rs.5 million and closing trade payables were Rs.9 million. What amount of cash was paid to suppliers?
- Rs.102 million
 - Rs.104 million
 - Rs.108 million
 - Rs.110 million

28. Zaman Limited extracted general ledger from which it shows salaries and wages expense of Rs.50 million during the year. Its cash flow statement reported cash paid to employees of Rs.42 million. The opening balance of accrued salaries and wages was Rs.3.6 million. What was the closing balance for accrued salaries and wages?
- a) Rs.11.6 million
 - b) Rs.11.8 million
 - c) Rs.4.4 million
 - d) Rs.3.8 million
29. Sale proceeds from disposal of property, plant and equipment are classified as:
- a) Financing activities
 - b) Operating activities
 - c) Investing activities
 - d) Either financing or operating activities, depending on which method (direct or indirect) is used to determine cash flows from operating activities
30. Which one of the following events will increase the cash balances of a business?
- a) Loan repayment to banks
 - b) Bank granting it an overdraft facility
 - c) Debtors paying amounts owed
 - d) Sale of stock on credit
31. A company with healthy profits is facing a cash shortage. Which of the following events could account for this?
- a) Delaying payments to creditors
 - b) The shortening of the credit period granted to debtors
 - c) The recent acquisition of machinery
 - d) An increase in dividend proposed by the directors
32. Which one of the following companies is most likely to run into cash flow problems?
- a) A loss making company making components of vital strategic importance to the government
 - b) A profitable new retailer about to embark on ambitious expansion plans
 - c) A company which has recently sold part of its operations so as to concentrate on its core areas
 - d) Reasonably profitable, long established company with no expansion plans
33. What is the immediate effect of making a capital repayment on a loan on cash flow and profits?
- a) On profit - None; On cash - Decrease
 - b) On profit - Increase; On cash - Decrease
 - c) On profit - Decrease; On cash - Decrease
 - d) On profit - Decrease; On cash - None
34. A company has a negative cash flow from operating activities. What could explain this negative cash flow?
- a) High levels of dividend payments
 - b) A substantial investment in new fixed assets
 - c) A significant decrease in trade payables
 - d) The repayment of a loan

35. Which of the following is NOT a cash outflow for the firm?
- Dividend payments
 - Interest payments.
 - Taxes
 - Bad debts
36. Which of the following would cause negative net cash flow from operating activities?
- Decrease in depreciation expense
 - A substantial investment in fixed assets
 - A significant increase in credit sales
 - Repayment of a long-term loan
37. In order to survive in the long run, a business must generate positive net cash flow from:
- investing activities
 - operating activities
 - financing activities
 - both (a) and (b)
38. Which of the following statements is/are correct?
- Cash flows information cannot be manipulated easily, as compared to profit or loss because it is not affected by different accounting policies.
 - Cash flows information can be manipulated easily, as compared to profit or loss because it is affected by different accounting estimates.
- Only (I) is correct
 - Only (II) is correct
 - Both are correct
 - None is correct
39. Which of the following may be presented in both statement of comprehensive income and statement of cash flows?
- Purchase of non-current assets
 - Issuance of shares
 - Repayment of loan
 - Depreciation
40. Alpha Limited made a profit before tax of Rs. 80,000 in the year just ended after charging depreciation of Rs. 75,000. There was a gain of Rs. 25,000 on disposals of property, plant and equipment. Net working capital excluding cash increased by Rs. 19,000. Income tax paid during the year was Rs. 24,000.
- What is the amount of cash generated from operations?
- Rs. 87,000
 - Rs. 111,000
 - Rs. 125,000
 - Rs. 148,000

41. A company's cash balances have increased from last year. Which of the following events could account for this?
- Delayed payments by debtors
 - Shortening of the credit period by the creditors
 - Acquisition of a long-term loan at high interest rate
 - A decrease in final dividend proposed by the directors
42. Which of the following statements is/are correct?
- Statement of cash flows is useful in assessing the ability of the entity to generate cash and cash equivalents.
 - Historical cash flows are often a fairly reliable indicator of the amount, timing and certainty of the future cash flows.
- Both are correct
 - Only (I) is correct
 - Only (II) is correct
 - None is correct
43. Which TWO of the following may appear in the operating cash flows?
- Increase in depreciation expense
 - Interest received
 - Dividend paid
 - Sale proceeds from disposal of property, plant and equipment
44. Alpha company issued 4 million ordinary shares of Rs. 10 par value for purchasing land having a fair value of Rs. 50 million. How should this transaction be reported by Alpha in its statement of cash flows?
- It should be reported as financing cash flows.
 - It should be reported as investing cash flows.
 - It should not be presented in the statement of cash flows but it will be presented in the notes to the financial statements.
 - It should be reported as investing cash flows as well as financing cash flows.
45. Beta Limited reported a net loss of Rs. 70,000 after charging depreciation expense of Rs. 81,000. If the working capital (other than cash) has increased by Rs. 8,100, then what is the amount of net cash provided (used) by operating activities?
- (Rs. 159,100)
 - (Rs. 142,900)
 - Rs. 2,900
 - Rs. 19,100
46. Which of the following statements is/are correct?
- Interest paid may be classified as an operating cash flow or as an investing cash flow.
 - Cash flows from operating activities calculated using 'Indirect method' are greater than cash flows from operating activities calculated using 'Direct method'.
- Only (I) is correct
 - Only (II) is correct
 - Both are correct
 - None is correct

ANSWERS

01.	(c)	Bonus issue of shares involves transfer from Reserves to share capital of the company. There is no cash flow involved.			
02.	(c)	The statement indicates that the company had net cash receipts (inflows) despite the losses, which is indicative of receipts of cash by issuing right shares.			
03.	(b)	No cash is paid or received for bonus issue of share capital. Entry to record bonus issue			
			Dr Rs.	CR Rs.	
		Share premium	10,000		
		Share capital			10,000
		Share Capital + Share premium			
				b/d 100,000+40,000	140,000
		c/d 110,000 + 30,000	140,000		
			140,000		140,000
04.	(c)	Accumulated depreciation			
		Particulars	Rs.	Particulars	Rs.
		Disposal (see below)	7,000	b/f	25,000
		c/f	38,000	Depreciation	20,000
			45,000		45,000
		Disposal			
		Particulars	Rs.	Particulars	Rs.
		Asset	10,000	Provision for dep. (balancing)	7,000
		Gain on disposal	3,000	Cash	6,000
			13,000		13,000
05.	(b)	Retained earnings			
		Particulars	Rs.	Particulars	Rs.
		Dividends paid	5,000	b/f	38,000
		Transfer to reserves	12,000	Profit for the year	29,000
		c/f	50,000		
			67,000		67,000
		Profit after tax 29,000 + Tax 4,000 = Rs. 33,000 profit before tax			

06.	(c)	Accounts receivables			
		Particulars	Rs.	Particulars	Rs.
		b/f	12,000	Cash (bal.)	59,000
		Sales	75,000	Discount allowed	3,000
				c/f	25,000
			87,000		87,000
07.	(b) & (d)	Decrease in accounts receivables indicates that they have paid the debt, hence, inflow for us. Increase in accounts payable indicates that we have not paid them, thus reducing outflows (or increasing cash flows) Bonus shares issued do not affect cash flows. Increase in inventory is cash outflows.			
08.	(b)	Dividend is paid to shareholders who provide finance to the business; therefore, it is treated as financing activity. Cash paid to acquire non-current assets is shown in investing activities. Bonus issues have no impact on cash flows of the business. Depreciation is non-cash item and is adjusted in operating activities.			
09.	(a)			Rs.	
		Operating profit before working capital changes		30,000	
		Increase in accounts receivables		(5,000)	
		Increase in inventory		(3,000)	
		Increase in accounts payable		2,000	
		Interest paid		(500)	
				23,500	
10.	(b)	Users of financial statements may predict future cash flows from past data of how the entity generates and uses its cash. Profitability is reflected in statement of comprehensive income. Debt/Equity and net assets are reflected in statement of financial position.			
11.	(c)	Only debentures and non – current assets purchased are included in investing activities; Rs. 50,000+45,000= Rs. 95,000 Investment in short term bonds will be considered cash equivalent and advance rent would affect operating activities cash flows.			
12.	(b)	Shares issued = $100,000/5 = 20,000$ Cash received = $20,000 \times \text{Rs.}1.2 = \text{Rs. } 24,000$			
13.	(a)	The gain on disposal is included in profit before tax as other income. This is deducted back in order to determine the cash figure.			
14.	(a) & (c)	Interest expense is added back as interest paid is separately reported.			
		Loss on disposal is added back as this is included in profit before tax as an expense.			
		Interest income is deducted back.			
		Tax charge need not be added back as already the amount taken is profit before tax.			

15.	(d)	Statement of cash flows only			
16.	(b)				
					Rs.
		Profit before tax			40,000
		Adjustments for non-cash items			
		Depreciation			4,000
		Loss on sale of fixed assets			3,000
		Operating profit before working capital changes			47,000
		Decrease in accounts receivables			1,000
		Cash generated from operations			48,000
17.	(b)				
		Cash flows from operating activities			Rs.
		Profit before tax			320,500
		Depreciation			32,500
		Operating profit before working capital changes			353,000
		Increase in accounts receivables			(45,000)
		Increase in inventory			(28,000)
		Increase in accounts payable			12,600
					292,600
		Cash flow from investing activities			
		Purchase of machinery			(125,000)
					167,600
18.	(a)				
		Interest payable			
		Particulars	Rs.	Particulars	Rs.
		Cash	30,000	b/f	10,000
		c/f	20,000	Interest expense	40,000
			50,000		50,000
		Interest expense = Rs. 1,000,000x4%= Rs. 40,000			
19.	(a)	Amounts to be shown in Cash flows from investing activities are;			
		Cash flows from investing activities			Rs.
		Cash paid to acquire assets			(200,000)
		Cash received on disposal			70,000
					(130,000)

Non-current assets			
Particulars	Rs.	Particulars	Rs.
b/f	350,000	Disposal	100,000
Cash	200,000	c/d	450,000
	550,000		550,000

Disposal			
Particulars	Rs.	Particulars	Rs.
Asset	100,000	Acc. Dep [100,000 – 40,000]	60,000
Gain on disposal	30,000	Cash	70,000
	130,000		130,000

20.	(d)		
			Rs.
		Cash generated from operations (β)	116,000
		Interest paid	(12,000)
		Income taxes paid	(65,000)
		Net cash from operating activities (β)	39,000
		Net cash outflow from investing activities	(160,000)
		Net cash inflow from financing activities	145,000
		Increase in cash and cash equivalents	24,000
21.	(d)	Its liquidity	
22.	(a)	Operating activities	
23.	(a)	A rights issue	
24.	(c)	Financing activity	
25.	(d)	Payment of dividends	
26.	(b)	Rs.116 million (i.e. Sales Rs. 120m – increase in receivables 4m)	
27.	(b)	Rs.104 million (i.e. Cost of sales Rs. -100m – increase in inventory 8m + increase in payables 4m = Rs. -104m)	
28.	(a)	Rs.11.6 million (i.e. Rs. 3.6m + 50m expense – 42m paid)	
29.	(c)	Investing activities	
30.	(c)	Debtors paying amounts owed	
31.	(c)	The recent acquisition of machinery	
32.	(b)	A profitable new retailer about to embark on ambitious expansion plans	
33.	(a)	On profit - None; On cash – Decrease	
34.	(c)	A significant decrease in trade payables	
35.	(d)	Bad debts	

36.	(c)	A significant increase in credit sales
37.	(b)	Operating activities
38.	(a)	Only (I) is correct
39.	(d)	Depreciation
40.	(b)	PBT 80,000 + Depreciation 75,000 – gain on disposal 25,000 – 19,000 increase in working capital = Rs. 111,000 Cash generated from operations
41.	(c)	Acquisition of a long-term loan at high interest rate
42.	(a)	Both are correct
43.	(b) & (c)	Interest received Dividend paid
44.	(c)	It should not be presented in the statement of cash flows but it will be presented in the notes to the financial statements
45.	(c)	Net loss (Rs. 70,000) + Depreciation 81,000 – Increase in working capital 8,100 = Rs. 2,900
46.	(d)	None is correct

STICKY NOTES

Format

ABC Limited		
Statement of cash flows for the year ended 30 June 2023		
Cash flows from operating activities		Rs. m
Cash generated from (used in) operations	(Note 1)	XX / (X)
Interest paid		(X)
Income taxes paid		(X)
Net cash from (used in) operating activities		XX / (XX)
Cash flows from investing activities		
Purchase of non-current assets*		(XX)
Proceeds from disposal of non-current assets*		XX
Purchase of short-term investments		(XX)
Disposal proceeds of short-term investments		XX
Receipt of grant related to assets		XX
Receipt of investment income / rental income / interest / dividend		XX
Net cash from (used in) investing activities		XX / (XX)
Cash flows from financing activities		
Proceeds from issue of shares		XX
Dividend paid		(X)
Repayment of long-term and short-term borrowings		(XX)
Long-term and short-term borrowings obtained		XX
Net cash from (used in) financing activities		XX / (XX)
Net increase (decrease) in cash and cash equivalents		XX / (XX)
Cash and cash equivalent at the beginning of the year		XX
Cash and cash equivalent at the end of the year		XX

*includes property, plant and equipment, investment property, long term investments and long-term deposits etc.

Format**Note 1: Cash generated from operations (direct method)**

		Rs. m
Cash received from customers	(1.1)	XX
Cash paid to suppliers and employees	(1.2)	(XX)
		XX/(X)

1.1: Cash received from customers

	Rs. m
Revenue	XX
Other income from customers	XX
(Increase) decrease in trade receivables	X / (X)
Increase (decrease) in advance from customers (unearned revenue)	X / (X)
	XX

1.2: Cash paid to suppliers and employees

	Rs. m
Cost of sales	(XX)
Other expenses	(XX)
Other income	XX

Adjustments:

Depreciation	X
Amortisation of government grant	(X)
Bad and doubtful debts expense (recovery or reversal)	X / (X)
Loss (gain) on disposal of non-current assets	X / (X)
Loss (gain) on investment property	X / (X)
Impairment (reversal) loss	X / (X)
Revaluation (reversal) loss (to the extent recognised in PL)	X / (X)
Rent income on investment property / investment income	(X)

Working capital changes:

Inventories	X / (X)
Prepayments	X / (X)
Trade payables	X / (X)
Accrued expenses	X / (X)
	(XX)

Format**Note 1: Cash generated from operations (indirect method)****Rs. m**

Profit (loss) before tax

X / (X)

Adjustments:

Depreciation

X

Amortisation of government grant

(X)

Bad and doubtful debts expense (recovery or reversal)

X / (X)

Loss (gain) on disposal of non-current assets

X / (X)

Loss (gain) on investment property

X / (X)

Impairment (reversal) loss

X / (X)

Revaluation (reversal) loss (to the extent recognised in PL)

X / (X)

Rent income on investment property / investment income

(X)

Finance costs

X

Operating profit (loss)

X / (X)

Working capital changes:

Inventories decrease /(increase)

X / (X)

Trade receivables decrease /(increase)

X / (X)

Prepayments decrease /(increase)

X / (X)

Trade payables increase / (decrease)

X / (X)

Advance from customers or unearned revenue increase / (decrease)

X / (X)

Accrued expenses increase / (decrease)

X / (X)

XX / (X)