ACCOUNTANCY

Class XII

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FOREWORD

Accounting plays a vital role in organizational management. It accumulates both monetary and non- monetary costs and its economic implication in the process of proving a provision of physical goods and services to the customers, and reports this information to the investors, managers and other wider stakeholders group. In the modern economy, accounting information adds to the organizational competitive edge through accounting analytics and supply of financial information to the management and investors. Besides, accounting provides an increasing opportunity of employment for our students in the fast developing economy. At the individual level, accounting can help develop a sense of accountability, ethics and organizational leadership skills.

It is critical that the Accountancy education taught in the school system aligns with what is practised in the real work place. Following the international suit, Bhutan adopted a set of international accounting standards called IFRS in 2013 (though these standards adopted in Bhutan are currently named as BASs), and required our business entities to prepare financial statements following these standards. Our school curriculum must therefore incorporate such changes to ensure the provision of right knowledge and skills to the learners for their career choice.

"Given the current scenario of globalization and liberalization, establishment of businesses in various emerging economies, cross border movements of capital and capital markets getting integrated, the use of financial statements of an entity are no longer limited to single country and hence it is of paramount importance that the accounting principles for reporting financial information to be consistent with other countries".

Accounting and Auditing Standards Board of Bhutan

The subject which was based on the curriculum materials designed by the foreign authors and publishers was taught since its introduction into the Bhutanese education system. Such a practice posed challenges to the Bhutanese learners as most of the content were irrelevant, outdated and was contextualised to foreign setting and needs. This hampered the learners in acquiring the required knowledge and skills.

With the rapid development and expansion of Bhutanese economy, and its participation in the global financial transaction, the need to develop an Accountancy curriculum that encompasses Bhutan's ideologies, principles, and philosophies in line with international standards was strongly felt. Of late, Bhutan has witnessed several Foreign Direct Investment (FDI) projects and establishment of joint venture undertakings with foreign companies, which also requires the financial reporting standards in line with the International Financial Reporting Standards. Thus, it is important that the Bhutanese education system accommodates such changes to ensure that our learners learn accountancy in keeping with the current realities.

The new textbook has been developed in close consultation with the relevant stakeholders ensuring right content and learning activities that provide the necessary knowledge and skills for our learners. Further, the revised content of the textbook is aligned with BAS, which ensure the practical knowledge and skills that are required to get employed in business industries.

The Royal Education Council anticipates that the revised accountancy curriculum delivers cutting edge accountancy education and prepare accountancy learners to join the world of works and contribute to achieving the Bhutan's goal of Gross National Happiness.

Karma Galay
Director General

Contents

Foreword -- vi

UNIT ONE: FINANCIAL ACCOUNTING

CHAPTER 1: Accounting for Taxation -- 1

CHAPTER 2: Accounting for Payroll ---------------------------------------47

CHAPTER 3: Accounting for Investment Property-----------------------59

CHAPTER 4: Accounting for Intangible Assets and Government Grants -75

CHAPTER 5: Liability, Provisions and Contingencies ------------------99

CHAPTER 6: Accounting for Equity Shares and Debt Finance------ 115

CHAPTER 7: Accounting for Partnership Firm------------------------ 149

CHAPTER 8: Financial Statements of a Limited Company ---------- 169

CHAPTER 9: Analysis and Interpretations of Financial Statements 221

UNIT TWO: COST ACCOUNTING

CHAPTER 10: Stores Ledger-- 243

UNIT THREE: MANAGEMENT ACCOUNTING

CHAPTER 11: Budgeting Process and Variance Analysis -------------- 277

CHAPTER 12: Application of Spreadsheet in Accounting ---------- 300

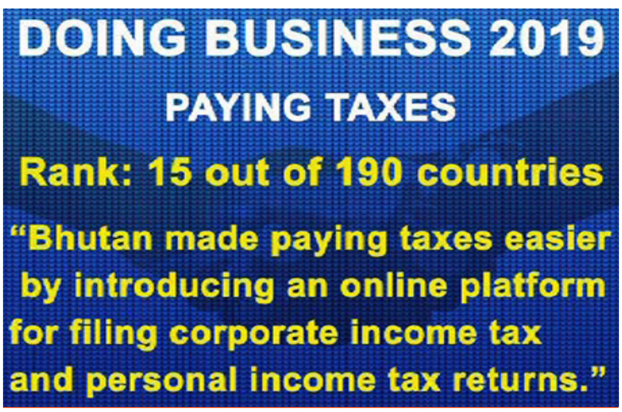
Assessment -- 312

Chapter 1
Accounting for Taxation

Learning Objectives:

- Explain the importance of taxation in business.
- Discuss the statutory responsibilities of managers for tax accounting in business.
- Differentiate between accounting profit and taxable profit, and illustrate how these differences arise.
- Explain the concept of current tax expense and tax liabilities including under or over provision of taxes.
- Explain the concept of deferred tax and make related accounting entries.
- Report tax components in the financial statements of the reporting entity.
- Understand the meaning and scope of BIT in Bhutan.
- Identify the source documents for BIT.
- Classify and explain items under allowable deductions under the Income Tax Act.
- Identify deductions not permissible under the Income Tax Act.
- Compute Business Income Tax (BIT).

Taxation is one of the important components of financial decisions of business.



The management of the business entity has a statutory responsibility to maintain proper records of tax effects of business transactions and deposit the tax money on a timely basis to the government account. Equally, the management can do tax planning for its financial transactions to optimize tax benefits. Income tax has a significant effect on the net profit of the business. Earlier in class XI you have studied the general principles and regulations of taxation. In this chapter you will be studying the basics of accounting for taxation and reporting tax components in the financial statements.

1.1 Accounting for Sales Tax Collected from Customers

The sales tax amount collected from customers is a liability owed to the government. Sales tax is levied on both cash sales as well as credit sales. For example, if a unit of goods is sold at Nu. 70,000 and a sales tax of 10% is levied, this will have created a tax liability of Nu. 7,000. Therefore, a total cash of Nu. 77,000 will be paid by the customer.

Cash A/c	Dr.	77,000	
To Sales income			70,000
To Sales tax-RRCO			7,000

Credit sales are similarly subject to sales tax.

Trade receivables A/c	Dr.	77,000	
To Sales income			70,000
To Sales tax-RRCO			7,000

The fixation of sales tax rates, and the range of commodities and services under the Sales Tax Schedule is updated and notified by the Government. Sales tax is collected at the point of sale or at the time of import. Where the sales tax is levied at the point of sale, tax liability is calculated on the sales price. The Sales Tax collected at the point of sale of goods and services is deposited with the Department of Revenue and Customs. In VAT taxation system, sales tax collected from customers is known as output VAT.

1.2 Accounting for Sales Taxes on Purchases and Expenses

In the VAT taxation system, the tax paid by the business entity on purchases and expenses is called input VAT. The registered business entity can recover his input VAT as an offset from the output VAT. For example, if the business entity purchases a unit of goods at Nu. 60,000, the supplier would have invoiced the business entity for Nu. 66,000 (10% sales tax).

Purchases A/c	Dr	60,000	
Sales tax-RRCO A/c	Dr	6,000	
To Trade payables			66,000

Sales tax is an indirect tax, that is, the incidence of the tax is eventually borne by the final consumer of goods and services. Countries like UK, Philippines, the Netherlands and many EU countries have adopted VAT (value added tax), while some countries like India, Singapore and Australia, have adopted GST (goods and service tax). In countries where GST form of taxation is used, GST subsumes various indirect taxes existed in the earlier regime such as exercise duty, sales tax and VAT. With the adoption of GST in India in 2017, the largest trading partner of Bhutan, it has become a priority for Bhutan to implement a similar goods and service tax. It has been proposed that Bhutan will implement a broad based GST by July 2020. GST and VAT taxation system require effective input tax credit, refund management and administrative mechanisms as preconditions for effective implementation of the GST taxation system. The proposed GST in Bhutan will take the form of value added tax (VAT) system with input tax crediting and a mandatory registration based on turnover of business entities.

If the output VAT is more than the input VAT, the difference is payable to the government. If the input VAT is more than the output VAT, the difference is recovered from the VAT office.

In the above example, the business entity collected output VAT of Nu. 7,000, and has paid Nu. 6,000 input VAT. The difference of Nu. 1,000 is payable to the government if remaining unpaid at the year end. This will be reported as current liability in the statement of financial position.

1.3 Accounting for Current Tax

The business entity is required to pay tax on the profit made in the accounting period unless the entity is exempted from tax payment. For example, the entity under tax holiday may be exempted from paying tax to the government for certain time period as stipulated by tax regulations. However, as discussed in the next section, the accounting income and the taxable income are different. Accounting income is calculated on the basis of accrual method of accounting while the taxable income is calculated on the basis of tax regulations of the country. The tax regulations generally provide a taxation rate to enable business entities to estimate their tax expense and tax liabilities at the time of closing the books of accounts. This does not mean that business entity will pay that amount as tax expense for the year. For example, if the reported profit before tax is Nu. 100,000, and 30 percent of tax is charged, Nu. 30,000 is not the amount that business entity will pay to the government. This amount is an estimate of the tax expense for the current year. The actual taxable income and the amount of tax payable to the government will be assessed by tax authorities for the year. The estimated tax on the current year's profit is treated as an expense in the income statement and current liability in the statement of financial position.

Tax expense A/c	Dr	30,000	
To current tax liability			30,000

It is possible that the tax estimated by the entity is different from what tax authorities assess at the time of tax filing. If the tax estimate is lower than the assessed tax, it results into under provision of tax. Consider the previous example of tax estimate of Nu.30, 000 calculated on the reported profit of Nu. 100,000. What if the tax authorities assess tax amount as Nu. 45,000. This will result into creation of additional tax expense or a tax liabilities by Nu. 15,000 which must be recognized in the books of accounts and present in the financial statements. The additional tax expense of Nu. 15,000 is to make up the under provision.

Tax expense A/c	Dr	15,000	
To current tax liability			15,000

Therefore, the current year's income statement will not only recognize tax expense on this year's profit, but also any under-provision of tax of the previous year.

1.4 Difference between Accounting Income and Taxable Income

There is a concept called accounting income and taxable income. The accounting income is the difference between total income earned and the total expenses incurred during the accounting period of the entity. This is also called the net profit. Accounting income is derived from the accrual method of accounting. The taxable income, on the other hand, is the income calculated by tax authorities by adjusting all tax admissible deductions of the income tax regulations on the accounting profit.

The tax regulations provide a lists of income and expense items which are recognized as taxable income and tax deductions. Take an example of an accrued interest. From the accounting perspective, accrued interest is an income that will increase the total income of the entity. However, from the taxation point of view, accrued interest will be accounted only in the next accounting year when the interest is actually received. Therefore, there is a difference between accounting income and a taxable income. Let's consider an operating profit before tax of Nu. 600,000 which includes accrued interest of Nu. 100,000. Tax authorities will not recognize accrued interest of Nu. 100,000 as income for assessment of taxable income for the current year even though the same amount has been treated as an income in the statement of income. Thus, because of the difference in the treatment of the accrued income, the taxable income is different from the accounting income.

Let's take another example. Depreciation features quite well in the income statement and for that reason tax authorities take interest in depreciation when they assess the taxable income. Since deprecation is an estimate, different entities may adopt a varying methods of deprecation that would affect the profit of the business and the tax payments. Especially when the depreciation rate and the method used is unreasonable, tax authorities insist on having the same depreciation rate for all business entities in the country. This was the case in Bhutan prior to adoption of new accounting standards in 2013.

Tax legislation allows depreciation on property, plant and equipment as deduction subject to the maximum rates prescribed by the income tax act. The items of property, plant and equipment as per the tax purpose are not depreciated in the year of disposal that is in contradiction to the accounting approach.

Let's consider few examples of income and expense items which are treated in different ways in accounting and tax rules.

a. *Bad debts*

In accounting, bad debts are treated as expense and reduce profit for the year. However, tax regulations generally allow only up to Nu. 25,000 per debtor for deduction.

b. *Inventory obsolescence*

In accounting, management must assess the obsolescence of inventory or slow moving inventory and write it off to reduce profit for the year, whereas, tax regulations do not allow such deduction unless the inventory obsolescence was caused by unavoidable circumstances.

c. *Penalties and fines*

Penalties and fines are treated as administrative expenses in accounting that will reduce net profit of the entity. However, tax regulations do not allow such expenses as deductions for tax calculation.

d. *Fully depreciated assets*

Tax regulations require the fully depreciated items of property, plant and equipment (say computer equipment) which is still in use to be recorded at Nu. 1 in asset register for asset identification. However, in accounting, management of the entity may review the useful life of the asset and reinstate to the cost and accumulated depreciation of the asset, if the cost and date of acquisition of the asset is known. If it is impracticable to identify the cost and the date of acquisition of the asset, an entity will revalue the asset and consider such value as deemed value of the asset.

e. *Research and development*

Tax regulations allow 2 percent of the assessed turnover of research and development cost for deductions. The treatment of research and development cost is different in accounting. Generally, all research costs are expensed and deducted from the income statement.

1.5 Accounting for Deferred Tax

The new accounting standards require business entities to recognize not only current tax expense and under-provision of tax of the previous year, but also the deferred tax. The deferred tax allows reporting entity to account the implication of tax on its taxable temporary difference. In the following section, you will learn the concept of deferred tax and method of accounting for such deferred tax in the books of accounts. Also, note the way how deferred tax is presented in the financial statements.

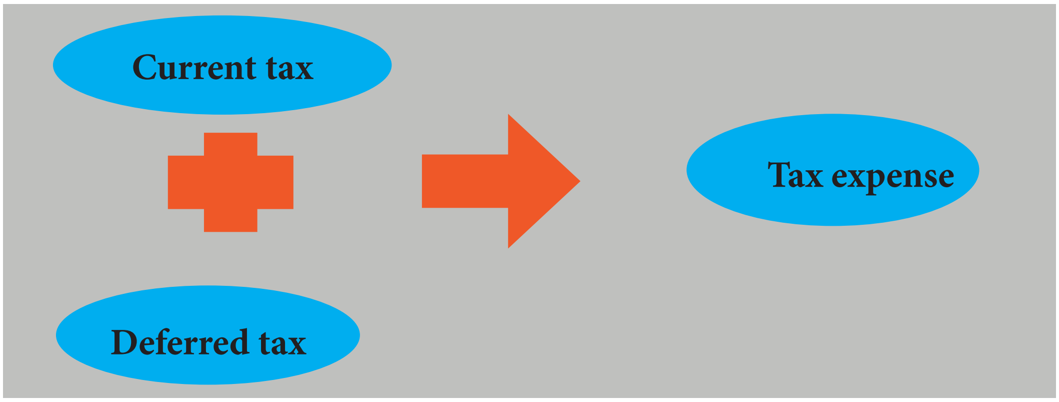
As the term denotes, deferred tax is the tax, the payment of which is deferred or delayed until future accounting period for the income earned in the current year. Let's consider the same example of the accrued interest income. For accounting purpose, we recognize the accrued income in the current year but for tax purpose we recognise that as the income in future when the amount is received. Assuming that an entity reports a profit of Nu. 600,000 which includes Nu. 100,000 accrued interest income in 2019, the tax regulation will not charge tax for Nu. 100,000 accrued interest income in 2019. The tax on this income will be levied only in the next accounting period when the amount is received. Therefore, this has created a taxable temporary difference of income. The accounting standards require the entity to recognize tax on this taxable temporary difference in the income statement of the current year and as a deferred tax liability in the statement of financial position. In this example the taxable temporary difference of income is Nu. 100,000. This difference in taxable income is temporary because entity will pay tax on this income in the next accounting period. Assuming 30 percent tax rate, we have the following tax expenses recognized in the books of accounts in 2019.

Tax expense A/c	Dr.	150,000	
To current tax liability			150,000
Tax expense A/c	Dr.	30,000	
To Deferred tax liability			30,000

Statement of comprehensive income for the year ended 2019

Particulars		**Amount**
Operating profit		500,000
Interest income		100,000
Profit before tax		**600,000**
Current tax	(150,000)	
Deferred tax	(30,000)	(180,000)
Profit after tax		**420,000**

As presented above, income tax expense for the year consists of current tax expense and deferred tax on the taxable income temporary difference. The entity will have many such taxable temporary differences of income arising during the course of its business. For all such taxable temporary difference, the entity will need to recognize tax expense and deferred tax liability as discussed above. This syllabus does not require student to know all sorts of transactions that give rise to deferred tax consequences.



Statement of Comprehensive Income

for the year ended on 31st December2017 **Amount in Nu.**

Particulars	Note No.	2017	2016
Income			
Electricity revenue		11,953,372,682.94	12,602,988,785.09
Interest Earned		120,889,001.79	159,258,446.38
Other Incomes		202,983,418.74	120,695,148.21
		12,277,245,103.47	12,882,942,379.68
Expenditure			
Wheeling charges		742,351,161.01	617,472,078.88
Insurance		113,043,211.21	114,271,454.59
Running and maintenance expenses	18	443,656,365.04	309,814,013.87
Employees' remuneration and benefits	19	847,624,681.20	812,915,270.97
Finance cost	20	345,415,270.69	477,493,972.42
Depreciation/amortization	2	2,267,598,498.36	2,307,281,458.81
Other expenses	21	293,101,904.60	292,084,940.18
		5,052,791,092.11	4,931,333,189.72
Operating profit		7,224,454,011.36	7,951,609,189.96
Profit before tax		7,224,454,011.36	7,951,609,189.96
Tax expense	22		
Current tax		2,137,363,491.72	2,360,252,582.32
Deferred tax		(105,565,278.49)	37,383,238.27
Income Tax for earlier years		105,685,844.33	
		2,137,484,057.56	2,397,635,820.60
Profit for the year		5,086,969,953.80	5,553,973,369.36

Tax expense split into current and deferred tax reported as separate line items in SoCI

DGPC Annual Report 2017

Statement of Financial Position

as at 31st December2017 **Amount in Nu.**

Particulars	Note No.	2017	2016
Assets			
Non- current assets			
Property, plant & equipment	1	42,312,400,734.10	43,425,707,386.04
Intangible assets	1	20,915,544.36	38,861,419.66
Investment property	2	32,000,000.00	32,000,000.00
Deferred tax asset	3	30,527,276.28	-
Investments in subsidiaries and joint ventures	4	5,207,928,305.22	4,296,883,410.86
Current Liabilities			
Trade and other payables	9d	510,221,940.06	446,932,070.72
Other financial liabilities	9e	2,521,260,976.05	2,413,112,292.10
Other current liabilities	12	43,925,248.83	44,118,103.23
Current tax liabilities	13	1,631,996,344.29	1,977,911,908.06
Employee benefit obligation	14	57,678,142.52	62,828,423.18
Total current liabilities		4,765,082,651.75	4,944,902,797.29
Total liabilities		8,776,271,520.43	10,889,086,685.20
Total shareholders' equity & liabilities		54,943,374,255.60	55,300,320,684.35

Note referred to above form an integral part of the Accounts

This is the Statement of Financial Position referred to in our report of even date in terms of our report of even date attached

Current tax liability reported as separate line item in SoFP

DrukGreen

Statement of Cash Flows

for the year ended 31st December 2017

Amount in Nu.

Particulars	2017	2016
Cash flows from operating activities		
Profit before taxation	7,224,454,011.36	7,951,609,189.96
Adjustment for:		
Depreciation / amortization	2,267,598,498.36	2,307,281,458.81
Foreign exchange loss	(127,013,702.07)	40,281,973.83
Loss/(gain) on sale of property plant & equipment	(1,851,728.90)	13,542,115.87
Investment income	(120,889,001.79)	(159,258,446.38)
Dividend income	-	(44,723,250.00)
Interest expenses	345,415,270.69	477,493,972.42
(Increase)/decrease in trade receivables and other receivables	231,138,856.41	(532,283,029.54)
(Increase)/decrease in inventories	4,596,451.15	(10,570,333.02)
(Increase)/decrease in prepayments and advances	90,475,182.43	(31,726,769.49)
(Increase)/decrease in assets classified as held for sale	(294,185.37)	(299,312.25)
Increase/(decrease) in trade and other payables	63,289,869.34	(55,578,384.30)
Increase/(decrease) in other current liabilities	(192,854.40)	1,710,265.91
Increase/(decrease) in employee benefit obligation	62,419,143.87	66,016,851.65
(Increase)/Decrease in Other asset	(152,941.14)	(148,099.86)
Cash generated from Operation	10,038,992,869.94	10,023,348,203.61
Income tax paid	(2,627,327,762.52)	(2,000,335,456.99)
Net cash from operating activities	7,411,665,107.41	8,023,012,746.62
Cash flows from investing activities		
Purchase of PPE & intangibles assets	(1,134,494,242.22)	(959,004,001.01)
Sale of PPE & intangible asset	(84,730.01)	164,803,842.13
Payment for investments in subsidiaries and joint ventures	(911,044,894.36)	(380,000,000.00)
Proceeds from held-to-maturity investments	(12,771,974.07)	274,852,167.13
Interest received	153,572,383.31	174,884,674.12
Dividend received	-	44,723,250.00
Net cash used in investing activities	(1,904,823,457.36)	(679,740,067.63)

Tax paid reported as separate line item in statement of cash flows

Illustration 1

MKB Enterprise develops software for accounting and other business functions. The software development process includes research, design, programming and testing of software before implementation of the software. MKB Enterprise receives overwhelming contracts from various customers. MKB Enterprise reports operating profit of Nu. 1.5 million in 2019. A total cost of Nu. 150,000 was incurred on research in 2019 which was treated as capital cost of the software design.

In 2020, MKB management adopted new accounting standards which require to expense all market research costs. As a consequence, the accountant of MKB needs to restate its profit figure. All business entities pay 30 percent tax on yearly profit.

Required:

a. Rewrite the statement of income of MKB Enterprise to report profit or loss as per the requirement of the new accounting standards for 2020.
b. Ascertain the tax expense before and after the adoption of new accounting standards.
c. Show tax components in the statement of financial statements.

Solution:

Statement of income for the year ended 2020 (before adoption of new accounting standards)

	Amount
Profit before tax	1,500,000
Tax (30%)	(450,000)
Profit after tax	**1,050,000**

Statement of income for the year ended 2020 (after adoption of new accounting standards)

	Amount
Profit before tax	1,500,000
Research expense	(150,000)
Profit before tax	1,350,000
Tax (30%)	(405,000)
Profit after tax	**945,000**

Statement of financial position as at 31 December 2020

	Amount
Current liability	
Tax liabilities	405,000

Illustration 2

A company presents the following ledger balance on 31 October 2019.

	Amount
Sales tax payable to Department of Revenue and Customs	33,550
Bank overdraft	150,000
Trade receivables	845,500

Following transactions took place in November and December 2019

Sales of Nu. 100,000 were made on credit.
Office equipment of Nu. 45,000 was bought and paid by cheque.
Materials purchased on credit for Nu. 70,000.
Materials costing 10,000 were returned to the supplier and refund received by cheque.
Nu. 3,500 administrative expense was paid by cheque.
Suppliers are paid Nu. 80,000 by cheque.
A refund of Nu. 25,000 was received by cheque from tax office.
Customers paid balance outstanding by cheque and were allowed Nu. 50,000 discount
Sales tax is 20% in all cases.

Required:

a. Prepare sales tax account for December 2019 showing the closing balance.
b. Calculate bank balance at 31 December 2019.

Solution

Sales tax account

Particulars	Amount	Particulars	Amount
Purchases	14,000	Balance b/d	33,550
Expenses	700	Sales	20,000
Office equipment	9,000	Purchase returns	2,000
Balance c/d	56,850	Bank	25,000
	80,550		**80,550**

Bank account

Particulars	Amount	Particulars	Amount
Purchase returns	12,000	Balance b/d	150,000
Tax refund	25,000	Office equipment	54,000
Trade receivables	795,500	Admin expense	4,200
		Trade payables	80,000
		Balance c/d	544,300
	832,500		**832,500**

Practical Problem 1

You are given the following invoice. Study this invoice and answer the questions that follow:

XXP Spare Shop Lambert Street Phone:91 ZIP: Kolkata	Bills payable on or before 60 days from the date of invoice		Invoice No: 102856 Date: 15/10/2019 ***Bill to:*** Karma Tshongkhang Phuntsholing Jorden Lam PB: 203 05234567
Particulars	**Quantity**	**Price**	**Total**
Bumper	50	15,000	750,000
Bonnet	10	9,000	90,000
Cowl screen	15	3,000	45,000
Tax 8 % (GST)			

a. Pass the entries in Karma Tshongkhang's books showing the details of tax component.

b. Prepare general ledger of Karma Tshongkhang.

Practical Problem 2

You are given the following trial balance of a business entity. Extract statement of income from the given trial balance and assess tax expense of the entity for the year 2019. The tax authorities in the month of March 2020 assessed the tax amount of Nu. 267,880. Make the necessary adjustment for under or over provision of tax expense for the year. All business entities are subject to 30% tax on profit. Make entries in the books for tax expenses.

Trial Balance

Particulars	Debit	Credit
Sales		1,930,000
Inventory -31-12-2019	340,000	
Purchases-inventory	600,000	
Wages	378,000	
Other direct costs	200,000	
Admin cost	200,000	
Interest on borrowing	130,000	
Freight -inward	10,230	
Advertisement	7,120	
Property, plant and equipment	765,320	
Accu. Depreciation-ppe	130,000	
Investment	700,000	
Cash	300,000	
Bank	423,000	
Trade receivables	500,000	
Trade payables		753,670
Capital		2,000,000
	4,683,670	**4,683,670**

1.6 Business Income Tax (BIT)

1.1.1 Meaning and Scope of Business Income Tax

In class XI, we discussed about how taxation system in Bhutan evolved over the period of time. The first major tax reform of 1989 replaced 2% turnover tax by Business Income Tax (BIT) on the net profit.

BIT is a non-corporate business tax. It is levied @ 30% on net profit. BIT is payable by all unincorporated business entities holding a trade license or registration certificate issued by the Ministry of Economic Affairs (MoEA) or any other competent authority.

Development and competitive nature of business has provided better scope for business as well as tax consultants. For business, it is important to claim expenses under the correct alternative in order to maximize claims as well as to avoid any penalties for non-compliance with law. For any claims, business should have an idea of what deductions are allowed or not as per the Act. However, claims may remain invalid if not supported by valid documents. This will be further discussed in detail.

1.1.2 Source Documents for BIT

All business units shall maintain proper accounting records. The specific book of accounts to be maintained by a taxpayer depends on the category of unit to which the taxpayer belongs. The categorisation of business is as follow:

a) Large and medium business units

All large and medium business units regardless of their size must maintain the following books of accounts and associated records:

i) Trial Balance
ii) Manufacturing & Trading Accounts
iii) Income Statements
iv) Statement of Financial Position
v) General/Nominal Ledger
vi) Cash Book, Bank Statements and Bank Reconciliation Statements
vii) Sales Ledger, Registers and Supporting bills, Cash Memos and Receipts
viii) Purchase Ledger, Registers and Supporting Bills, Receipts and Vouchers
ix) Journal Book
x) Non-Current Asset Register
xi) Inventory Register

b) Small, Cottage/Micro Business Units

Small businesses must maintain basic accounting records to ensure that all transactions are recorded. Therefore, for these businesses, records such as cash book, a daily list of sales summarised monthly & annually, cash memos, and purchase invoice may be maintained. However, where these records are not available, annual tax assessment shall be done on an estimated basis as per the General Provisions of the Income Tax Act.

c) Information from Third Parties

All public and private entities and individuals upon written request by a Regional Director or the Head of the Department shall furnish any relevant information on a taxpayer. The request for information shall be made when a Regional Revenue and Customs Office (RRCO) requires the information to determine tax liability of a taxpayer.

1.1.3 Allowable deductions as per Income Tax Act of Kingdom of Bhutan, 2001 (4^{th} Edition)

Deductions shall be allowed for tax purposes if proper books of accounts are maintained as per the General Provisions of the Act. In order to qualify as an allowable deduction, an expense must be incurred solely and exclusively for the purpose of the business and transactions done on an arm's length basis[1]. All expenses must be supported by objective evidences such as purchase invoices, money receipts or other legally valid documents. Where only part of an expense has been incurred for the purpose of business or company, then only that part of the expenses shall be allowed as a deduction in the calculation of taxable profit. Any expenses charged in excess of the limits prescribed under these Rules shall be added back to Net Profit and subject to tax.

Allowable deductions are grouped into the following broad categories:

a) Direct Costs

All direct costs incurred solely for the purpose of the business and associated with its operation are allowable deductions. Direct costs are those costs, which can be directly attributed to the generation of income. e.g. raw materials purchased by manufacturing industries.

b) Employment expenses

Employment expenses means salary, wages, labour permit fees and allowances paid in money or money's worth to an employee in relation to his or her employment and includes pay and any benefits provided free of cost or at a concessional rate by

1 Arms length's basis mean transactions at the prevailing market conditions and where there is no conflict of interest.

an employer. The treatment of employment expenses for tax purpose can be treated as follows:

c) Salary

Salary means pay, allowances and includes benefits provided free of cost or at a concessional rate to an employee who is employed full time in the business. Salary shall be allowed as deductible expense only up to the maximum ceiling prescribed in the Table 15.1and on fulfilment of the following conditions:

i) all information and documentary evidence are available regarding the payment of salary.

ii) the employee is a regular employee of the business,

iii) the employee is actually working with the business, and

iv) the employee is actually located at the appropriate place of work.

Table 1.1 Employee Salary ceiling for BIT purposes

Category	BIT (per month)
Large	50,000
Medium	40,000
Small	30,000
Cottage/Micro	20,000

Note:

- The above limits may be raised for technical experts and highly professional employees with the prior approval of the Ministry.
- The categorisation of companies and businesses shall be as per categorisation given in Annexure I.

Illustration 3

During the income year 2019, Gyemsap, a trading firm with an investment of Nu. 1.5 million made a turnover of Nu. 6.1 million. The proprietor claims a salary expense of Nu. 45,000 per month. As per the Income Tax regulations, how much salary expense is admissible?

Solution: According to Annexure I (ITA), the categorization of firm for tax purpose is done under two categories i.e. Investment and Turnover Range.

Gyemsap's firm falls under both categories. According to investment range, it falls under small scale while according to turnover it falls under medium scale business.

However, salary expense allowable is higher in medium scale bracket (i.e. Nu. 40,000) compared to Nu. 30,000, in case of small scale business.

d) Wages

Wages means payments made to an individual who is not a regular employee of an organization.

e) Benefits

Benefits means benefits provided by an employer to its employee such as education facilities, accommodation, domestic services, holiday trips, tiffin allowances, telephone facilities, medical benefits. Benefits shall be treated as tax-deductible expenses provided that it is clubbed under salary and is within the prescribed limits. Such benefits shall be valued at the actual cost incurred by the employer, or as agreed in the Service Manual of the organisation or in accordance with the employment contract. If actual costs incurred apply to more than one employee, the total cost shall be allocated on a pro rata basis.

Benefits provided free of cost or at a concessional rate to an employee should be valued as follows:

i) ***Accommodation***

Accommodation provided free or at a concessional rate by an employer to its employee is a deductible expense if it is within the salary limit prescribed in Rule No.12.3.2.(a). Valuation of accommodation shall be;

- The actual cost incurred by the employer in providing the accommodation, or 30% of the employee's basic salary if the cost cannot be determined.
- The actual concessional rate provided to the employee, or 30% of the employee's salary less the rent being charged by the employer if the cost cannot be determined.

ii) ***Domestic Service***

- Domestic services provided by an employer to its employee is a deductible expense if it is within the prescribed salary limit. The valuation of domestic services provided free of cost should be done on the actual cost incurred by the employer in providing the service.

iii) ***Gas, Electricity and Water Supplies***

- Gas, electricity and water supplies provided free or at a concessional rate to an employee is a deductible expense. The valuation of such benefits shall be the actual cost incurred by the employer in providing such benefits. Where the cost cannot be determined, 2% of the employee's basic salary shall be taken as the cost of the benefits.

iv) ***Conveyance or Transport Facility***

- Conveyance or transport facility provided free or at a concessional rate to an employee is a deductible expense. Valuation of such benefits shall be the actual cost incurred by the employer in providing such benefits. However, bus services provided for daily transport of staff to work place shall not form part of the salary

v) ***Telephone facilities***

- Telephone facilities provided to an employee is a deductible expense. The value of such benefit shall be the actual cost incurred by the employers in providing the facilities to the employee.
- However, where such benefits cannot be segregated between private and business use, 50% of the total expense shall be treated as benefits for PIT purposes.

f) Bonus

The term 'bonus' include all incentives or productivity related payments made to an employee. Bonuses paid shall be allowed as a deduction subject to fulfilment of the following conditions:

i) the amount is reasonable with regard to the employee's pay and conditions of service,

ii) the amount is consistent with the practice in other similar enterprises, and

iii) the total bonus payable is limited to 10% of the assessed net profit or 3 months' basic pay per employee, whichever is lower.

However, in the case of an unincorporated business, bonus paid to a business proprietor, partner, or their immediate family (father, mother, spouse or children) shall not be allowed as deduction for tax purposes.

Illustration 4

Zeko Enterprise earned an annual profit of Nu. 1 million during the income year 2018. The enterprise declared a bonus of Nu. 250,000 in the same year, out of which Nu. 100,000 were paid to Dawa, the Manager, and the balance to the other employees. Dawa is the son of Zeko, owner of the enterprise. How would you treat this case as an Assessor?

Monthly salary schedule of Zeko Enterprise:

Sl. No.	Name	Designation	Salary (Nu.)
1	Dawa Dorji	Manager	15,000
2	Karma Jamtsho	Finance Controller	15,000
3	Sonam T Dema	Administrator	8,000
4	Bom Bdr. Rai	Sales Executives	7,000
5	Chungku	Front Desk Officer	5,000

Assuming the Self Assessed Net Profit is Nu.1 Million, Under ITA Rule 2.3.4 bonuses paid shall be allowed as deduction subject to fulfilling following conditions :

a. The amount is reasonable with regard to the employee's pay and conditions of service,
b. The amount is consistent with the practice in other similar enterprises; and,
c. The total bonus payable is limited to 10% of the assessed net profit or 3 months basic pay per employee, whichever is lower.

Solution

The Rule states that, in the case of an unincorporated business, bonus paid to a business proprietor, partner, or their immediate family (father, mother, spouse or children) shall not be allowed as deduction for tax purposes. Since Dawa is the son of proprietor, bonus paid to him will not qualify for deduction

Bonus claimed: Nu.250, 000

(A) Bonus disallowed due to regulation (Dawa is the son of proprietor) = Nu. 100, 000

Bonus allowable as per booking = Nu.150, 000

Self declared Net Profit = Nu.1, 000, 000

Add: Bonus claimed = Nu. 250, 000

Assessed Net Profit = Nu. 1, 250, 000

10% of Assessed Net profit= Nu.125, 000

Now, calculate 3 months basic pay of other four employees:

45,000+24,000+21,000+15,000= Nu. 105,000

As per the above rule (c), the total bonus payable is limited to 10% of the assessed net profit or 3 months basic pay per employee, whichever is lower. Therefore, bonus allowable is 3 month's basic pay (Nu.105,000) for remaining employees:

	Bonus allowable as per booking	Nu.150, 000
	3 months basic pay of four employees =	Nu.105, 000
(B)	Bonus disallowed due to the difference =	Nu.45, 000
	Total bonuses to be disallowed:	
(A)	Bonus disallowed due to regulation	Nu.100, 000
(B)	Bonus disallowed due to the difference	Nu.45, 000
	Total Bonus disallowed	Nu.145, 000

Therefore, Total amount of Nu.145, 000 will NOT be allowed as deduction and have to be added back to Net Profit to compute Taxable Income.

Illustration 5

Lobneykha Construction Company has declared net loss of Nu. 50,000 during the Income year 2018. The business declared one-month's basic pay as the bonus to all its employees, which amounted to Nu. 150,000. The above loss is derived after deducting the bonus. Compute the taxable net profit and tax amount.

Solution:

Self Assessed Net Loss during the year	Nu.(50,000)
Add: Bonus paid to employees	Nu.150,000
Assessed Net Profit	Nu. 100,000
Less: Bonus allowed @ 10% of Assessed Net Profit	Nu. 10,000
Taxable Net Profit	Nu. 90,000
BIT @ 30% (30%*90,000)	**Nu. 27,000**

g) Contribution to Provident Fund and Gratuity Fund

Contributions made by an employer to the Provident Fund & Gratuity Fund for the benefit of the employees are allowable deductions subject to the following conditions:

i) such contributions are invested with a financial institution in a separate account as PF and GF Account, and

ii) the limits to be applied to this expenditure must be consistent with the Service Manual of the company or business. If no such Service Manual exists, then the Civil Service Rules shall apply.

In cases where the eventual pay out to the employee upon his or her retirement is less than the guaranteed amount in the Service Manual, any additional amount contributed thereof by the employer to make up the guaranteed amount shall be allowed as deduction. Contributions not payable due to termination of services shall be added back to the Net profit and subject to tax.

h) Staff Welfare Expenses

Staff welfare expenses means provision of canteen and recreational facilities to employees within the business premises and shall be allowed on an actual basis.

i) Medical Expenses

Actual cost of treatment of an employee outside Bhutan shall be allowed as tax deductible expense subject to the following conditions:

i) the expenses are in respect to an employee only, and

ii) medical treatment shall be as per the National Guideline for Patient Referral issued by the Government from time to time.

j) Human Resource Development Expenses

Expenses incurred for Human Resource Development of employees shall be allowed as deductible expense provided such expenses are incurred for the purpose of upgrading and developing the employees' craft, supervisory and technical skills or increasing the productivity or quality of its products. If such expenses exceed 1% of the assessed turnover, then the full expenditure must be spread equally over a period of three years starting from the year the expense is incurred.

1.1.4 Overhead expenses

Overhead expenses include the following heads subject to fulfilment of certain conditions:

a) Preliminary Expenses

Preliminary expenses mean all legitimate expenses incurred prior to the commencement of a business or in connection with the extension of an existing business. Such expenses incurred may be spread equally and allowed as deduction over the first 3 years of operation. Examples of these expenses include feasibility studies, market surveys, engineering services, project reports, and legal fees.

b) Research & Development

Research and development is defined as "use of scientific or technical know- how" to produce new or substantially improved materials, mechanisms, products, processes, systems or services. Research and development shall be allowed as deduction subject to the following conditions:

i) Research and development cost not exceeding 2% of the assessed turnover will be allowed as a deductible expense;

ii) Research and development cost exceeding 2% of the assessed turnover will be treated as capital expenditure. The full amount of the cost will be capitalised and depreciated in three subsequent years immediately following the income year.

iii) Any cost of buying machinery, inventory, stock in trade and immovable property acquired for the use of research and development shall be depreciated in accordance with the ordinary rules of depreciation.

c) General Office Expenditure

The following items of general expenditure incurred for the purpose of the business shall be treated as allowable deductions:

i. Printing & stationery.
ii. Postage & telegram expenses.
iii. Telephone.
iv. Trunk call & telex charges.
v. User charges.
vi. Administrative fees and charges.

vii. Any other expenses of similar nature.

d) Insurance Premium

Insurance premium paid for any assets owned by an enterprise is an allowable deduction, provided that the asset is owned / registered and used for the purpose of the business. Insurance premium paid for employees to protect against occupational risks and hazards at their work place shall be allowed as deduction.

e) Maintenance & Repair Costs

Maintenance & repair costs refer to current repairs of buildings and other assets owned and used for the purpose of the business. The asset must be shown in the Statement of Financial Position and included in the taxpayer's Non-Current Asset register. Current repair costs refer to any cost incurred to maintain the asset in a consistent working condition, without changing the nature of the asset. Only current repair costs shall be treated as revenue expenditure.

Major repair/enhancement work that modifies or significantly improves the asset, such that the original nature of the asset is altered, must be treated as capital expenditure and depreciated accordingly.

Where a taxpayer purchases an asset, but that asset requires additional expenditure to bring it to a useable condition, such additional expenditure must be capitalised as part of the cost of the asset. Where a worn out asset is replaced with a new asset, the cost of the new asset must be capitalised. Where an asset is upgraded, i.e. its nature is fundamentally altered, then associated cost must be capitalised.

f) Hire of Plant, Machinery & Vehicles

The hire cost of plant, machinery and vehicles plus any associated costs referred to in the lease agreement shall be treated as an allowable deduction, provided that the expenditure is incurred for the purpose of business and the services are availed from another tax entity.

g) Rent of Land & Buildings

Rental of property used for business purposes along with associated costs referred to in the lease agreement shall be treated as an allowable deduction provided that the expenditure is incurred for the purpose of business and the services are availed from another tax entity.

h) Municipal and Motor Vehicle Tax

Municipal and motor vehicle tax shall be allowed as tax deductions provided that the asset is owned and used for the purpose of business. However, motor vehicles tax paid by licensed/ registered transport companies/businesses shall be adjusted against their final tax liability.

i) License Registration & Renewal Fees

License registration and renewal fees are allowable deductions. However, this provision only applies to fees related to licenses issued and renewed by authorised agencies. All other fees that are sometimes referred to as 'license fees' including auction rights such as liquor license fees, mining rights are not covered under this provision and not allowed as deductions.

j) Legal & Professional Fees/Expenses

All fees and expenses related to legal and professional work carried out on behalf of an enterprise for the purpose of business are allowed as deductions.

k) Annual Membership Fees & Subscriptions

Any membership fees paid or subscriptions made to any organisation or association relevant to the business shall be allowed as deductions.

l) Interest on Loans

Interest on loans shall be allowed as deductions subject to the conditions and procedures prescribed below:

i) Loans are taken from a recognised financial institution and within the maximum limit of debt equity ratio of 3:1, i.e. the total borrowings for tax purposes shall not exceed thrice the owner's equity of the business. Borrowings include all types of capital loans (e.g. bonds, term loans etc.), plus any working capital borrowings (e.g. bank overdrafts). Capital includes owners' investment (BIT taxpayers), plus any retained profit reserves.

ii) For the purpose of debt equity ratio calculation, the average debt and equity over a period of twelve months shall be considered.

iii) The loan must be taken in the name of the companies/business and for the purpose of the said business.

iv) Interest paid prior to the commissioning of a project (or commencement of a business) shall be capitalised, and depreciated as part of the asset.

Illustration 6

Pala, Kala and Bala formed a business under the name M/S Phuensumtshog. The business borrowed loan from Bhutan Development Bank Limited in the name of Drowa, wife of Mr. Pala amounting Nu. 300,000 @ 9% p.a. The Income Statement of M/S Phuensumtshog disclosed a net profit of Nu. 120,000 after interest on such loan. Does this interest expense qualify as deductible expenses for tax purpose? Justify with reasons. What would be the actual taxable profit?

Solution:

Rule 2.4.12 of the Income Tax Act states about financial expenses, interest on loans shall be allowed as deductions provided the loan must be taken in the name of the companies/business and for the purpose of the said business.

Since M/S Phuensumtshog took loan not in the name of the business, but in the name of spouse of one of the co-owners of the business irrespective of whether it fulfills other condition i.e. loan from recognized financial institution and within the limit of debt equity ratio of 3 : 1. Therefore, interest on loan borrowed will not be allowed as expenses but added back to self-assessed net profit of Nu. 120,000.

Self Assessed Taxable Net Profit	Nu.120,000
Add: Interest on loan (inadmissible) (9%*300,000)	Nu. 27,000
Taxable Net Profit	**Nu.147,000**

Illustration 7

As of 31st December 2017, Tshering Enterprise has an average capital balance of Nu. 100,000, Reserves and Surplus Nu. 20,000. Proprietor withdrew Nu. 15,000 in the same year. On the same date the average loan balance is Nu. 350,000. Interest paid during the year is Nu. 10,000. Will the interest of Nu. 10,000 permissible for tax deduction as per the Income Tax Rule? If not, compute the actual allowable interest expenses.

Solution:

Application of **Rule 2.4.12** of ITA condition (a)

Loans are taken from a recognised financial institution and within the maximum limit of debt equity ratio of 3:1, i.e. the total borrowings for tax purposes shall not exceed thrice the paid up capital of the company; borrowings include all types of capital loans (e.g. bonds, term loans etc.), plus any working capital borrowings (e.g. bank overdrafts). Capital includes paid up share capital (CIT taxpayers) or owners' investment (BIT taxpayers), plus any retained profit reserves.

Loan amount	Nu.350,000
Capital (Owner's Equity)	
Average Capital as on 31st December, 2017	Nu. 100,000
Reserves and Surplus	Nu. 20,000
Drawings of proprietor	Nu. (15,000)
Net Equity/Capital	**Nu. 105,000**

105,000 * 3 = Nu. 315,000

Excess loan over Debt Equity ratio of 3:1 (350,000-315,000) = 35,000

Hence, interest on loan admissible under the rule will be calculated proportionately,

$$\frac{10,000}{350,000} \# 35,000 = \mathbf{1000}$$

Therefore, allowable loan interest = Nu.9, 000 (Nu.10, 000 – Nu.1, 000)

1.1.5 Sales and marketing expenses

Sales and marketing expenses means expenses incurred for promotion of sales and include expenses such as commission, entertainment, publicity, advertisement etc. The following are some of the sales and marketing expenses:

a) Commission

Commission paid on purchase transactions is an allowable deduction as it forms part of the purchase payment for goods or services. However, such commissions must be clearly stated in the documentation relating to the purchase.

Commission paid to a sales agent is an allowable deduction provided that the commission is clearly stated in all relevant bills, invoices and cash memos, or a special agreement in writing must exist between the parties and is properly recorded in the books of accounts.

b) Entertainment

Entertainment expenses refer to hospitality and gifts provided to existing or potential clients or customers, agents or suppliers. Entertainment expenses directly related to sales promotion of the business shall be allowed as deductions on actual expenses or 2% of the assessed Net Profit, whichever is lower.

Illustration 8

Lepta Enterprise has deducted Nu.5,000 as entertainment expenses in their income statement of the year 2019. After this deduction, the self-assessed net profit of Nu.10,000 in the same year were declared. Compute BIT of the year.

Solution:

According to **Rule 2.5.2** of ITA states entertainment expenses directly related to sales promotion of the business shall be allowed as deductions on actual expenses or 2% of the assessed Net Profit, whichever is lower.

2% * self-assessed net profit = 2%*15,000 = 300

Since 2% of assessed net profit is lower than actual expense incurred, only Nu.300 will be allowed as deduction for tax purpose.

Self Assessed Net Profit	Nu. 10,000
Add: Actual Entertainment expenses	Nu. 5,000
Adjusted Taxable net profit	Nu. 15,000
Less: Admissible entertainment expenses	Nu. 300
Final adjusted taxable net profit	Nu.14,700
BIT @ 30% PAYABLE (30%*14,700)	**Nu.4,410**

c) Publicity & Advertisement

Publicity expenses such as printing of brochures and advertisement through media and magazines shall be allowed as deductions on an actual basis or 2% of the assessed Gross Profit, whichever is lower.

Illustration 9

Seltob Poultry farm in Thimphu has income of Nu.200,000, gross profit of Nu.180,000 and net profit of Nu.160,000 during the income year 2018. The firm spent Nu.7,000 on publicity and advertisement. Do you think the self- assessed taxable income is correctly computed? If no, re-compute the taxable net profit as per Income Tax Rules.

Solution:

Under **Rule 2.5.3** of ITA, Publicity expenses such as printing of brochures and advertisement through media and magazines shall be allowed as deductions on an actual basis or 2% of the assessed Gross Profit, whichever is lower.

Allowable publicity expenses 2%*180,000	Nu. 3,600
Self Assessed Net Profit	Nu. 160,000
Add: Publicity expenses in excess of 2%	Nu. 3,400
Adjusted Final Taxable Net Profit	**Nu. 163,400**

1.1.6 Irrecoverable Debts

Irrecoverable debts shall be allowed as deductions subject to the fulfillment of the following conditions:

a) Irrecoverable debts up to Nu. 25,000 per Debt

A irrecoverable debt of Nu. 25,000 or less per debtor shall be allowed as deduction on the fulfilment of the following conditions:

i) Tax has been paid on such debts in a previous year;

ii) The debt is not less than 5 years old; and

iii) Irrecoverable debt shall be incorporated as income if recovered in the subsequent years; or

iv) Where the debtor is declared bankrupt under the Bankruptcy Act of the Kingdom of Bhutan; or

v) Scheme of arrangement is made under the supervision of a judge.

In the case of financial institutions, irrecoverable debts below Nu.100,000 per debtor may be written off if the conditions above are met.

b) Irrecoverable debts exceeding Nu. 25,000 per Accounts receivable

Irrecoverable debts exceeding Nu. 25,000 per debtor shall be allowed as deductions on the fulfilment of the following conditions:

i) Tax has been paid on such debts in the relevant previous year;

ii) Judicial recourse has been exhausted in respect of the debt;

iii) Irrecoverable debt shall be incorporated as income if recovered in the subsequent years; or

iv) Where the debtor is declared bankrupt under the Bankruptcy Act of the Kingdom of Bhutan, or

v) Scheme of arrangement is made under the supervision of a Judge.

1.1.7 Miscellaneous/general expenses

The following items constitute miscellaneous/general expenses for tax purpose.

a) Accidental Loss

Accidental loss means loss due to events such as theft, fire, earthquake, flood and road accidents. Documentary evidences such as police report and Court order must support accidental losses, if applicable. Accidental losses for the purpose of taxation shall be treated as follows:

i) Revenue losses shall be allowed as deductions and revenue receipts/ compensation as taxable income.

ii) Capital losses shall be treated as per Income Tax Act Rule.

b) Stock Obsolescence

Stock obsolescence shall not be allowed as deductions unless the obsolescence is due to unforeseen circumstances and the taxpayer was not in a position to avoid it. Conditions to be fulfilled for the above exceptions are:

i) Maintenance of a proper stock inventory register and

ii) Proper records showing disposal and sale of the obsolete stock.

c) Stock Shortages

Stock shortages due to unavoidable circumstances within an industry average shall be allowed as deduction subject to maintenance of proper books of account. Shortages due to negligence shall not be allowed as deductions for tax purposes.

d) Bhutan Sales Tax (BST)/Customs Duty

BST or Customs Duty paid on assets shall be capitalised and depreciated as per depreciation rule for tax purpose.

However, BST collected on sale of domestic goods and services such as BST on hotels, restaurant, beer, cement and entertainment services shall not be allowed as deductions.

e) Carriage & Freight Charges

Carriage and freight expenses incurred for business purposes shall be allowed as deductions. However, such charges incurred for initial transportation of Non-Current Assets to its place of use shall be capitalised and depreciated accordingly.

f) Donations

Donations made to organisations exempted by the Ministry shall be allowed as deductions subject to the condition that such donation is supported by relevant documents. Further donations for purposes such as;

i) A Relief Fund for natural calamities in Bhutan.

ii) For the preservation and promotion of Religion and Culture in Bhutan.

iii) For the promotion of Sports, Educational and Scientific activities in Bhutan.

Donations made in respect of the above shall be allowed as deductions, subject to the condition that such purposes have the approval of the Government/Ministry and is supported by the relevant documents.

Note: However, the total donation under point 1 and 2 of this section shall be allowed as tax deductible expenditure up to a maximum limit of 5% of the assessed Net Profit.

Illustration 10

Himalayan Enterprise in Tsirang recorded expenses on donation for following purposes:

i) Donated a water dispenser to Damphu L.S.S. worth Nu. 12,000

ii) Paid Nu. 10,000 to Dzongkhag Sports Association.

iii) Paid for annual rimdro approved by the Dzongkhag in a community, Nu. 1,000

The self-assessed net profit of the firm during income year 2018 at the time of filing income tax return was Nu.200,000 after claiming the above deductions. Explain whether the deduction with respect to donations is justified. Compute the adjusted taxable net profit.

Solution:

Rule 2.7.6 of the ITA states Donations made to organisations exempted by the Ministry shall be allowed as deductions and donations for purposes such as Relief Fund for natural calamities in Bhutan, for the preservation and promotion of religion and Culture in Bhutan, for the promotion of Sports, Educational and Scientific activities in Bhutan. However the total donation should not exceed 5% of the assessed Net Profit.

Self Assessed Net Profit	Nu.200, 000
Add: Donation claimed	Nu.23, 000
Assessed Net Profit	Nu.223, 000
5% of Assessed Net Profit	Nu.11, 150

Total donation claimed	Nu.23, 000
Disallow due to regulation (donation to rimdro)	Nu.1, 000
Donation allowable as per booking	**Nu.22, 000**

Working Note:

Donation allowable as per booking	Nu. 22, 000
Maximum Limit allowable 5% of Assessed Net profit	Nu.11, 150
Donation disallowed due to difference	**Nu. 10, 850**

Total donations to be disallowed:

Donation disallowed due to regulation (donation to rimdro)	Nu.1, 000
Donation disallowed due to the difference	Nu.10, 850
Total donation disallowed	**Nu.11, 850**

Therefore, Taxable Net profit shall be as shown below:

Self Assessed Net Profit	Nu.200, 000
Add: Donation disallowed	Nu.11, 850
Taxable Net Profit	**Nu.211, 850**

Illustration 11

Dago Enterprise, registered with initial investment of Nu.5 million is a distributor of soft drinks. The net turnover of the firm for the Income Year 2017 is 2 million. The net profit as revealed by its Income Statement is Nu. 800,000. While Desk Assessment was carried out, the assessing officer discovered following irregularities:

i) Stock shortages due to negligence of the store keeper worth Nu.5,000 was booked.

ii) Entertainment expenses included refreshments served to its employees worth Nu.10,000.

iii) Manager of the firm is provided accommodation near the business premises. However, the cost of accommodation could not be determined. Manager's basic salary is Nu. 10,000 p.m. The firm has not claimed the deduction for accommodation.

Compute the taxable net profit and the tax payable by Dago Enterprise according to the Income Tax Act Rules.

Solution:

i) Stock shortage due to negligence is not be allowable

ii) Entertainment expenses for serving refreshment to employees is not allowable

iii) Cost of accommodation to Manager is allowable under Rule 2.3.3 (a)

Self Assessed Net Profit	Nu.800,000
Add: Inadmissible expenses:	
Entertainment expenses	Nu.10,000
Stock shortage	Nu.5,000
Adjusted Taxable Net Profit	**Nu. 815,000**

1.1.8 Non-Current Assets and depreciation

Non-Current Assets are assets that are intended for use within the enterprise on a continuous basis for more than one accounting period. The Rules regarding depreciation of Non-Current Assets are as follows:

i) Depreciation on assets purchased and owned by the taxpayer and used for the purpose of the business except antiques, works of art and land, will be allowed as deduction subject to the maximum depreciation rates prescribed in Annexure II.

ii) For unincorporated businesses where an asset is owned by the taxpayer and it is used in the business, depreciation expenses shall be allowed only for the portion of the asset used in the business. e.g. Mr. Hodo owns a 5 storied building (ground+ four floors) which he converts into a Hotel. The hotel covers four floors and the ground floor is used to let out as shop space. For the purpose of taxation, depreciation expense shall be allowed only for the four floors of the building being used as a hotel. The income from the ground floor from shop space will not form a part of his Business Income, but would be his personal income accountable under PIT.

iii) Depreciation shall be calculated on the Straight Line Method (SLM) on an asset at the end of the year.

iv) Assets purchased during the year shall be depreciated on a pro rata basis from the date of purchase.

v) Assets disposed off during the year shall not be depreciated in the year of disposal and the difference between the sale proceeds and the written down value at the beginning of the year shall be declared in the statement of income.

vi) Small assets costing up to Nu. 25,000 in total per taxpayer in each income year may be written off. e.g. calculator, blow/rod heater, fans etc.

vii) Maintenance of an asset register for all types of assets is mandatory, and must include details of each individual Non-Current Asset owned by the business or company.

viii) Fully depreciated assets that are still in use must be recorded in the asset register at a value of Nu.1 for identification purposes.

The depreciation rates given in Annexure II are the maximum limits allowed. Where a taxpayer applies a lower depreciation rate than that prescribed in Annexure II, the taxpayer will be permitted to make a clear adjustment on the tax return. However, if this adjustment is not made, the tax officer will not be responsible for increasing the depreciation claim on the taxpayer's behalf, and should accept the lower amount charged in the accounts.

Where business premises are closed for a considerable period or more than 180 days in one income year, no depreciation of assets will be allowed during that time. In order to claim depreciation, the following conditions must be fulfilled:

i) The asset must be purchased and registered in the name of the business or company.

ii) The asset must be intended exclusively for use of the business or company.

iii) Proper books of account must be maintained, including a complete Non-Current Asset register containing details of each individual asset for which depreciation is claimed.

iv) Where the asset is only partially used by the business, then only an appropriate portion of the depreciation can be charged for tax purposes.

Illustration 12

The accounting profit of Everest Tours & Travels owned by Mr. Kumar for the Income Year 2019 disclosed Nu.5 million. The business owns three vehicles, the ownership and cost of which are as follow:

i) Hiace bus registered in the name of above business – Nu.1 million.

ii) Car registered in the name of Kumar's spouse – Nu.0.5 million.

iii) Van in the name of above business – Nu. 0.5 million.

The date of acquisition of bus and van was on 1 January, 2019 while car was purchased on 1st July, 2019. Compute the amount of depreciation as per the income tax rule for the Income Year 2019.

Solution:

According to **Rule 4.1** of ITA depreciation on assets purchased and owned by the taxpayer and used for business purpose will be allowed as deduction, subject to the maximum depreciation rates prescribed in Depreciation Annexure calculated on the Straight Line Method (SLM) on an asset at the end of the year. Assets purchased during the year shall be depreciated on a pro rata basis from the date of purchase. Depreciation on car registered in Kumar's spouse will not qualify for deduction. So depreciation on only bus and van will be allowed as deduction.
Hence, Total depreciation subject to calculation @15% on Straight Line method is:

Depreciation on Hiace Bus (15%* 10,00,000)	Nu.150,000
Depreciation on Van (15%* 500,000)	Nu. 75,000
Total Depreciation admissible	**Nu.225,000**

1.1.9 Deductions not allowable under the Income Tax Act, 2001

The following expenses shall not be allowed as deductions:

a. Domestic and private expenses on food, clothing, marriage etc;
b. Personal administrative fees of employees. Example: fees paid for processing employees' identity card, citizenship card etc.
c. Payments of dividend or profit distributions to shareholders, partners and proprietors before tax;

d. Creation of or adjustments to reserves.
e. Creation of allowances for irrecoverable debts/advances except for financial institutions.
f. Life and/or health insurance premiums except for schemes that have been approved by the Government.
g. Business, Corporate and Personal Income Tax.
h. Penalties, fines, penal interest, forfeiture, etc.
i. Donations other than those authorised by the Ministry.
j. Irrecoverable debts not fulfilling the conditions under the Act;
k. Any sum, by whatever name called, payable for the use of license or permit through public auction or tender;
a. Any other expenses not related to the business.

1.1.10 Rates and Calculation of BIT

The rate and calculation of tax shall be as per the Rules prescribed below:

a) Full Tax Liability

Unincorporated business units shall pay Business Income Tax (BIT) at the rate of 30% of the Net profit. Net profit for the purpose of calculating the tax shall be the Gross income minus the allowable deductions under these Rules.

b) Time Limit for Payments

All businesses shall pay their tax on a self-assessment basis to the RRCO before the 31st of March following the end of the income year (1st January to 31st December). However, provisional taxes paid by way of tax deducted at source (TDS) and advance tax shall be paid as per General Provisions Act.

c) Adjustment of Provisional Taxes

Advance tax, taxes paid on a quarterly basis and Taxes deducted at source shall be adjusted in the following manner:

i) Advance Tax shall be adjusted at the time of filing of tax return against provisional tax payable provided accounts are submitted.

ii) Taxes paid on a quarterly basis shall be adjusted at the time of filing of tax return provided revenue receipts are produced.

d) Interest on Outstanding Tax

Any taxes not paid to the RGOB shall result in fines and penalties at the rate of 24% per annum from the due date.

Annual BIT Return FORM BIT 2

In the format shown below, dd/mm/20yy represents the day/month/year of the end of the current accounting period; 19yy represents the end of the previous accounting period (of the same duration); XXXX are current year values; YYYY are prior year values.

Profit and Loss Account for the year ended dd/mm/yy

Particulars	Schedule	Schedule	Current Year Nu.000	Current year Nu.000	Previous year Nu.000	Previous year Nu.000
Total sales	1		xxxx		yyyy	
TOTAL INCOME			xxxx		yyyy	
Less: Direct expenses	3		xxxx		yyyy	
GROSS PROFIT			xxxx		yyyy	
Other income	2		xxxx		yyyy	
Less: Selling Expenses	4		xxxx		yyyy	
Less: Administrative Expenses	5		xxxx		yyyy	
Less: Depreciation for year		14		xxxx		yyyy
Less: Other financial Expenses	6		xxxx			yyyy
Less: Interest Paid				xxxx		
NET PROFIT FOR THE YEAR		(#)		**xxxx**		**yyyy**
Add: Inadmissible expenses for tax purposes						
Direct	7		xxxx		yyyy	
Selling	8		xxxx		yyyy	
Administration	9		xxxx		yyyy	
Financial Expenses		10		xxxx		yyyy
Appropriations	11		xxxx		yyyy	
INITIAL SELF ASSESSED PROFIT FOR YEAR(A)			xxxx		yyyy	
Add: Bonus limit@10%=amount disallowed	12			xxxx		yyyy
Ent/Staff welfare limit@2%=amount disallowed	13			xxxx		yyyy
SELF ASSESSED TAXABLE PROFIT			xxxx		yyyy	
Less: tax allowed losses carried forward				(xxxx)		(yyyy)
FINAL SELF ASSESSED TAXABLE PROFIT(B)			xxxx			
SELF DECLARED BIT/BIT@30% of B		(*)		xxxx	yyyy	yyyy
Less: amount already paid						
Advance taxes				(xxxx)		(yyyy)
BIT withheld at source				(xxxx)		(yyyy)
BALANCE BIT PAYABLE				**XXXX**		**YYYY**

Note : please note that a tax allowed loss could only be carried over for a maximum of three years and then it becomes invalid. An account showing how much loss and to which year the loss relates to, needs to be kept.

Practical Problem

Yegyal potato chips has three employees whose basic pay are as follow:
Mr. Tandi, the Manager, Nu. 25,000 p.m.
Mrs. Kencho, an Accountant, Nu. 15,000 p.m.
Miss Om, an Administrative Officer, Nu. 10,000 p.m.
The business has declared a bonus of three month's basic pay to all employees. The net profit is Nu. 1.3 million during the Income Year 2017.

- Calculate the allowable bonus expense. Explain your findings.
- Why do you think business provide bonus to its employees?

Illustration 13

Salary Schedule

Sl.No.	Employees	Designation	Basic Pay (Nu)	Months	Amount (Nu.)
1	Nima	Manager	15,000	12	180,000
2	Dawa	Adm. Officer	10,000	12	120,000
3	Karma	Accountant	7,000	12	84,000
				Total Salary	384,000

Depreciation Schedule

Sl.No.	Particulars	Date of Acq.	Initial Cost	Dep %	Dep. Amount	Acc. Dep
1	Vehicle	1.1.2015	1,500,000	15.00%	225,000	
2	Computer	1.7.2015	25,000	15.00%	3,750	
3	Furniture	1.1.2015	150,000	15.00%	22,500	
4	Laserjet Printer	1.1.2015	8,000	15.00%	1,200	
	Total Dep		1,683,000		252,450	

Bemchen and Sachen took over their parents business named ~~Bright Future Exporter~~ where they focused mainly on the export of boulders to Bangladesh. They purchased a ten wheeler dumper truck for Nu. 1.5 million. At the end of the year their business reported net profit of Nu.361,550.

For the purpose of filing BIT returns, the business furnished the following information.

Sl .No	Particulars	Amount
1.	Purchases	1,500,000
2.	Employment expenses	384,000
3.	Repairs	5,000
4.	Office expenses	25,000
5.	Rent	60,000
6.	Depreciation	252,450
7.	Interest charges	45,000
8.	Miscellaneous expense	30,000
9.	Accounts payable	100,000
10.	Cash and cash equivalents	270,000
11.	Accounts receivable	350,000
12.	Property, Plant and Equipment	183,000
13.	Capital	1,475,000
14.	Sales	2,500,000

Their books of account revealed opening inventories of Nu. 150,000. One of their parties in Bangaledesh gave false promise and he didn't clear an amount of Nu. 25,000 which they treated as irrecoverable debts. As part of the social responsibility of their business they donated Nu. 12,000 for the renovation of a lakhang in their locality. At the end of the year inventories amounted to Nu. 350,000. You as an account officer of the business is required to compute the taxable net profit and BIT payable for the Income Year 2019 for the Bright Future Exporter, considering the details furnished to you.

Solution :

Particulars	Amount
Sales	2,500,000
Direct Expenses:	
Purchases	1,500,000
Opening stock	150,000
Closing Stock	350,000
GROSS PROFIT	**1,200,000**
Other income	0
Less :	
Employment expenses	384,000
Irrecoverable debts	25,000

Repairs	5,000
Office expenses	25,000
Rent	60,000
Depreciation	252,450
Donations	12,000
Interest charges	45,000
Miscellaneous expenses	30,000
NET PROFIT FOR THE YEAR	**361,550**
Add : inadmissible expenses for tax purposes	
Depreciation	1,875
Donations	12,000
Irrecoverable debts	25,000
TAXABLE NET PROFIT	**422,425**
Less : Donation allowed	12,000
FINAL SELF ASSESSED TAXABLE PROFIT	**400,425**
BIT PAYABLE@30%	**120,127.5**

Explanations:

1) Its assumed bad debt was incurred during the Income year 2015. It should be at least 5 years old.
2) Depreciation of Nu. 1,875 is written back as it is not computed on pro-rata on computer.
3) It is assumed donation was paid to organization authorized by the Government. Further the amount does not exceed 5% of the Assessed Taxable net profit.

Illustration 14

Sonam D choden and Sonam D Paldon are Commerce graduates from Gedu College of Business Studies. Right after their graduation, they didn't wait for the government job, rather they decided to start a business.

They commenced Damcho Shoe Manufacturing Pvt. Ltd in Chukha. Initially they have invested Nu.111,000 as their capital with property, plant and equipment worth Nu. 20,000. To start manufacturing, they purchased raw materials for Nu.150,000. They employed Mr. Daotu, an expert in shoe making who monitors other staff and paid wages and salaries of Nu. 50,000 out of which Nu.2,000 was paid to one of the staffs as an advance.

Their monthly rent has amounted to Nu.15,000. Office expense of Nu.12,000 need to be paid along with outstanding office expenses of Nu. 8,000 which was incurred in the previous year while they were planning to set up their business which they have decided to carry forward.

They manufactured 100 pairs of shoes under the brand Abibas, and in order to attract more customers, they spent Nu. 8,000 on publicity and advertisement.

There was an opening stock of Nu.50,000 which they carried forward from previous year before they formally started their business. During its operation, they purchased raw materials from TD enterprise on credit where accounts payable amounted to Nu.120,000.

They insured their business and paid premium in advance Nu.2,000. There was a religious program conducted in the locality where the business donated Nu. 10,000. The owners of the business withdrew Nu. 15,000 each p.a for their personal use. The sales amounted to Nu. 311,000. Their books of account s showed account receivable of Nu.183,780. The depreciation on property, plant and equipment due to continuous use amounted to be Nu.3,000. The business also received an interest of Nu. 4,000.

The unfortunate part for the business was, there appeared irrecoverable debts of Nu.11,000 and at the end they determined that closing stock was Nu. 60,000. The good news for the business was, though the owners struggled a lot but they were rewarded with a net profit of Nu.62,000. There are some additional information pertaining to the business as follow:

1. Tax has been paid on above mentioned debts in the previous income year.
2. Internal arrangement scheme was made with the debtors, however, debtor failed to pay.
3. Out of the donations, Nu.5,000 was paid towards VAST Bhutan.

You are required to compute the taxable net profit according the rules laid down under Income Tax Act, Kingdom of Bhutan. Also calculate the amount of income tax payable under BIT after considering the above transactions.

Solution:

Particulars	Amount (Nu.)
Sales	311,000
Direct Expenses:	
Purchase	150,000
Opening Stock	50,000
Closing Stock	60,000
GROSS PROFIT	**171,000**
Indirect Income	4,000
Wages and Salaries	50,000
Rent	15,000
Irrecoverable debts	11,000
Publicity and Advertisement	8,000
Donations	10,000
Office expenses	20,000
Depreciation	3,000
Less: Advance to staff	-2,000
Less: Prepaid insurance	-2,000
NET PROFIT	**62,000**
Add: Inadmissible expenses for the purpose of tax	
Bad debts (note 1)	11,000
Donations (note 2)	5,000
Publicity and Advertisement (note 3)	4,580
FINAL SELF ASSESSED TAXABLE PROFIT	**82,580**
BIT @30%	**24,774**
Less: BIT withheld at source (TDS)	6,220
BALANCE BIT PAYABLE	**18,554**

Explanation:

1. Irrecoverable debts is a disallowed loss as it does not fulfill all the conditions listed under Rule 2.6.1 of ITA
2. Donation of Nu.5, 000 is allowable expense as it was paid to an organization listed in the Exempted List of organizations issued by Ministry of Finance.
3. Only 2% of the Publicity expense is deductible, the balance is written back to profit as it is taxable.

Exercises:

1. Explain the difference between current tax expense and deferred tax expense. Assess the merit of deferred tax treatment in the books of accounts.

2. Identify one item or event that will give rise to taxable temporary difference. Discuss how that taxable temporary difference will be treated in the accounts and reported in the financial statements.

3. Pema wants to start a new business in vegetable oil extraction with the financial aid of priority sector lending. He is planning to buy property, plant and equipment including a delivery van. His friend Dorji who has some accounting knowledge advises him to use straight line method of depreciation (SLM) for tax benefits for all items of property, plant and equipment accounting. He also insist Pema to use depreciation rate given in the income tax regulations. Assess whether this makes sense in terms of accounting.

4. A business entity chose to use LIFO method of inventory valuation although LIFO method is not allowed by the accounting rules. Discuss why the entity is still using LIFO method instead of FIFO and Weighted Average Cost method (student should have the knowledge of inventory valuation to complete this exercise).

5. Following is the financial statements for the Income Year 2017 of Kalo Enterprise, a small manufacturing unit.

Income Statement for the year ending 31st December, 2017

Particulars	Notes	Amount (Nu.)
Revenue	1	2,269,000
Total Revenue		2,309,000
Cost of goods Sold	2	-1,086,000
Gross Profit		1,223,000
Add: Other Income	9	5000
Administrative Costs	3	-705,000
Other Expenses	4	-23,000
Profit before Tax (PBIT)		500,000
Interest Cost		-

Profit Before Tax (PBT)		500,000
		-
Profit for the year (Net Income)		500,000

Statement of Changes in Financial Position
As at 31st December, 2017

Particulars	Notes	Amount (Nu.)
Assets		
Non- Current Assets		
Property, Plant and Equipment	5	1,343,000
Current Assets	6	412,000
Cash and Cash Equivalents	7	665,000
Total Assets		**2,420,000**
Equity and Liabilities		
Owner's Equity		1,500,000
Retained Earnings		500,000
Non- Current Liabilities		
Current Liabilities	8	420,000
Total Liabilities		**2,420,000**

Note No. 1 Revenue	**2,318,000**	
Less: Returns sales or inward	**(9,000)**	2,309,000
Total		**2,309,000**
Note No. 2 Cost of Goods Sold		
Opening Inventories		250,000
Purchases		800,000
Less: Closing Inventories		(100,000)
Direct Expenses		
Wages		126,000
Carriage and duties		10,000
COGS		**1,086,000**

Note No. 3 Administrative Costs	
Salaries	408,000
Electricity	12,000
Telephone and fax	4,000
Advertisement and Publicity	18,000
Maintenance and Repairs	**26,000**
Depreciation	**237,000**
Adm. Cost	**705,000**
Note No. 4 Other Expenses	
Irrecoverable debts	10,000
Insurance Premium	13,000
Total	**23,000**
Note No. 5 Property, Plant and Equipment	
Computer	80,000
Machinery	1,500,000
Less accumulated depreciation	-237,000
Total	**1,343,000**
Note No. 6 Current Assets	
Prepaid Insurance	2,000
Advance Tax	10,000
Trade Receivables	300,000
Closing Inventories	100,000
Total	**412,000**
Note No. 7 Cash and Cash equivalents	
Cash Balance	125,000
Bank Balance	540,000
Total	**665,000**
Note No. 8 Current Liabilities	
Trade payable	400,000
Outstanding Wages	6,000
Outstanding Salaries	14,000
Total	**420,000**
Note No. 9 Other Income	
Commission received	**5,000**

Statement of changes in Equity

Particulars	Share capital	Retained Earning	Owner's Equity
Opening Balance			
Owner's Equity	1,500,000		1,500,000
Profit for the year		500,000	500,000
Dividends			
Closing Balance	1,500,000	500,000	2,000,000

Salary Schedule of the unit

Sl.No.	Employee Name	Designation	Monthly Pay	Annual Salary
1	Menchu Bum	Manager	15,000	180,000
2	Dhombo	Executive	9,000	108,000
3	Sila Maya	Accountant	7,000	84,000
4	Sakshe	Peon	3,000	36,000
			Total	408,000

Depreciation Schedule

Sl.No.	Particulars of PPE	Dep. Value (Op.)	Dep. Rate	Dep. Amount
1	Machinery	1,500,000	15%	225,000
2	Computer	80,000	15%	12,000

Additional information:

1. Depreciable value of PPE excludes an old machinery sold for Nu.25000 on 30.8.2017 whose WDV on the same date was Nu.20,000. Profit was not disclosed in income statement.
2. Irrecoverable debts were of not older than two years.

Assess the financial statements of the firm for BIT purpose and then compute the Taxable Net Income and the BIT payable by the business. Give explanation where necessary to support your computation. Take into consideration all details furnished to you.

[Ans: Taxable Net Income (Profit) Nu.580,500]

1.1.11 Annexure

ANNEXURE I CATEGORIZATION

<table>
<tr><th>SECTOR</th><th>CATEGORY</th><th>INVESTMENT RANGE</th><th>TURNOVER RANGE</th></tr>
<tr><td rowspan="4">Trading</td><td>Large</td><td>More than Nu. 5 million</td><td>More than Nu.10 million</td></tr>
<tr><td>Medium</td><td>Between Nu.3 - 5 million</td><td>Between Nu.6 - 10 million</td></tr>
<tr><td>Small</td><td>Between Nu.1 - 3 million</td><td>Between Nu.2- 6 million</td></tr>
<tr><td>Micro</td><td>Less than 1 million</td><td>Less than 2 million</td></tr>
<tr><td rowspan="4">Manufacturing</td><td>Large</td><td>More than Nu.100 million</td><td rowspan="4"></td></tr>
<tr><td>Medium</td><td>Between Nu. 10 - 100 million</td></tr>
<tr><td>Small</td><td>Between Nu. 1 - 10 million</td></tr>
<tr><td>Cottage</td><td>Less than Nu. 1 million</td></tr>
<tr><td rowspan="4">Service</td><td>Large</td><td>More than Nu.10 million</td><td>More than Nu.20 million</td></tr>
<tr><td>Medium</td><td>Between Nu. 5 - 10 million</td><td>Between Nu.10 - 20 million</td></tr>
<tr><td>Small</td><td>Between Nu.1- 5 million</td><td>Between Nu.2 - 10 million</td></tr>
<tr><td>Micro</td><td>Less than 1 million</td><td>Less than 2 million</td></tr>
</table>

Note:

i) All companies and businesses shall be categorized based on fulfillment of either one of the criteria.

ii) Investment means owners contributions/ paid up share capital plus long term loans.

iii) However, the construction sector will be categorized in accordance with the classification made by the Construction Development Board.

ANNEXURE II DEPRECIATION SCHEDULE

Block	Sl.No	Asset type	Maximum Rates
I		INFRASTRUCTURAL FACILTIES	
	1	Building - Permanent - all types	3%
	2	Bridges – Permanent	
	3	Compound walls and Fencing	
	4	Roads – Permanent	
	5	Tube Wells and Deep wells and Water Pipe lines	
	1	Semi Permanent	20%
	2	Temporary	50-100%
II		ELECTRICITY GENERATION AND TRANSMISSION	
	1	Devices for controlling transmission loss	5%
	2	Generator (Hydro)	
	3	Power House Equipments	
	4	Poles & Pillars	
	5	Sub Station Equipment	
	6	Transmission Lines - HT & LT	
	7	Underground Cables	
III		EQUIPMENT	
	1	Audio/Visual Equipments	15%
	2	Computer/Data Processing System	
	3	Deep Freezers/Refrigerators (hotels &General Use)	
	4	Fire Fighting Equipments/System	
	5	Lighting Arresters	
	6	Laboratory Equipments	
	7	LPG Cylinders	
	8	Office Equipments - all types	
	9	Photographic/Reprographic Equipments	
	10	Pollution Control Equipments	
	11	Telephone including PABX system	
	12	Tools and Implements	
	13	Trekking Equipments	
	14	Vacuum Cleaner	
	15	Water Cooler and Water Purifier	
	16	Weighing Machines	
	17	Washing Machines	

<table>
<tr><td>IV</td><td colspan="2">FURNITURE, FIXTURES & UTENSILS</td><td></td></tr>
<tr><td rowspan="7"></td><td>1</td><td>Ceramic and Glass Utensils</td><td rowspan="7">15%</td></tr>
<tr><td>2</td><td>Carpets of all types</td></tr>
<tr><td>3</td><td>Curtains & Heavy Drapes</td></tr>
<tr><td>4</td><td>Domestic Electrical Appliances and Fixtures</td></tr>
<tr><td>5</td><td>Furniture of all Kinds</td></tr>
<tr><td>6</td><td>Mattresses. Pillows and Blankets</td></tr>
<tr><td>7</td><td>Silver, Steel, and Metallic Cookeries</td></tr>
<tr><td>V</td><td colspan="2">PLANT & MACHINERY (Including spare parts and accessories)</td><td></td></tr>
<tr><td rowspan="16"></td><td>1</td><td>Boilers</td><td rowspan="16">15%</td></tr>
<tr><td>2</td><td>Cinema Projectors and Screen</td></tr>
<tr><td>3</td><td>Cranes, Chain and Pulley</td></tr>
<tr><td>4</td><td>Deep Freezers & Refrigerators (Industrial Purposes)</td></tr>
<tr><td>5</td><td>Earth Moving Machinery including Bulldozers,</td></tr>
<tr><td>6</td><td>Scrapers, Excavators, Wheel Loaders, etc</td></tr>
<tr><td>7</td><td>Fork Lifts</td></tr>
<tr><td>8</td><td>Industrial Gas Cylinders</td></tr>
<tr><td>9</td><td>Lifts</td></tr>
<tr><td>10</td><td>Mining Equipments and Machineries</td></tr>
<tr><td>11</td><td>Petrol Pump Installation and Tanks</td></tr>
<tr><td>12</td><td>Printing Machineries</td></tr>
<tr><td>13</td><td>Rope Way Installation</td></tr>
<tr><td>14</td><td>Road Rollers</td></tr>
<tr><td>15</td><td>Railing & Locomotives’ Storage Tanks</td></tr>
<tr><td>16</td><td>Wood Cutting / Processing Machines</td></tr>
<tr><td>VI</td><td colspan="2">VEHICLES, VESSELS & AIRCRAFTS</td><td></td></tr>
<tr><td rowspan="6"></td><td>1</td><td>Aircraft including Helicopter</td><td rowspan="6">15%</td></tr>
<tr><td>2</td><td>Buses & Vans</td></tr>
<tr><td>3</td><td>Cycles & Rickshaws</td></tr>
<tr><td>4</td><td>Light Motor Vehicles including two or three Wheelers</td></tr>
<tr><td>5</td><td>Trucks & Trailers</td></tr>
<tr><td>6</td><td>Vessels - Ships, Boats, Rafts, etc</td></tr>
<tr><td>VII</td><td colspan="2">Small assets costing up to Nu. 25000 in total per taxpayer per income year</td><td>Write off</td></tr>
</table>

Chapter 2
Accounting for Payroll

Learning Objectives:

- Explain the concept of payroll
- Explain the concept of gross pay, deductions (including TDS, Pension and GIS) and take home pay
- Differentiate between salaries and wages
- Prepare pay-sheet
- Record payroll expenses including recoveries.
- Report employee costs on financial statements

Employee remuneration and benefits form another significant costs in the organisation. A proper accounting of this cost is important not only for management but also for external information users as it includes various components of remunerations paid to the company senior executives. Lack of proper accounting and reporting will not only mislead the information users but also can demotivate employees as remunerations serve as the basic motivation factor for employees.

The corporate scandals of the past also indicate that employee remuneration and payroll can be easily manipulated and forged by the staff and managers. A typical case of Satyam Company in India (2008) highlights this issue in corporate world.

This chapter highlights the importance of accounting for payroll and deals with some practical skills of recording and reporting employee costs in the financial statements of an entity.

2.1 Employee Remunerations and Benefits

Employees are paid different packages of remunerations to attract and motivate them to perform in the organisation. Employee remunerations are broadly classified into two:

i) Nonperformance based (fixed) remuneration, and

ii) Performance based remuneration.

Nonperformance based remunerations are paid as the basic remunerations to support employees irrespective of their performance. This includes basic salary, pension, house rent allowance, health insurance etc. which do not change with the change in the performance of the entity. On the other hand, performance based remunerations such as bonus and share options paid to employees are tied up with performance targets to be achieved by the individual employees or the entity as a whole.

Employee remunerations also includes post-employment benefits such as gratuity, pension and provident funds paid to employees after their retirement. Thus, employee remunerations can be either short term remunerations such as salaries and wages or long term benefits such as gratuity and pension

2.2 Accounting for Employee Remunerations and Benefits

Accounting and financial reporting for employee remunerations and benefits depend on whether it is short term or long term benefits. Short term remunerations are paid in consideration of the services rendered by the employees whose service benefits are expected to be consumed within the accounting year.

Accounting for long term post-employment benefits such as gratuity, pension and provident are complex and will not be covered in this syllabus. The remaining part of this chapter will discuss and cover accounting for short term remunerations of employee.

2.2.1 Salaries and wages

a) Salary

When the employee is recruited to work on a monthly or annual rate, the payment is called a salary.

b) Wages

Payments made to an employee for work done, when calculated either on hourly rate (e.g. Nu.20 per hour or at piece rate (e.g. Nu.100 per unit of goods produced), or daily basis (e.g. Nu.130 per day). The wages may be accumulated for a period and paid at the end of the period, say a month. Employees recruited under muster rolls normally are paid wages. The recruitment of employees under muster roll might differ from government and public sector organizations to corporate organizations.

c) Basic salary

Basic salary is the minimum amount of remuneration paid to employees based on his experience and the position to be filled in. The fixation of basic salary may vary from one to another organisation. Many organisations use 50:50 proportion i.e. the basic salary constitute 50% of the total remuneration paid to the employees.

d) Allowances and other components of remunerations

Employees may be paid additional remunerations in the form of allowances such as house rent, health and medical benefits, car allowance, fuel allowance, group insurance, difficulty allowance, etc. These allowances are normally calculated as a percentage on the basic salary.

e) Gross and net salaries and wages

The total of basic salary and other additional remunerations give the gross salary/ remuneration of the employee.

f) Deductions

Deductions are statutory or organizational recoveries from the employees including personal income taxes adjusted with the salary or wage income payable to the employees. Deductions include, house rent, salary tax, pension, insurance, personal loans (if it is an employee loan), etc.

g) Net salaries and wages

This is the net take home salary or wage income of the employee after adjusting for the recoveries/deductions.

h) Employee personal files

The HR section of the oragnisation maintains a file for each employee containing all employment contract documents of the employee. The personal file is updated for any development and changes in the employment contracts with the organisation.

The changes in the remunerations payable to the employee must be properly authorized and validated.

2.3 Accounting Records for Salaries and Wages

The salary and wage payments to employees must be properly documented before disbursement of the payment. The accounting documents include preparation of payment/disbursement vouchers and writing of a payment cheque. The payroll staff must ensure that the employee list is updated for the month before disbursement of payment. Also, the entitlement of employees must be updated with the HR section for each month. Particularly for the months of January and July where employee promotions and salary increments are most common and require updates of the personal files of employees.

All short term employee remunerations including leave encashment are recognized as expense in the statement of income, and accrued remunerations recognized as current liabilities if remunerations or benefits are payable. Similarly costs incurred on trainings and development of employee are expensed when incurred.

PAY SLIP					
Tshering Pem					
Employee ID	122		TPN:	TAP224887	
Designation	Sweeper		Grade:	GSP	
Bank Details	101456220				
Years of Service	12				
Employee Type	Contract				
Over time allowance	0				
Earnings	Amount	Gross Salary	Deductions	Amount	Gross Salary
Basic Pay	7000	7000	TDS (10% of GP)#	1145	1145
HRA(20% of BP)	1400	1400	Provident Fund**	0	0
Contract Allowance (30% of BP)	2100	2100	GIS ***	0	0
Service Allowance *	1050	1050	Health Contribution	100	100
Over time allowance (300/Hr)	0	0	Staff Welfare Fund	100	100
		0	BoB Loan	0	0
Total Earnings	11550	11550	Total Deducations	1345	1345
			Net Amount	10205	10205

*(Less than 5 Years: NA, 5 -10 years: 10% of BP, 11-15 Years: 15%, Above 15 Years: 20%)

**15% of their basic pay for regular employees

***Grade I-III= 1000, IV-VIII=500, IX-XII=300, ESP&GSP=NA

#TDS=10%(GP-[PF,GIS,HC])

Dema Mining Pvt. Limited
Payroll for July, 2019

Employee Code	Name	Gender	Designation	Employee Type	Grade	Years of Service	Basic Pay	Over Time	EWF	Bank Account	TPN	Loan Instalment
111	Karma Uthra	F	CEO	Regular	I	20	65,000	0	Yes	101456226	KAP442121	10,000
112	Sangay Jamtsho	M	General Manager	Regular	II	20	35,000	0	Yes	101456230	SAP664215	5,000
113	Ugyen Dorji	M	Engineer	Regular	II	20	40,000	10	Yes	101456218	UAP221239	
114	Karma Loday	M	Asst Engineer	Contract	III	3	36,000	5	Yes	101456229	KAP442214	
115	Sonam Jamtsho	M	Supervisor	Regular	IX	5	12,000	5	Yes	101456227	SAP331245	
116	Shacha Singye	M	Technician	Regular	X	4	15,000	8	Yes	101456221	SAP114522	
117	Ugyen Jamtsho	M	Driver	Regular	XII	10	8,000	5	Yes	101456224	UAP112233	3,500
118	Pema Rigzin	M	Finance Officer	Regular	VI	12	20,000	5	Yes	101456223	PAP143326	
119	Sangay Dorji	M	Driver	Contract	XII	13	12,000	6	Yes	101456222	SAP661142	
120	Rinzin Lhamo	F	Office Assistant	Regular	X	5	10,000	8	Yes	101456225	RAP412145	1,500
121	Leki Dema	F	PA	Regular	X	3	8,000	1	Yes	101456216	LAP558941	
122	Tshering Pem	F	Sweeper	Contract	GSP	12	7,000	0	Yes	101456220	TAP224887	
123	Lekila	M	Night Guard	Contract	ESP	10	5,000	12	Yes	101456228	LAP443217	
124	Dhan Maya Tamang	F	Accountant	Regular	IX	8	16,000	13	Yes	101456219	DAP145587	2,000
125	Bolanath Sharma	M	Site Supervisor	Contract	X	2	14,000	0	Yes	101456217	BAP884512	

2.4 Accounting Records

On disbursement of monthly salary and wages

On disbursement of monthly salary and wages

Salary and wages expense A/c Dr

To Salary tax

To House rent

To GIS

To Pension and provident (if entity has pension and provident fund scheme for employees)

To Personal loan (if any)

To Bank (net pay credited to employee bank account)

For remittance of recoveries to agencies

RRCO	A/c	Dr	(for income tax deduction)
Insurance	A/c	Dr	(for GIS deduction)
Pension fund	A/c	Dr	(for pension and provident deduction)
Loan	A/c	Dr	(for recovery of loan)

To Bank (recoveries deposited to individual agency accounts)

2.5 Some Ratios Relevant to Payroll Staff

i) ***Staff turnover ratio***

Staff turnover ratio measures the average number of employees leaving the organisation per year. It is calculated as:

$$Staff\ turnover = \frac{No\ of\ resignation\ during\ the\ year}{Average\ no\ of\ employees\ for\ the\ year}$$

Average employees during the year:

Number of employees in the beginning of the year	xxx	----------(A)
Add: New recruitments	xxx	
Less: Retirement and resignation during the year	(xxx)	
Total employees at the year-end	xxx	------------(B)

$$Average\ employees\ during\ the\ year = \frac{(A + B)}{2}$$

ii) ***Salary increment rate***

	2019	2018	2017
Average number of employees for the year	x	y	z
Average salary per employee for the year	o	p	q
Increments =	o - p	p-q	-

$$\textit{Increment rate} = \frac{[(o-p)-(p-q)]}{p-q}$$

These ratios are useful in accounting for employee benefits such as gratuity and pensions as well as for employee cost analysis.

2.6 Reporting Employee Remuneration and Employee Benefits in Financial Statements

Employee remunerations and benefits are reported as personnel cost or employee costs in the financial statements.

The salaries, wages and all other short term employee costs are presented as expense in the statement of income. Accrued salaries and remunerations are presented as accrued expenses or payables under current liabilities.

Consolidated Statement of Comprehensive Income for the year ended 31 December 2017

(In millions Ngultrums)

INCOME	Notes	31st-Dec-2017	31st-Dec-2016
Revenue from customers	2	37,110.25	39,598.13
Other Income	3	1,724.86	1,761.08
Share of Profits of Associates	4a	60.45	0.84
Total Income		38,895.56	41,360.05
EXPENDITURE			
Direct Costs of Sales	5	11,098.05	13,401.02
Personnel and Other Costs	6	8,461.76	7,843.60
Finance Cost		1,614.49	1,751.28
Depreciation and amortization	7& 11	5,667.89	5,710.27
Impairment losses		88.64	64.34
Share of Losses of Associates & Joint venture	4a&b	64.96	34.51
Total Expenditure		26,995.79	28,805.02
Profit on Operations before Tax		11,899.77	12,555.03
Income Tax Expenses	8	5,888.99	5,960.61
Profit on Operations after Tax		6,010.78	6,594.42

Personnel Costs

Source: DHI Annual Report 2017

Consolidated Statement of Financial Position as at 31 December, 2017 Contd..,

(In millions Ngultrum)

Current Liabilities				
Current Portion of Borrowings	22	3,654.86	3,716.21	3,994.19
Deferred Government Grants	23	76.44	100.34	-
Income Tax Payable		3,477.22	4,058.84	2,617.48
Trade and Other Payables	25	4,173.67	3,376.80	2,652.61
Other Current Liabilities	26	4,018.28	2,176.40	2,523.99
Total Current Liabilities		15,400.47	13,428.59	11,788.27
TOTAL EQUITY AND LIABILITIES		172,949.66	163,619.78	157,333.76

Accrued personnel cost presented with other payables

25. EMPLOYEE BENEFITS EXPENSES

	As on December 31, 2017	As on December 31, 2016
Payroll and related expenses -		
Salaries and Performance based variable pay	41,903,901	45,825,109
Leave travel allowance	2,470,506	2,710,621
Bonus	4,858,638	5,407,397
Overtime allowances	86,400	99,063
Medical expenses	555,945	789,253
Staff welfare	69,620	585,513
Uniforms	16,145	45,712
HRD expenses	13,733,157	11,237,725
	63,694,312	**66,700,393**
Post employment benefits -		
Provident fund contribution	2,099,558	2,233,828
Gratuity	942,555	674,830
	3,042,113	**2,908,658**
Other employee benefits		
Leave encashment (Annual benefit)	674,073	793,320
Leave encashment (Separation benefit)	275,628	461,021
Others	502,620	473,345
	1,452,321	**1,727,686**
	68,188,746	**71,336,737**

Source: DHI Annual Report 2017

Dema Mining Pvt. Ltd
Pay-sheet for July, 2019

Employee ID	Name	Basic Pay	Earnings				Gross Salary	Deductions						"Total	Net Pay
			HRA	CA	SA	OTA		PF	GIS	HC	TDS	SWF	Loan		
111	Karma Uthra	65,000	13000	0	13000	0	91,000	9750	1000	100	8015	100	10000	28965	62,035
112	Sangay Jamtsho	35,000	7000	0	7000	0	49,000	5250	1000	100	4265	100	5000	15715	33,285
113	Ugyen Dorji	40,000	8000	0	8000	3,000	59,000	6000	1000	100	5190	100	0	12390	46,610
114	Karma Loday	36,000	7200	10800	0	1,500	55,500	0	1000	100	5440	100	0	6640	48,860
115	Sonam Jamtsho	12,000	2400	0	1200	1,500	17,100	1800	300	100	1490	100	0	3790	13,310
116	Shacha Singye	15,000	3000	0	0	2,400	20,400	2250	300	100	1775	100	0	4525	15,875
117	Ugyen Jamtsho	8,000	1600	0	0	1,500	11,100	1200	300	100	950	100	3500	6150	4,950
118	Pema Rigzin	20,000	4000	0	3000	1,500	28,500	3000	500	100	2490	100	0	6190	22,310
119	Sangay Dorji	12,000	2400	3600	1800	1,800	21,600	0	300	100	2120	100	0	2620	18,980
120	Rinzin Lhamo	10,000	2000	0	1000	2,400	15,400	1500	300	100	1350	100	1500	4850	10,550
121	Leki Dema	8,000	1600	0	0	300	9,900	1200	300	100	830	100	0	2530	7,370
122	Tshering Pem	7,000	1400	2100	1050	0	11,550	0	0	100	1145	100	0	1345	10,205
123	Lekila	5,000	1000	1500	0	3,600	11,100	0	0	100	1100	100	0	1300	9,800
124	Dhan Maya Tamang	16,000	3200	0	1600	3,900	24,700	2400	300	100	2190	100	2000	7090	17,610
125	Bolanath Sharma	14,000	2800	4200	0	0	21,000	0	300	100	2060	100	0	2560	18,440
Total		303,000	60,600	22,200	37,650	23,400	446,850	34,350	6,900	1,500	40,410	1,500	22,000	106,660	340,190

Exercises:

1. The year-end trial balance of Karma Printings, as shown below includes the net salary paid to the employees and the tax deducted at source. Tax deductions are 10% of gross pay and national pension fund contribution is 6% from employees and another 9% from employer.

Particulars	Amount (Nu)
Salaries	166,740,000
Payments to Tax and Pension fund:	
Tax	17,250,000
Pension fund	27,500,000

Required:
Determine the amount to be stated in the statement of income and the liabilities to be reported, if unpaid on the statement of financial position. The net salary paid after deducting 10% tax and 6% pension fund is 84% of gross salary.

2. Phuntsho and Banu are two employees of a Bhutan Shoes company. They receive wages calculated at Nu. 420 per unit and Nu. 450 per unit produced respectively. Minimum wage per week is Nu. 975. Any employees producing more than 80 units is paid at Nu. 500 per unit for the excess. In week 43, Phuntsho produced 105 units and Banu produced 64 units.

Required
Calculate the gross pay for the week of the company.

3. Gyeltshen Construction Company's payroll shows that a pension fund contribution is at 6%. Employer's contribution is 9%. By the year-end net salary paid to its employees amounts to Nu. 154,630,000 and the total amount remitted as the pension contribution is Nu. 21,400,000.

Required
Calculate the amount of salary to be reported as expense and a liability for pension fund.

4. The year-end trial balance of a Bluescope Limited Company as at 31 December 2019 reports a staff loan of Nu. 10,000 as an asset. Monthly recoveries of Nu. 500 made from pay-sheet, from August should be accounted for as:
   Debit cash, credit staff loan with Nu. 2,500
   Debit staff loan, credit cash with Nu. 2,500
   Debit salaries account, credit staff loan account with Nu. 2,500
   Debit staff loan account, credit salaries account with Nu. 2,500

5. The reporting entity accounts its employee costs and prepares payroll every month and sends employee pay slips by the last day of the month. In its financial reporting, what amount should be recognized as expense in its statement of income for the year?
   The gross salary payable to the employee.
   The net salary paid after making all pay sheet recoveries.
   The gross salary payable for the year plus employer's contribution to pension fund.
   The net salary paid plus the amount of all pay sheet recoveries.

6. Create a Payroll in a spreadsheet for a business firm considering following benefits and deductions given to the employees.
   vii. Basic Pay
   viii. House rent allowance 20% of basic pay for all the employees
   ix. Contract allowance 30% for employment status with 'Contract'
   x. Service allowance of 10% for those who served 5 to 10 years, 15% for those serving in 11 to 15 year and serving above 15 years are paid 20%
   xi. Overtime allowance of Nu.300 per hour irrespective of the grade
   xii. Provident fund is deducted at 15% of basic pay
   xiii. Group Insurance Scheme of Nu.1,000 from grade IV and above, Nu.800 for grade VII to V, Nu.500 for grade IX to XII and not deducted if employees are in grade ESP and GSP.
   xiv. Heath contribution of Nu.200 is compulsory for all
   xv. Staff welfare contribution of Nu.200 for grade VIII and above and those below grade IX contribute Nu.100 per month.
   xvi. Salary tax deducted at source is 10% of gross pay after PF,GIS and Health contributions
   xvii. At least five staff have taken loan from different banks and must be shown as deduction in the payroll.

Chapter 3
Accounting for Investment Property

Learning Objectives:

- Explain the concept of investment property.
- Explain the recognition and measurement basis for investment property.
- Discuss issues in classification of investment properties.
- Record accounting transactions related to investment property.
- Present investment property in financial statements.

"Price is what you pay. Value is what you get." (Warren Buffet). This quote aptly underlines the reason why many business entities invest in properties. Business entities usually invest in properties such as land, buildings, gold and other precious metals apart from keeping their money in banks and investment in stocks of other entities. The property market provides a platform for buyers and sellers to undertake such transactions related to properties. However, the price of property may not be fully determined by the market players especially when the government intends to

intervene in the market in order to address the social disparities. The distribution of residential houses by the National Housing Development Corporation in Thiphu and Phunstholing is a typical example of such control of price of property. In more competitive market, investment in properties yield good returns to the investors.

In this chapter, you will learn the concept of investment property, methods of accounting and reporting of investment property in entity's financial statements. In fact, accounting for investment property addresses the issue of accounting for real estate business (building, land or both) that are held for the purpose of capital appreciation or rental income or both.

3.1 Concept and Definition of Investment Property

Investment property is property (land or a building or part of a building or both) held (by the owner or by the lessee under a finance lease) to earn long-term rentals or for capital appreciation or both. As such, investment property generates cash flows or income independently of the other assets held by an entity. Other properties such as land, and buildings generate cash flows with combination of other related properties.

On the other hand, owner-occupied property is property held (by the owner or by the lessee as a right-of-use asset) for use in the production or supply of goods or services or for administrative purposes. The owner here refers to the business entity and not the capital providers of the business. Property, plant and equipment is an example of an owner-occupied property.

Examples of investment property:

- land held for long-term capital appreciation
- building leased out under an operating lease
- vacant building held to be leased out under an operating lease
- property that is being constructed or developed for future use as investment property

The following are not investment property:

- property held for use in the production or supply of goods or services or
- for administrative purposes
- property held for sale in the ordinary course of business or in the process of construction of development for such sale
- property being constructed or developed on behalf of third parties
- owner-occupied property
- property held for future development and subsequent use as owner-occupied property,
- property occupied by employees and owner-occupied property awaiting disposal

- property leased to another entity under a finance lease

You will observe in the definition of investment property that it does not include gold and other precious metals which otherwise is the most sought after property for investment. Apart from gold and other precious metals, investment in properties other than land and buildings do not make sense when they are held especially for appreciation in its value over the years. Thus, investment property includes only land and buildings or part of land and buildings and no other properties.

Other definitions used in investment property include:

Cost: 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.

Fair value: 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.

Owner occupied property: Property that is held (by the owner or by the lessee under a finance lease) for use in the production or supply of goods or services or for administrative purposes.

Statement of Financial Position as at 30th June 2018

Particulars	Note	30-June-18	30-June-17
Assets			
Cash and cash equivalent	4	546,907,673	1,044,294,701
Trade receivables	5	7,056,259	3,910,885
Term deposits	6	11,379,618,764	10,306,537,704
Investments in bonds and commercial papers	7	4,406,821,100	4,958,624,209
Loans	8	12,190,581,280	8,570,206,110
Investment in equity shares	9	3,216,096,180	3,096,824,575
Inventories	10	642,396	541,892
Investment property	11	568,039,820	519,185,535
Property, plant and equipment	12	180,365,244	188,244,657
Intangible assets	13	4,821,569	7,349,525
Other receivables	5	835,977	827,377
Other assets	14	16,349,127	11,751,575
		32,518,137,387	28,708,298,745

Source: NPPF Annual Report 2017-2018

Note 11. Investment Property

Particulars	Gross blocks				Accumulated depreciation				Net block	
	01-Jul-17	Additions during the year	Adjustments	30-Jun-18	01-Jul-17	Depreciation during the Year	Adjustments	30-Jun-18	30-Jun-18	30-Jun-17
RE land	76,347,937	638,000		76,985,937	-	-		-	76,985,937	76,985,937
RE building	447,364,255	4,795,535	(4,424,414)	447,735,376	134,258,099	8,631,921	(4,191,396)	138,698,624	309,036,752	313,106,156
RE building (Semi-Permanent)	2,420,278	806,846		3,227,124	358,943	133,003		491,946	2,735,178	2,061,335
Road network	7,896,690	1,533,599		9,430,289	6,689,687	867,291		7,556,978	1,873,310	1,207,003
Retention wall	2,192,352	-		2,192,352	238,135	73,196		311,331	1,881,021	1,954,217
Capital work in progress	114,457,122	61,381,578	(7,135,980)	168,702,720	-	-			168,702,720	114,457,122
Capital stores	10,051,766	820,963	(4,047,827)	6,824,902	-	-			6,824,902	10,051,766
Total	**660,730,399**	**69,976,522**	**(15,608,222)**	**715,098,699**	**141,544,864**	**9,705,411**	**(4,191,396)**	**147,058,879**	**568,039,820**	**519,185,535**

Particulars	Gross blocks				Accumulated depreciation				Net block	
	01-Jul-16	Additions during the year	Adjustments	30-Jun-17	01-Jul-16	Depreciation during the Year	Adjustments	30-Jun-17	30-Jun-17	30-Jun-16
RE land	76,347,937	-	-	76,985,937	-	-		-	76,985,937	76,985,937
RE building	413,584,867	35,077,300	(1,297,912)	447,364,255	126,897,311	8,365,356	(1,004,568)	134,258,099	313,106,156	286,687,556
RE building (Semi-Permanent)	2,420,278	-	-	2,420,278	260,513	98,430	-	358,943	2,061,335	2,159,765
Road network	7,830,756	65,934	-	7,896,690	5,640,709	1,048,978	-	6,689,687	1,207,003	2,190,047
Retention wall	2,041,974	150,378	-	2,192,352	167,753	70,382	-	238,135	1,954,217	1,874,221
Capital work in progress	98,294,173	37,464,958	(21,302,010)	114,457,122	-	-	-	-	114,457,122	98,294,173
Capital stores	3,805,159	6,246,607	-	10,051,766	-	-	-	-	10,051,766	3,805,159
Total	**604,325,144**	**79,005,177**	**(22,599,922)**	**660,730,399**	**132,966,286**	**9,583,146**	(1,004,568)	**141,544,864**	**519,185,535**	**471,358,858**

Source: NPPF Annual Report 2017-2018

g. Investment Property

Property that is held for long-term rental yields or for capital appreciation or both, and that is no occupied by NPPF, is classified as investment property is measures initially at its cost, including related transaction cost and where applicable borrowing costs. Subsequent expenditure is capitalized to the asset's carrying amount only when it is probable that future economic benefits associated with the expenditure will flow to NPPF and the cost of the item can be measured reliably. All other repairs and maintenance cost are expensed when incurred. When part of an investment property is replaced, the carrying amount of the replaced part is derecognised.

Capital work in progress is stated at cost incurred including provision for outstanding bills up to the date of the statement of financial position.

An item of investment property is depreciated using straight line method on their depreciable amount over their estimated useful life as mentioned in note 3(f)

Disclosure of accounting policy adopted by NPPF for investment property (Source: NPPA Annual report 2017-2018)

STATEMENT OF FINANCIAL POSITION FOR THE YEAR ENDED 31 DECEMBER 2018

(All figures in millions of Bhutanese Ngultrums, except share data and as otherwise stated)

	Notes	Consolidated		Parent	
		31-Dec-18	31-Dec-17	31-Dec-18	31-Dec-17
Non-current Assets					
Property, Plant and Equipment	8	88,445.88	88,715.53	104.85	68.51
Capital work in progress	11	11,533.81	9,414.25	75.84	12.37
Investment Property	12	335.06	325.05	-	-
Intangible Assets	13	1,438.12	1,354.27	0.34	0.64
Goodwill	14	11.95	11.95	-	-
Investments	15	5,136.32	4,103.61	53,312.53	51,038.29
Long Term Financial assets	16	2,169.09	2,444.69	-	-
Banking Loans and Advances		35,179.02	33,802.76	-	-
Long Term Employee Benefits		75.39	6.52		
Other Non Current Assets	17	128.51	252.02	367.59	86.09
Total Non-current Assets		**144,453.15**	**140,430.65**	**53,861.15**	**51,205.90**

Source: DHI Annual Report 2018

Illustration 1

DNT Company operates a logistic and courier service business. In 2018 DNT rented 10 refrigerated trailers to another similar logistic company ST Logistics on 1.1.2019. The contract was signed for a period of 5 years for which all costs related to maintenance and repairs will be borne by ST Logistics. These trailers are acquired at Nu. 2.1 million each in 2017 and are depreciated at straight-line method over 15 years.

Discuss whether the trailers can be accounted as investment property.

3.2 Recognition of Investment Property

Investment property should be recognised as an asset when it is probable that the future economic benefits that are associated with the property will flow to the entity, and the cost of the property can be reliably measured. These are the basic requirements for recognition of asset in the financial statements.

Remember this recognition conditions will work only if the property meets the definition of investment property. In the later part of the chapter you will be introduced to some issues of classification of investment property which will also pose some challenges in the recognition of investment property.

Illustration 2

Company A reported all items of land and buildings as fixed assets before adoption of a new accounting standards. In order to improve its reporting and accounting information, company A adopted BAS in which it is required to classify it's assets. The company management provides you the list of their assets as follows:

a. 15 acres of land is used for construction of office buildings and car parking of their employees
b. 10 acres of land is held for future use
c. 20 units of buildings were used for administrative purpose of the company
d. 25 units of building were allotted to their staff for which they collect monthly rent
e. 10 units of buildings are rented out to tenants
f. A vacant building owned by parent company and to be leased out under an operating lease
g. Company A has a real estate department that develops land and constructs buildings for sale. They have currently 50 units of buildings under this category of asset.

Discuss each category of asset and classify them into:

i) Property, plant and equipment

ii) Investment property

iii) Inventory

Solution

Properties described under items (a), (c), (d) and (f) would qualify as property, plant and equipment as these items are used for company's own office, and employees.

Properties described under items (b) and (e) will be classified as investment property as these properties are held either for capital appreciation or held for rental. The land held for future use indicate that the company would derive the benefits of increased value of the land over the years.

Properties described under items (g) should be classified as inventory as these units of buildings are held for sale in the ordinary course of business.

3.3 Initial Measurement of Investment Property

Investment property is measured at cost at initial recognition. Costs include all directly attributable cost of the investment property such as legal fees, brokerage fees, property transfer taxes and other transaction costs in addition to the cost of acquiring investment property. However, in case of construction of investment property, abnormal waste of materials and general costs which are not directly attributable to the construction of investment property are excluded from the cost.

3.4 Subsequent Measurement

In the subsequent years, investment property can be measured either at:

i) fair value, or

ii) cost

One method must be adopted for all of an entity's investment property. Change is permitted only if this results in a more appropriate presentation. Generally, if the entity has used fair value method, it would be highly unlikely that it would require to change it to cost method as the carrying amount of investment property at fair value will bring a better presentation of investment property in the financial statement. In the next section, you will learn the basic difference between the two methods of accounting for investment property.

3.4.1 Fair value model

Under this method, investment property is remeasured at fair value. Remember that we measured the investment property initially at cost at the time when the investment property was first time recognized in the books. Now in the following year, we need to remeasure the investment property, this time at fair value. If there is any difference in the value of the investment property when we measured at fair value, this represents a gain or a loss arising from changes in the fair value of investment property. The gain or loss on remeasurement should be reported in the income statement for the period in which it arises. Remember, the revaluation surplus in case of property, plant and equipment is accounted as part of equity but the difference in fair value and carrying amount of investment property is always taken to income statement.

The concept and practice of fair value needs careful consideration of the market conditions. Fair value means the price that is acceptable to both buyers as well as sellers without any transaction cost. In the developing economies, fair value poses a challenge in the absence of active market where the item of investment property or a similar property is bought and sold. However, in the absence of such information, the entity may consider current prices on less active markets. If an entity has previously used fair value method, it should continue to use fair value measurement until disposal of its investment property, even if the market is less active and market prices is less readily available. Note that under fair value method, no depreciation is charged on investment property.

Illustration 3

A company has rented a property where it collects a yearly rent of Nu. 120,000 from the tenants. The property was constructed at a cost of Nu. 2 million before 5 years. The company charged 10% depreciation on written down value method. In the current year, management intends to change the method of measurement from cost to fair value due to the volatility of property market in the country. The fair value of the similar property in the market was reported as Nu. 1,345,800.

Compute the gain or loss on remeasurement of the investment property and pass journal entries to record the effect.

Solution

Year	Cost	Depreciation Rate	Depreciation	Carrying Amount
1	2,000,000	10%	200,000	1,800,000
2	1,800,000	10%	180,000	1,620,000
3	1,620,000	10%	162,000	1,458,000
4	1,458,000	10%	145,800	1,312,200
5	1,312,200	10%	131,220	1,180,980
6	Carrying amount			1,180,980
	Fair value			1,345,800
	Gain in value of property			**164,820**

Year 6:

Accumulated depreciation Dr 819, 020
To Investment property 819,020

Investment property Dr 164,820
To Income Statement 164,820

Cash/accrued income Dr 120,000
To rental income 120,000

3.4.2 Cost model

When the entity chooses cost model in the subsequent years, investment property is accounted for in accordance with the cost model as set out in IAS 16 Property, Plant and Equipment. The value of investment property then will be reduced by the amount of yearly depreciation and impairment losses if there is any.

Illustration 4

A business entity invested in a property where it desired to have a regular source of income from the property in the form of rents. The property was purchased at Nu. 550,000 in 2017 and it incurred legal fees and other transaction costs of Nu. 50,000. The entity collects a monthly rent of Nu. 12,000 from the property. The management of the entity decided to use cost model in the subsequent years with 8.5% depreciation on carrying amount.

Compute carrying amount of investment property for the year ended 31 December 2019. Also, record entries for the same effect.

Solution

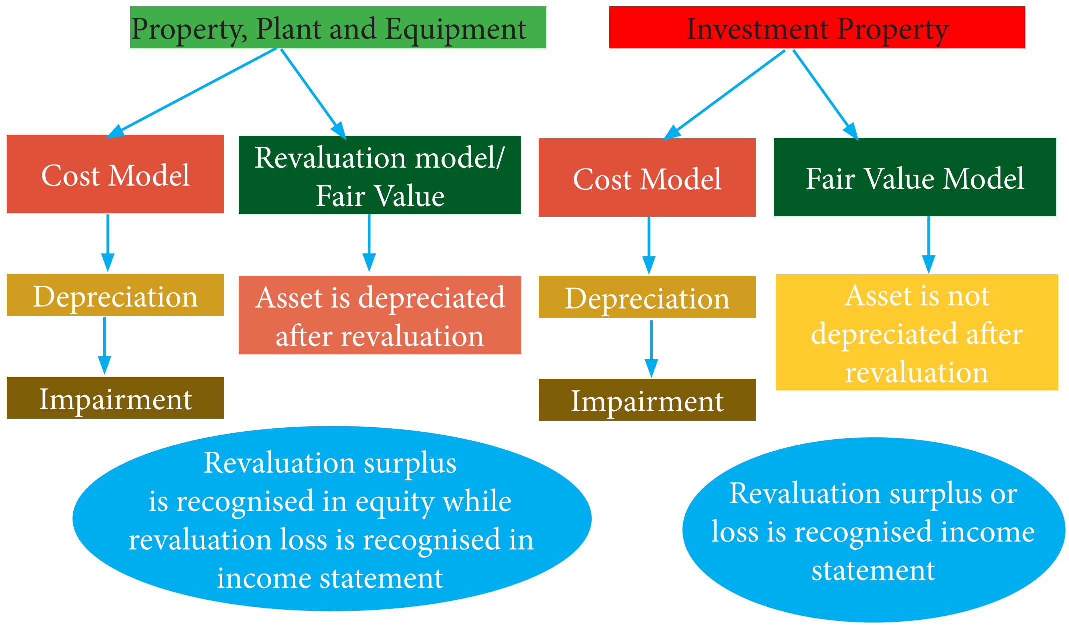
Year	**Cost**	**Depreciation Rate**	**Depreciation**	**Carrying amount**
2017	600,000	8.5%	51,000	549,000
2018	549,000	8.5%	46,665	502,335
2019	502,335	8.5%	42,698	**459,637**

Year 2019

Cash/Accrued income Dr 144,000 (12000x12months)
To rental income 144,000

Depreciation Dr 42,698
To Accumulated depreciation 42,698

Summary of accounting for property, plant and equipment, and investment property



3.5 Transfers to or from Investment Property Classification

It is possible that an entity having investment property may transfer the investment property to its own use (owner-occupied) or the owner occupied property to investment property. This transfer of property to and from owner occupied property should only be made when there is a change in use, evidenced by one or more of the following:

a. commencement of owner-occupation (transfer from investment property to owner-occupied property)
b. commencement of development with a view to sale (transfer from investment property to inventories)
c. end of owner-occupation (transfer from owner-occupied property to investment property)
d. commencement of an operating lease to another party (transfer from inventories to investment property)
e. end of construction or development (transfer from property in the course of construction/development to investment property

In other words, an entity should transfer a property to, or from, investment property only when the property first meets, or ceases to meet, the definition of investment property.

3.6 Some Issues of Classification

3.6.1 Partial own use.

Figure 3.1 Properties partially occupied by owner and rented

If the owner (business entity) uses part of the property for its own use, and part to earn rentals or for capital appreciation, and the portions can be sold or leased out separately, they are accounted for separately. The part that is rented out is investment property. The other part that is used by the owner is accounted as property, plant and equipment.

3.6.1 Ancillary services.

If the entity provides ancillary services to the occupants of a property held by the entity, the appropriateness of classification as investment property is determined by the significance of the services provided. If those services are a relatively insignificant component of the arrangement as a whole (for example, the building owner supplies security and maintenance services to the rented property), then the entity may treat the property as investment property. However, if the services provided are more significant (such as food, housekeeping and help-desk services in the rented property), the property should be classified as owner-occupied. This means, the property should be treated as property, plant and equipment.

Note that the classification of property will depend on the extent of ancillary services provided as part of the contract as a whole. Therefore, a single thump rule may not be sufficient to classify the property as investment or not.

Figure 3.2 Significant ancillary services

3.7 Disposal of Investment Property

Like property, plant and equipment, an investment property should be derecognised on disposal or when the investment property is permanently withdrawn from use and no future economic benefits are expected from investment property. Any gain or loss on disposal should be recognized in the income statement.

Illustration 5

Happy Homes Limited (HHL) supplies sofa sets and internal decoration items to local market. The company accounts all its properties using revaluation model after its initial recognition. HHL has a building which was revalued on 31 December 2019 to its fair value Nu. 100,000. On 1 July 2020, the company management decided to transfer this building which was occupied by the business to investment property. On 1 July 2020, the following information were obtained related to this building:

i) fair value at the date of transfer Nu 90,000

ii) Revaluation surplus of the building Nu. 15,000

iii) Carrying amount of the building at the date of transfer Nu. 98,000

At the end of 2020, fair value of investment property was Nu. 88,000. The property was later disposed of at Nu. 100,000 in June 2021.

Required:

Explain how a change in use of property from owner-occupied to investment property will be accounted. Pass all the required journal entries so that the full economic activities related to the property are captured in the financial records.

Solution

The change in use of property from owner-occupied to investment property will result into change in accounting for building. When the property was owner-occupied, it was accounted as property, plant and equipment (BAS16). However, after management decision to transfer to investment property, building will be accounted as investment property (BAS40).

The carrying amount of the property at the date of transfer was Nu. 98,000. However, the fair value of building was Nu. 90,000. This fair value represents the cost of investment property when it is initially recognized.

Therefore, on 1 July 2020, carrying amount of the property should be brought down to Nu. 90,000 by passing the following entry.

Revaluation surplus A/c Dr 8, 000 [accounted as per BAS16]
To PPE-Building 8 000
Investment property- building Dr 90,000 [transfer and reclassification of property]
To PPE-building 90,000

31 December 2020

Revaluation loss (I/S) A/c Dr 2,000
To Investment property- building 2,000

June 2021

In June 2021, investment property was disposed of and derecognised. This require reclassification of the remaining revaluation surplus in equity as follows.

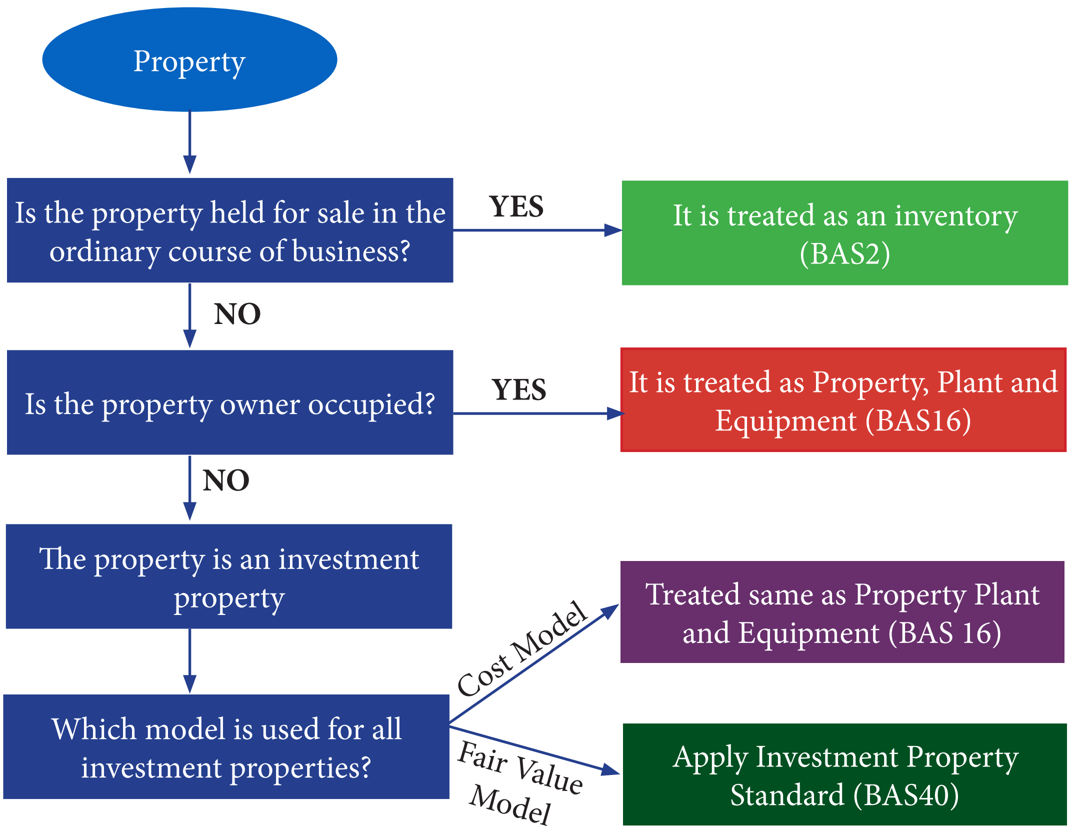
Equity- Revaluation surplus A/c Dr 7, 000
To Equity- Retained earnings 7, 000

Cash A/c Dr 100,000
To Investment property (building) 88,000 [derecognised IP]
To Income statement 12,000 [gain on disposal]

Read the following statement of changes in equity and the reclassification of revaluation surplus from one component of equity to another component of equity.

Statement of changes in equity				
	Share capital	Revaluation surplus	Retained earnings	Total Equity
Opening balance 1.1.2020	1,000,000	15,000	450,000	1,465,000
Profit for the year 2020			600,000	600,000
Dividend paid			-200,000	-200,000
Adjustment of FV		-8,000		-8,000
Closing balance 31.12.2020	1,000,000	7,000	850,000	**1,857,000**
Opening balance 1.1.2021	1,000,000	7,000	850,000	1,857,000
Transfer of revaluation surplus		-7,000	7000	0
Profit for the year2021			550,000	550,000
Dividend for the year			-200,000	-200,000
Closing balance 31.12.2021	1,000,000	0	1,207,000	**2,207,000**

The decision tree



Exercises:

1. City Builders Limited, a real estate business purchased a land in Thimphu at Nu 1.2 million. The management of City Builders Limited not decided whether to hold the land for a couple of years and then sell it or to develop it into a high-rise rental property. The company incurred the following costs, in addition to the purchase price:

   i) Cost of demolishing an old building Nu 10,000

   ii) Erecting a fence around the perimeter of the land Nu 40,000

   iii) Paying overdue real estate tax Nu 80,000

   Required:

   1. Does this property qualify as investment property under BAS 40?
   2. What is the total cost to be recorded for this land?

2. A year after purchasing the land, City Builders Limited decided not to sell the land but rather to build its own office building since the location is excellent. However, because of the decline in property price in Thimphu, the fair value of this land now is Nu 1.1 million.

   Required:

   What action does City Builders Limited have to take in relation to this decision?

3. The central bank of a country A holds gold worth hundred millions of its national currency. Generally the central banks hold gold and other precious metals as reserves to ease out its liquidity problems.

   Required:

   Discuss in group whether gold holding of the central bank can be classified as investment property.

Chapter 4
Accounting for Intangible Assets and Government Grants

Learning Objectives:

- Explain the concept of intangible asset.
- Discuss the capitalization criteria for an item of intangible asset.
- Discuss the nature of internally generated goodwill and other intangible assets.
- Record and report intangible asset in financial statements.
- Record and report for impairment and amortization of intangible assets.
- Explain the concept of government grants.
- Account government grants under accrual or deferral methods.
- Report government grants in financial statements.

This chapter is divided into two parts. First part will discuss on the concept of intangible assets and its accounting methods while the second part will introduce a topic on government grants and the approach to accounting and reporting of government grants by business entities.

Companies like Pfizer, GlaxoSmithKilne and Johnson and Johnson continuously develop different healthcare products to global consumers. A large part of the revenue of these companies comes from the manufacture and sale of biopharmaceutical products such as medicines and vaccines. Another significant thing of these companies is that they carry huge intangible assets on their statement of financial position in the form of intellectual property rights (mostly as patents) and licensing rights.

Strengthening the R&D Commercial interface

Every year these companies spend millions of dollars in research and development activities. Pfizer's spent $ 7,657 million in research and development alone. They reported $ 48,741 million intangible assets in 2017 year-end excluding goodwill. This makes 28 percent of the total assets of the company. Together with goodwill, 61 percent of the Pfizer's asset was made up by intangible assets.

Read the extracts of their financial statements given below.

Pfizer Inc. and Subsidiary Companies

	As of December 31	
(MILLIONS, EXCEPT PREFERRED STOCK ISSUED AND PER COMMON SHARE DATA)	2018	2017
Assets		
Cash and cash equivalents	$ 1,139	$ 1,342
Short term investments	17,694	18,650
Trade accounts receivable, less allowance for doubtful accounts: 2018-$541 2017-$584	8,025	8,221
Inventories	7,508	7,578
Current tax assets	3,374	3,050
Other current assets	2,461	2,289
Assets held for sale	9725	12
Total current assets	49,926	41,141
Long-term investments	2,767	7,015
Property plant and equipment, less accumulated depreciation	13,385	13,865
Identifiable intangible assets, less accumulated amortization	35,211	48,741
Goodwill	53,411	55,952
Noncurrent deferred tax and other noncurrent tax assets	1,924	1,855
Other noncurrent assets	2,799	3,227
Total assets	$ 159,422	171,797

Intangible Assets

Identifiable Intangible Assets and Goodwill

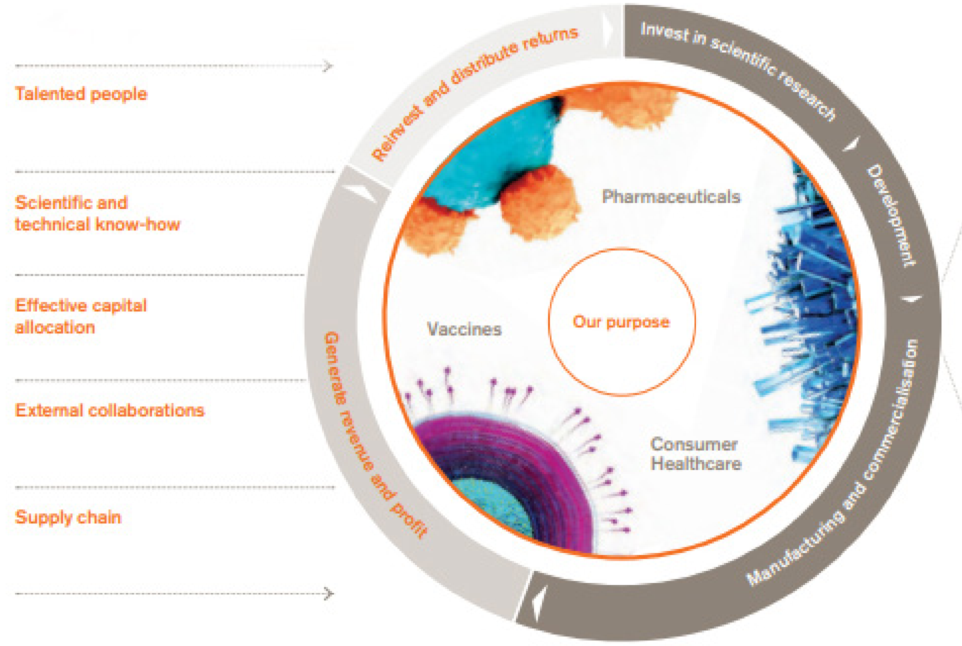
The following table provides the components of identifiable intangible assets:

	December 31, 2018			December 31, 2017		
(Millions Dollars)	Gross Carrying amount	Accumulated amortization	Identifiable intangible assets, less accumulated amortization	Gross Carrying amount	Accumulated amortization	Identifiable intangible assets, less accumulated amortization
Finite-lived intangible assets						
Developed technology right	$ 89,430	$ (58,895)	30,535	$ 89,550	$ (54,785)	$ 34,765
Brands	923	(708)	215	2,134	(1,152)	982
Licensing agreement and other	1,436	(1,140)	296	1,911	(1,096)	815
	91,788	(60,743)	31,045	93,595	(57,033)	36,562
infinite-lived intangible assets						
Brands and others	1,994		1,994	6,929		6,929
IPR&D	2,171		2,171	5,249		5,249
	4,165		4,165	12,179		12,179
Identifiable intangible assets	$ 95,954	$ (60,743)	$ 35,211	$ 105,774	$ (57,033)	$ 48,741

Let's look at another pharmaceutical company, GlaxoSmithKline, a British company.

The company boldly declares its strategic resources as people's talent, scientific and technical know-how, external collaborations and effective supply chain management. How does this impact financial accounting and reporting? These strategic resources collectively generate a huge amount of intangible assets. GlaxoSmithKline reported about 58 percent of intangible assets including goodwill of its total assets in 2017.

> As a science-led global healthcare company our three businesses have the common aim of improving health. On this page we describe the resources we rely on, how our business activities span the life cycle of a product, and how we create long-term value for shareholders and society.



Business entities whose success depends on scientific research, development and innovation of products and services must spend huge amount on such scientific research and innovation in order to meet the complex demand of the consumers. As discussed above, a major chunk of their assets is made up by intangible assets.

There are many such companies in the world including our own national companies that engage in scientific research and development. Not only that these companies also have very strong brand equity.

Consolidated balance sheet as at 31 December 2018		Financial statements Investor information	
Non-current assets	Notes	**2018 £m**	**2017 £m**
Property, plant and equipment	17	11,058	10,860
Goodwill	18	5,789	5,734
Other intangible assets	19	17,202	17,562
Investments in associates and joint ventures	20	236	183
Other investments	21	1,322	918
Deferred tax assets	14	3,887	3,796
Derivative financial instruments	42	69	8
Other non-current assets	22	1,576	1,413
Total non-current assets		**41,139**	**40,474**

Goodwill and other identifiable intangible assets

GlaxoSmithKline Annual Report 2018

BHUTAN TELECOM LIMITED – *Always there for you*

Statement of Financial Position for the year ended 31st December, 2018

Amount in Nu

Particulars	Notes	As at 31st December, 2018	As at 31st December, 2017
I. ASSETS :			
(a) Non-current assets			
Property, plant and equipment	2(a)	3,035,956,265	3,353,676,890
Intangible assets	2(b)	1,129,198,308	1,337,580,391
Capital work-in-progress	2(c)	83,416,952	15,077,015
Financial Assets			
- Investment in associate	3	-	92,308,400
- Investments	4	190,682,583	124,734,293
Deferred tax assets (net)	5	27,892,024	9,659,869
Other non-current asset	6	1,282,729	-
Total non-current assets		**4,468,428,861**	**4,933,036,858**

Software application (21% of total assets)

Bhutan Telecom Limited Annual Report 2017

Statement of Financial Position

	Notes	As at December 31, 2018	As at December 31, 2017
ASSETS			
Non-current assets			
Property, plant and equipment	5	23,038,202,033	21,992,373,551
Intangible assets	6	65,061,864	14,576,623
Investments	7	-	155,590,324
Long-term loans and advances	8	535,714	459,654
Other receivables	9	199,330	199,330
Other non-current assets	10	505,962,594	947,327,154
Total non-current assets		**23,609,961,535**	**23,110,526,636**

Note 6: Intangible assets

Computer Software	As at December 31, 2018	As at December 31, 2017
Opening gross carrying value (i)	**219,106,646**	**217,176,585**
Additions	66,033,794	1,930,061
Closing gross carrying value (ii)	**285,140,440**	**219,106,646**
Opening accumulated amortization (iii)	(204,530,023)	(194,905,716)
Additions	(15,548,553)	(9,624,307)
Closing accumulated amortization (iv)	**(220,078,576)**	**(204,530,023)**
Net carrying value (ii-iv)	**65,061,864**	**14,576,623**

Source: Bhutan Power Corporation limited Annual Report 2018

Statement of Financial Position: as at 31st December 2018 **Amount in Nu.**

Particulars	Note No.	2018	2017
Assets			
Non- current assets			
Property, plant & equipment	1	41,062,098,514.24	42,312,400,734.10
Intangible assets	1	12,994,358.93	20,915,544.36
Investment property	2	32,000,000.00	32,000,000.00
Deferred tax asset	3	39,640,095.76	30,527,276.28
Investments in subsidiaries and joint ventures	4	6,373,520,668.70	5,207,928,305.22
Long-Term Investments	5a	788,406,858.80	725,682,631.67
Other assets	5b	847,980.42	667,619.28
Total non - current assets		**48,309,508,476.85**	**48,330,122,110.91**

Source: Druk Green Power Corporation Limited Annual Report 2018

4.1 Concept of Intangible Assets

Before defining intangible asset, let's recall the definition of an asset discussed in chapter 2 of Class XI Accountancy. An asset is a resource controlled by an entity as a result of past events, from which economic benefits are expected to flow to the entity. BAS 38 expands this definition to intangible asset. It defines intangible assets as "an identifiable non-monetary asset without physical substance".

Monetary assets are money held in the form of cash and assets to be received in fixed or determinable amounts of money.

In nutshell, intangible asset has three characteristics:

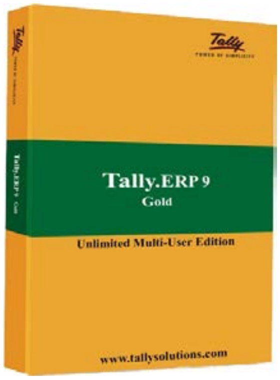
- i. Intangible asset is controlled by the entity.
- ii. Intangible asset does not have physical substance unlike property, plant and equipment.
- iii. Intangible asset is identifiable.

Examples of intangible assets include- software license, licensing rights such as to operate TV/radio, patent and copy rights, brands, trademarks, franchise agreements, video and audiovisual materials (e.g. motion pictures, television rights), royalty and database.

Some examples of intangible assets

Before we discuss the accounting aspects of intangible assets, let's consider some examples of intangible assets so that we are able to understand the concept thoroughly.

Let's take the case of operating system of computer such as Windows 2016. Does it fulfill the definition of and recognition criteria of an intangible asset? Yes, it does. However, windows is an integral part of the computer and without windows operating system, computer cannot run. Therefore, windows operating system as part of computer is recognized as property, plant and equipment.



Now think about accounting software such as Tally ERP, MYOB and QuickBooks. Can we recognise these softwares as intangible assets? They do meet the definition as well as recognition criteria of intangible assets. Therefore, we recognize them as intangible assets. However, we must know that we recognize license to use these software as intangible asset and not the software itself, because the computer can operate without these accounting software.

Intangible assets

Computer Software	As at December 31, 2018	As at December 31, 2017
Opening gross carrying value (i)	**219,106,646**	**217,176,585**
Additions	66,033,794	1,930,061
Closing gross carrying value (ii)	**285,140,440**	**219,106,646**
Opening accumulated amortization (iii)	(204,530,023)	(194,905,716)
Additions	(15,548,553)	(9,624,307)
Closing accumulated amortization (iv)	**(220,078,576)**	**(204,530,023)**
Net carrying value (ii-iv)	**65,061,864**	**14,576,623**

Think about an advertisement. Some entities argue that advertisement can create future economic benefits, and therefore must be capitalized or recognized as intangible asset. However, from the definition we know that intangible asset must be identifiable from other assets or the entity. Since advertisement and its benefits cannot be separated from rest of the business (or sell it to others), cost incurred on advertisement cannot be recognized as intangible asset. Therefore, it must be recognized as expense in the statement of income.

Let us consider one more example. Many people are fans of English football clubs such as Manchester United, Real Madrid and Chelsea. Can the football clubs capitalize expenditure incurred on buying players for the club? Obviously, the value of the player depends on the fame and popularity of the player that will help the club generate economic benefits or cash revenues. The fundamental question here is whether the club can control the player leaving the club if he so desires to move to another club? Well, this can be applied to contract with employees in the organization. As discussed earlier, an organization cannot capitalize costs incurred to recruit or develop employees as the organization cannot control them. However, in the football club, the case may be different from employees in the organization. For example, a player in the football club might be prohibited to play in other clubs by a regulation of the club. Moreover, the contracts with individual players might legally bind the player to stay with the same club for a number of years. That way, we would be able to demonstrate control and recognize the player as an intangible asset. Again, remember that an intangible asset is the 'right to use' the player and not the player itself.

4.2 Goodwill vs Intangible Assets

Goodwill is generally interpreted as an intangible asset by many entities as it lacks physical substance like other intangible assets. However, unlike other intangible assets such as copy rights and patents, goodwill cannot be separated from other assets. Goodwill is recognised as of the acquisition date measured as the excess of consideration paid over net of the identifiable assets acquired and the liabilities assumed on the date of acquisition. Let's consider a case where entity A purchases entity B on 1 January 2019 at a fair value of Nu. 200,000. Entity B has assets worth of Nu. 180,000 and a liability of Nu. 15,000. Assets and liabilities of entity B are measured at fair value at the time of acquisition. In the books of entity A, the excess payment of Nu. 35,000 is recognized as goodwill.

Goodwill is recognised only in a business combination as explained in the case. This means goodwill does not fulfil the definition of intangible asset as goodwill cannot be identified from other assets.

An asset is identifiable if it is capable of being separated from the entity and sold, transferred, licensed, rented or exchanged either individually or together with a related contract. Intangible assets also arise from legal or contractual rights regardless

of whether these rights are transferrable or separable from the entity.
Goodwill recognised in a business combination is an asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognised. Therefore, intangible assets do not include goodwill and goodwill, if recognized, must be reported separately from other intangible assets. The calculation of goodwill in partnership accounting is merely to facilitate adjustment of partners account at the time of admission of a new partner or retirement of the partner. Accounting standards do not recognize internally generated goodwill.

Goodwill is an intangible asset but not identifiable. Therefore, goodwill is not accounted under BAS38 Intangible Assets. It is accounted under BFRS3 Business Combination.

4.3 Acquisition of Intangible Assets

Intangible assets can be acquired through many of ways as listed below.

i. An entity may acquire intangible assets by a separate purchase from the vendors, like any other assets.
ii. Intangible assets can also be acquired through acquiring another business.
iii. Government may transfer or allocate intangible assets to the entity as a government grant. For example, government may allocate the right to operate radio and television to some private operators.
iv. Intangible assets may be acquired by exchange of assets.
v. Many entities also generate its own intangible assets. These are self-created or internally generated intangible assets. The introductory part of the chapter discussed on how industries (e.g. pharmaceutical) spend millions of amount in research and development activities to discover, develop and innovate new products and designs. These are good examples of internally generated intangible assets. You must carefully consider the recognition criteria for such internally generated intangible assets in the later section.

4.4 Recognition criteria of an intangible asset

As you know that a mere fulfillment of a definition of an item does not permit us to recognize the item in the books of accounts. In other words, in addition to the definition, an item must meet the recognition criteria given by the standards. The recognition of an item as an intangible asset requires an entity to demonstrate that the item meets:

i. the definition of an intangible asset; and
ii. the recognition criteria.

An intangible asset is recognised if, and only if:

i. it is probable that the expected future economic benefits that are attributable to the asset will flow to the entity; and
ii. the cost of the asset can be measured reliably.

Future economic benefits can be derived either in the form of increased revenue or reduction in expenses.

4.5 Measurement of an Intangible Asset

An intangible asset is measured initially at cost. The cost of a separately acquired intangible asset comprises:

i) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates; and
ii) any directly attributable cost of preparing the asset for its intended use.

An intangible asset may be acquired in the business combination. In that case, the acquisition cost of the intangible asset is at its fair value at the date of acquisition. In the business combination, the acquiring entity may also recognize a group of complementary intangible assets such as trademarks, formula, recipes and technological know-how as single intangible asset, if these intangible assets have same useful lives.

4.6 Acquisition of intangible asset by way of a government grant

Some intangible assets may be acquired by an entity free of cost or at nominal fees through government grant. There are number of examples of government grants allocated to business entities. These may include-import license, airport lending rights, license to operate television or newspapers, import quotas and rights to have access to certain restricted public resources such as mining. The intangible asset acquired as a government grant may be initially measured at fair value or at a nominal amount. If measured at a nominal amount, the entity must add any directly attributable cost incurred to prepare the item of intangible asset ready for its intended use.

4.7 Internally generated intangible assets

It is quite usual that some entities incur expenditures to generate future economic benefits, for example, the expenditure incurred on training and development of human resources, improvement in business processes and customer relationship programmes. There is a tendency that an entity may recognize such expenditure that generates future economic benefits as intangible assets. The issue with this approach of recognizing intangible asset is that it is difficult to establish clearly (i) whether and when there is an identifiable asset that will generate future economic benefits and (ii) determine the cost of the asset reliably. In many cases it will be difficult to distinguish between costs incurred directly on the intangible asset and those incurred for maintaining or enhancing internally generated goodwill or on day to day operations. Because of this, the expenditure expected to generate intangible asset in the entity is categorized into (i) a research phase and (ii) a development phase.

4.7.1 Research phase

Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

All expenditure incurred in research phase of the project to develop an intangible asset are treated as expense when incurred. This is because at a research phase of the project, the entity cannot demonstrate that an intangible asset exists that will generate future economic benefits.

4.7.2 Development phase

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.

An entity can recognize intangible asset arising from development phase if, and only if, an entity can demonstrate all of the following:

i. the technical feasibility of completing the intangible asset so that it will be available for use or sale,
ii. its intention to complete the intangible asset,
iii. its ability to use or sell the intangible asset,
iv. how the intangible asset will generate probable future economic benefits. For example, 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,
v. the availability of adequate technical, financial and other resources to complete the development, and
vi. its ability to measure reliably the expenditure attributable to the intangible asset during its development.

If all of the above conditions are fulfilled, the expenditure incurred on development phase of the project can be recognized as intangible asset. This is because, at this stage of the project, the entity can identify the intangible asset that will generate future economic benefits. Examples of development activities include design, construction of model, prototype and pilot testing of system, process, product, and devices.

By the same token, internally generated brands, mastheads, publishing titles, customer lists and items similar in nature are not recognised as intangible assets. Costs incurred on these activities are treated as expense in the statement of income and not capitalized.

Note "28" : Administrative and general expenses :		
Deposit Work Expense	92,852,139.57	67,672,953.97
Business Promotion	1,642,030.00	2,422,898.95
Directors Fees	932,000.00	740,000.00
Brand & Management Fees	19,435,675.45	6,510,290.29
Fees and Subscriptions – National	57,890,723.22	54,786,507.88
Printing and Stationary	25,050.00	109,680.00
Advertisement	1,784,265.68	1,887,439.25
Communication (Fax, Mail, Post)	629,781.90	809,405.20
Office Maintenance	528,384.42	702,448.33
Water and Sewerage	140,697.57	132,520.74
Rent	5,193,443.08	5,443,188.18
Fines & Penalty	303,093.23	661,932.17
Travel – Foreign	716,427.83	1,432,598.39
Travel – Local	12,482,798.50	10,873,111.73
Travel - Maintenance & Project	3,271,293.00	4,485,738.00
Rates and Taxes	1,296,578.14	790,845.65
Custom Clearing Charges	-	-
Registration and Filing Fees/Survey	658,481.21	531,939.13
General Insurance	540,103.87	13,044,392.09

Brand management cost is not recognized as an intangible asset

Source: Bhutan Telecom Limited Annual Report 2017

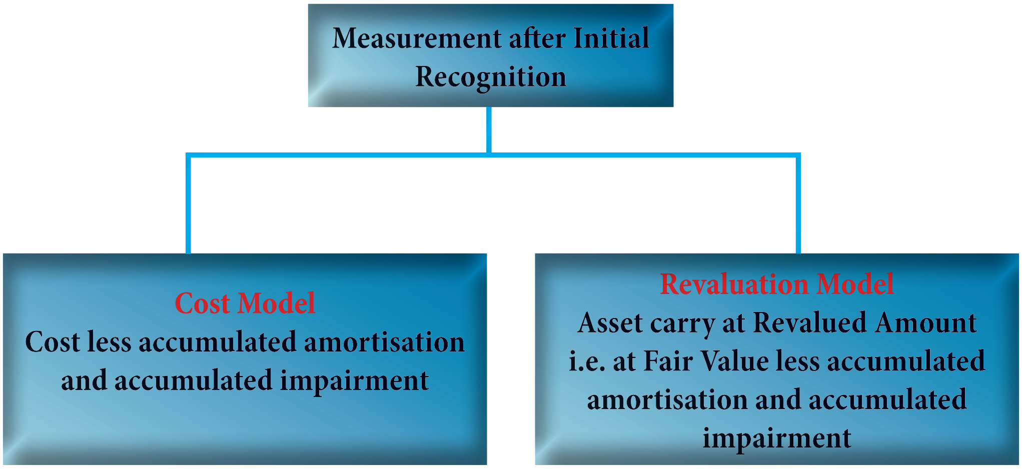
4.7.3 Costs of internally generated intangible asset

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. Remember recognition criteria is at the development phase of the project when an intangible asset can be identified.

The cost of an internally generated intangible asset comprises all directly attributable costs necessary to create, produce, and prepare the asset to be capable of operating in the manner intended by management. These costs include materials consumed, employee costs and fees to register legal rights.

4.7.4 Measurement after initial recognition

An entity may choose either cost or revaluation model as in the case of property, plant and equipment in the subsequent years.



4.8 Accounting for Intangible Asset

Accounting for intangible assets remained quite elusive in the past as business entities struggled to agree on a definition of intangible asset and the controversy of capitalizing cost. These issues have been largely resolved with the issuance of *IAS 38 (equivalence of BAS38 Intangible Assets*) way back in 1998 and later revised in 2004. The accounting of an intangible asset is based on its useful life. The useful life of an intangible asset can be (i) finite or (ii) indefinite.

4.8.1 Finite useful life

Finite useful life indicates that the intangible asset has a limited period for which the entity can expect to derive the economic benefits. Imagine about the computer software and many other intangible assets that are heavily based on technology. Due to rapid technological changes these software become susceptible to obsolescence making the useful life of the intangible assets much shorter. Intangible assets such as licensing rights, franchise agreements, and technological patent rights are subject to legal contracts. Thus, the useful life of these intangible assets is determined by the legal contracts. An intangible asset with a finite useful life is amortised over its useful life. The carrying amount of the intangible asset is calculated as acquisition or development cost less accumulated amortization and any accumulated impairment loss of the asset.

$$\text{Carrying amount of Intangible Asset} =$$
$$\text{Cost} - (\text{accumulated amortization} + \text{accumulated impairment loss})$$

The depreciable amount (cost) of an intangible asset with a finite useful life is allocated in a systematic basis over its useful life. Amortization begins when the asset is available for use. As in the case of a property, plant and equipment, the amortization method should be based on the pattern of consumption of the economic benefits of the asset. When that pattern cannot be determined reliably, the straight-line method of amortization is used. The amortization is recognized as expense in the statement of income. The other methods of amortization include diminishing balance method and the units of production method.

The useful life and the amortization method of the asset must be reviewed at least at each financial year-end.

4.8.2 Indefinite useful life

Indefinite is not same as infinite. The indefinite useful life of the intangible asset means that there is no foreseeable limit to the period over which the asset is expected to generate cash inflows for the entity. Examples include brands, trademarks and perpetual franchise agreements. An intangible asset with indefinite useful life is not amortised.

An entity is required to test an intangible asset with an indefinite useful life for impairment by comparing its recoverable amount with its carrying amount annually and whenever there is an indication that the intangible asset may be impaired. Also, the useful life of an intangible asset must be reviewed each period to determine whether events and circumstances continue to support an indefinite useful life assessment for that asset.

4.8.3 Residual value of an intangible asset

The residual value of an intangible asset with a finite useful life is assumed to be zero, unless:

i) there is a commitment by a third party to purchase the asset at the end of its useful life; or

ii) there is an active market for the asset;

iii) residual value can be determined by reference to that market; and

iv) it is probable that such a market will exist at the end of the asset's useful life.

4.9 Derecognition of an intangible asset

An intangible asset must be derecognised when no future economic benefits are expected from its use or when the asset is disposed off. The gain or loss on disposal must be recognized in the statement of income.

Amortisation of an intangible asset with a finite useful life does not cease when the intangible asset is no longer used, unless the asset has been fully depreciated or is classified as held for sale which is then accounted in accordance with BFRS5.

Illustration 1

Phuensum City Restaurant (PCR) acquired a new catering business from Lhamo Restaurant (LR). As part of the acquisition deal, Phuensum City Restaurant obtained a customers' list from Lhamo Restaurant. These customers have remained loyal to LR for more than a decade which the valuers have estimated worth Nu. 1. Million. The new manager of PCR intends to capitalize this as intangible asset.

Required:

Advise PCR whether they can recognize customers' list as intangible asset in their books of accounts.

Solution

Customers list is a list of customers who have remained loyal and repeatedly subscribed to the goods or services of the entity for a long period of time. One can argue that this is a potential source of revenue for the business and must be capitalized. However, whether to capitalize this will depend on (i) whether the asset is identifiable and (ii) whether it will meet the recognition criteria of intangible asset. In this case, PCR can neither sell nor transfer the customers list without selling the whole business as a going concern. In addition, PCR would not have control over customers list to assure that these customers would continue to be loyal and economic benefits will flow to the entity. Thus, PCR should not capitalize or recognize customers list as an intangible asset.

Illustration 2

In the above illustration, Lhamo Restaurant which was given the contract for catering service by the local schools amounting Nu. 1.2 million was transferred to PCR. It is not certain whether PCR will be able to sell or transfer the contract to others. PCR has also learnt that the contract will not be renewed after the expiry of the existing contract by 30 June 2022.

Solution

The catering service contracts from the local schools are an intangible assets coming by way of government grants. They are identifiable intangible assets although they may not be separable or transferred due to a legal contract. The contracts also meet the recognition criteria since the economic befits are assured and within PCR's control. The amount of the contract is also reliably measured as PCR is prepared to pay them as a separate acquisition.

Illustration 3

ABC Company limited was researching for a medication to treat high level of cholesterol in the bloodstream. On 1st March 2017, it paid Nu.3,600,000 to acquire equipment for carrying out research. During 2017 it spent Nu.1,460,000 on research and in 2018 Nu. 980,000 on developing the prototype of the medication. Nu. 210,000 of the development cost was incurred before 1st March 2018 when the project met the recognition criteria. Further development cost of Nu. 1,210,000 were incurred on this project in 2019. The product launched in 2020 with the expectation that its market will continue for not less than five years. The research equipment is expected to have a useful life of five years and is depreciated using the straight line method.

Required:

Show how the transactions will be accounted and reported in the company's financial statements for 2020.

Solution

Statement of financial position as at 31 December 2020

	Note	Amount
Non-current assets		
Research Equipment	1	840,000
Development cost	6	2,640,000

Statement of income for the year ending 31 December 2020

	Note	Amount
Depreciation and amortisation		
Depreciation –PPE		720,000
Amortisation on intangible assets	5	660,000

Notes:

1. Equipment – 3,600,000 – 2,760,000 = 840,000 (600,000+720,000*3)
2. Research expense of Nu. 1,460,000 and Nu. 210,000 are expensed in 2017 and 2018.
3. Development cost is capitalized as follows:
   2018: 980,000 – 210,000 = 770,000

2019: = 1,210,000

1,980,000

4. Depreciation for equipment
   2018: =600,000 (720,000*10/12)
   2019: =720,000
   Total Development cost = 3,300,000(1,980,000+600,000+720,000)
5. Amortization of intangible asset (2020-2024)
   = 660,000 (3,300,000/5 years)
6. Carrying amount of intangible asset for 2020
   = 2,640,000 (3,300,000-660,000)
7. Amortisation of intangible asset/development cost starts as soon as commercial exploitation of it begins (in our case is from 2020) over its useful life where economic benefits are expected to flow.

4.10 Accounting for Government Grants

The second part of this chapter will introduce learners to accounting for government grants. Government grants are sometimes known by other names such as subsidies, subventions, or premiums. There are many entities who receive government grants either in the form of direct monetary or non-monetary assets and other government assistance such as marketing services, entrepreneurship development and training facilities, and other general support. The government subsidy of 50% printing cost of private newspaper companies *(Kuensel, 2018)* is a typical example of the government grants. A few other examples are listed below.

Examples of government grants :

i) Bhutan Trust Fund for Environmental Conservation (BTFEC) as part of its small grants project awarded four project grants of Nu. 400,000 to four entities involved in environmental conservation *(May 4, 2018, http://www.bhutantrustfund.bt)*.

ii) SUNGJAB, an electronic scarecrow to protect crops from wild animals was given a government grant through Information and Communication Ministry.

iii) The government approved annual subsidy amount of Nu. 2.725 million to support 50 percent of the printing cost of private newspapers for a period of two years. In addition to that, the government through MOIC has also approved additional Nu 2M annually in the 12th Plan under the budget head 'Support to media enterprise' to be used for capacity and content development. *(Kuensel, 2018).*

iv) ADB $ 35 million for health sector development, out of which grant of $ 15 million is specifically for a project called Skills Training and Education Pathway Up gradation Projection. *(Kuensel, 2018)*

Read the financial statements presented in the following sections and identify government grants reported in these financial statements of different companies.

II. EQUITY AND LIABILITIES : (a) Shareholders Fund			
Equity share capital	13	854,082,000	854,082,000
Retained earnings & reserves		2,903,751,554	2,938,916,121
Total shareholders fund		**3,757,833,554**	**3,792,998,121**
(b) Deferred government grants	14	87,633,714	110,957,565
(c) Non-current liabilities			
Financial liabilities			
- Long term borrowings	15	602,627,144	648,615,398
- Other non-current liabilities	16	155,400,000	194,250,000
Deferred tax liability (net)	5	-	-
Long term provision	17	57,164,638	67,340,966
Total non-current liabilities		**815,191,782**	**910,206,364**

Source: Bhutan Telecom Limited Annual Report 2018

Note 28: Depreciation & amortization

Particulars	As at 31st December, 2018	As at 31st December, 2017
Depreciation*	605,754,716	460,260,722
Amortization*	347,081,358	259,405,538
	952,836,074	**719,666,260**

** Depreciation expense has been netted off with amortisation of govt grant Nu. 23,323,850*

Source: Bhutan Telecom Limited Annual Report 2018

4.10.1 Definitions

The following definitions are reproduced from the standards to help you to understand the accounting methods of government grants.

Government refers to government, government agencies and similar bodies whether local, national or international. In Bhutanese context, government means the central government, dzongkhags, gewogs and chiwogs. It also includes all government funded agencies and international agencies operating in Bhutan. For example, entities receive grants from ADB and World Bank. Such grants may qualify as government grants.

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. All government grants come with some conditions to be fulfilled by the recipient entity such as the one given in the above examples. No government grants are awarded as gratuitous.

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

Note that government grants do not include government assistance. The government assistance can be seen in the form of technical and marketing support to the entity whose value cannot be measured reliably. This form of benefits received from the government is not recognized as income or asset. It is merely disclosed as notes in the financial statements of the entity.

4.10.2 Recognition criteria of government grants

A government grant is not recognised until there is reasonable assurance that:

i) the entity will comply with the conditions attaching to it, and

ii) the grant 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.

4.10.3 Treatment of government grants

Accounting for government grants depend on the purpose of the grants received. Government grants can be received either for:

i. **Acquisition of assets.** These types of grants are called grants related to assets. These 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, Or

ii. **Reimbursement of cost.** These types of grants are called grants related to income. They are government grants other than those related to assets.

4.10.4 Accounting for grants related to assets

Accounting standards specify two methods of accounting for government grants when the grants are received for acquisition of assets.

i. Deferred income approach, or
ii. Asset approach

Illustration 4

An entity received a government grants to install drinking water from Mawongpa Water Solution on its premise of Nu. 200,000. The cost of the project was Nu. 315,000 and its useful life is 10 years. An entity acquired the facilities on 1 April 2019 and charged depreciation on a straight line basis.

Solution

You will understand that this grant is related to acquisition of property, plant and equipment. We can account and report under two methods for this type of government grants.

i. **Government grants treated as deferred income**

When we use this method, government grant received is credited to deferred income (this means that an income has been received in advance) and amortise it over the useful life of the asset in order to match grant income with the relevant cost. As in the case of property, plant and equipment, the relevant cost here is the depreciation charges).

Journal entries

Date	Particulars	L/F	Debit	Credit
1.1.2018	Cash/bank A/c To Deferred Income		200,000	 200,000
31.12.2018	Deferred income A/c ** To Income from government grants (adjustment entry)		15,000	 15,000

*** Deferred income recognized as income (depreciation charges) = (200,000/10)/12*9 months = 15,000*

Statement of financial position as at 31 December 2019

	Amount
Equity and liabilities **Non-current liabilities** Deferred Government grants	185,000

Statement of income for the year ended 31 December 2019

	Amount
Other income Government grants	15,000

ii. Deduction from an asset

In this method, we calculate carrying amount of the asset by deducting the grants received from the cost of asset acquired. This means, the recognition of grants in statement of income is automatically reflected in depreciation charges. This will give us Nu. 115,000 as the carrying amount of the facilities (315,000-200,000) upon initial recognition.

The annual depreciation charge is Nu. 8,625 [315,000-200,000]/10*9/12

Journal entries

Date	Particulars	L/F	Debit	Credit
1.1.2018	Cash/bank A/c To PPE-water solution facilities		200,000	 200,000
31.12.2018	Depreciation A/c To PPE- water solution facilities		8,625	 8,625

Illustration 5

Bhutan Trust Fund for Environmental Conservation (BTFEC) as part of its small grants project awarded grants of Nu. 400,000 to an entity for environmental conservation activities during 2018-2022. The entity spent Nu. 100,000 in 2018. A total of Nu. 600,000 is estimated to incur in the project.

Solution

This grant is the case of grant received to reimburse the expenses for environmental conservation activities in 2018-2022. What is important in this method is the entity needs to recognize the income from grant in the periods when relevant expenses are incurred.

Journal entries

		Debit	Credit
Cash/Bank A/c		400,000	
To Deferred Grant Income			400,000
Deferred Income A/c		66,667***	
To Grant income			66,667

*** (Total spent/Total cost of project/asset) x Government grants received.

Illustration 6

Let's assume that the entity received a grant of Nu. 1 million on 1 January 2019 to cover or compensate the expenses incurred on environmental conservation project undertaken by the entity in 2016-2018.

Solution

In this case the grant is received to compensate the expenses already incurred by the entity. Since the expenses have been already incurred in the previous accounting year, the grants received will be immediately recognized as expense in the year when the grant is received.

Journal entries

		Debit	Credit
Cash/Bank A/c		1 million	
To Deferred income			1 million
Deferred income A/c		1 million	
To Income statement			1 million

Exercises:

1. In a group of 2-3 students, complete this learning activity and share your results with the class.

   Dragon Tours and Treks (DTT) was in the business for twenty years. It has seen the changing landscape of the tourism industry in the country. Today DTT has established almost 45 percent of market share. Recently, an international firm from Switzerland proposed a deal to buy DTT. In the proposal, there was not anything on the brand and logo of DTT which DTT management is very concerned about. DTT management feels that its brand and logo should be fairly priced and form part of the consideration.

   Required:

   Assess whether DTT management can value their brand and add to the consideration of the acquisition.

2. A local firm was contracted by an international firm to research and develop a hybrid plant that can adapt to a local climate. If successful, this will be launched as commercial undertaking which is expected to last for at least 10 years. All research and development costs will be fully reimbursed by the international firm. During the year ended 31^{st} December, 2019, a total expenditure of Nu. 670,000 were incurred to carry out the project. The project will continue for another 2 years. If successful, the patent right of the hybrid plant will be automatically owned and controlled by the international firm.

   Required:

   Explain how this cost will be treated in the books of the local firm when they prepare the financial statements for the year ended 31 December 2019. Share your workings with the class.

3. In a small group of 2-3 students discuss the following questions and present the outcome of your discussion to the class.
   i. Company A acquired a popular brand name as part of business acquisition which is expected to have a useful life of 50 years. Discuss how this will be accounted in the books of Company A.
   ii. Company B regularly supplied free goods and gifts to its customers to maintain customers' loyalty. Discuss how this will be accounted as per accounting for intangible asset rules.
   iii. Company C conducted research to improve its product in the market and incurred Nu. 1.5 million. Discuss how this cost will be treated in the books of Company C and reported.

4. XYZ Limited produces school shoes and supplies to all central schools in Bhutan. It received a grant of Nu. 800,400 in 2018 from the UNICEF Thimphu office. This grant will be used to meet the operating expenses of the company for 2018-2020 when they produce school shoes to central schools. 30% of the grant will be used in 2018. The company estimates a total operating cost of Nu. 1.8 million over 2018-2020.
   Required:
   i. Identify the type of grant received by XYZ limited.
   ii. Explain how the grant received will be accounted in the books of XYZ limited. Write entries as well.

5. LNT limited is an export company. It received a government grant of Nu. 2.5 million to construct a warehouse on 30 June 2018. The warehouse will have an estimated useful life of 50 years over which it will be depreciated using a straight line method. The construction last for 6 months in 2018 and was put into use from 1 January 2019. The company incurred Nu. 3 million as construction cost.
   Required:
   Account for grant correctly using the method of deferred income. Prepare the extracts of financial statements showing the grants in the appropriate financial statements.

6. LNT limited in learning activity 2 received a week-long training in marketing sponsored by the agriculture marketing department. Thirty employees of the company attended the training in 'export marketing and how to be a good marketer in international business' from 15 October -21 October 2018.
   Required:
   Discuss the nature of government assistance in this case and explain how this information will be presented in the financial statements of LNT Company for 2018 reporting.

Chapter 5
Liability, Provisions and Contingencies

Learning Objectives:

- Explain the concept and recognition criteria of liability.
- Explain the concept of provisions and when a provision needs to be created.
- Calculate and record provision.
- Explain the concept of contingent liability and contingent asset.
- Differentiate between liability, provision and contingent liability.
- Identify disclosure requirement of contingencies in financial statements.

The disclosure of provisions, contingent liabilities and contingent assets has been an area of much debate in the field of accounting. In particular, the accounting treatment of provisions has been criticized for being used as an earnings management tools. 'Earnings Management' is a term used to describe manipulation of the recognition of revenue and expenses items to smooth out fluctuations in profit or to achieve predetermined profit results. When provision is used for income smoothing, the financial statements will provide misleading information.

The introduction of BAS 37 has addressed these issues in the best interest of the stakeholders. This chapter deals with the recognition criteria of liability, concept of provisions, treatment of contingent liabilities and contingent assets, and will further discuss on the disclosure requirement of contingencies in financial statements.

5.1 Liability

A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. (BAS 37, para. 10).

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

5.1.1 Recognition Criteria of Liability

Apart from satisfying the definition of liability, the following criteria have to be fulfilled before a liability can be recorded in financial statement:

a. The outflow of resources embodying economic benefits (such as cash) from the entity is probable.
b. The cost / value of the obligation can be measured reliably.

The first test requires liability to be recognized only if it is likely that the entity will be required to settle it. The second test ensures that only liabilities that can be objectively measured are recognized in the financial statements.

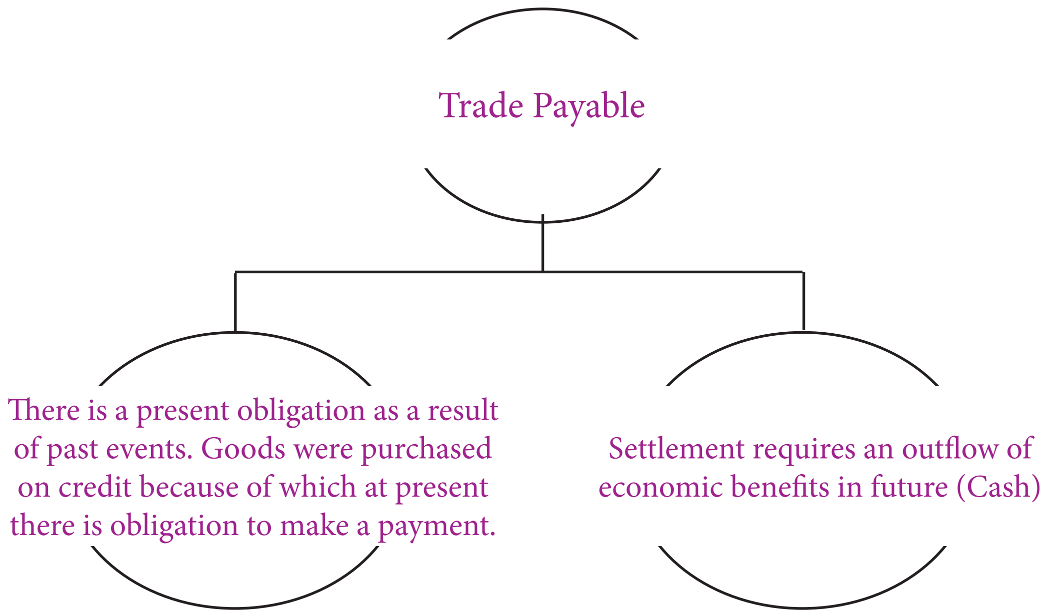


Figure 5.1 Represents the use of recognition criteria for liability:

Hence, Debit Inventory Account and Credit Trades Payable if the cash payment is probable and the amount can be measured reliably.

5.2 Provision

A provision is a liability of uncertain timing or amount. How is provision different from a liability? As we discussed in the previous section, the liability is a present obligation and both the timing when to settle the liability and the amount of liability to be settled are known to the entity at the date of reporting. Provision is also a present obligation. However, in provision, there is an uncertainty about the timing or amount of the future expenditure. Whilst uncertainty is clearly present in the case of certain accruals such as trade receivables and loans receivables, the uncertainty is generally much less than for provisions. In such situation, what the entity can do is to make the best estimate of the amount that it may need to settle the obligation.

Provision = Liability + Uncertainty

Illustration 1

Dejung Graphics and Printing firm started a printing business on 1 January 2019 by acquiring a printing machines at Nu. 480,000. The useful life of the printing machine is estimated at 10 years and the total cost of repair and maintenance during the whole life estimated at Nu. 120,000. Accordingly, in the financial statements from the year ended 31 December 2019, they have depreciated the machine by Nu.48, 000 and have, in addition, set up a provision for machine repair and maintenance of Nu. 12,000. The actual cost of repair and maintenance for the year was Nu. 3,200 which was adjusted with provision.
Explain whether the accounting for provision was made correctly.

Solution

The accounting for the provision is wrong because there is no present obligation on the reporting date. The cost related to future repair and maintenance is not a present obligation and is not permitted to set up a provision. The obligating event is the need to repair and since it has not arisen at the date of reporting there is no past event triggering the obligation. Moreover, there is no certainty in the amount of obligation and the timing to settle the obligation. The repair and maintenance of the printing machine in future may be quite obvious, however, the entity cannot be certain about when such repair need to be carried out. It could also happen that the entity may avoid repair by replacing the machine with a new one.

5.2.1 Recognition criteria of provisions

A provision should be recognized as a liability in the financial statements when:

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

5.2.2 Present obligation from a past event

This rule has two parts, first the type of obligation, and second, the requirement for it to come from a past event (something must have already happened to create the obligation).

a. Types of obligation

The obligation could be a legal or contractual one, arising from a court case or some kind of contractual arrangement.

The second type of obligation is called a constructive obligation. A constructive obligation is an obligation that derives from an entity's actions where:

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

Illustration 2

ABC Co. has published an environmental policy to replant trees in order to counter-balance the environmental damage resulting from its operations. It has a consistent history of honoring this policy. During 2018, it opened a new factory, leading to some environmental damage estimated at Nu.400, 000 for restoration works.

Even if the country has no legal regulations forcing ABC Co. to replant trees, it will have a constructive obligation because it created an expectation from its publications, practice and history.

b. Past event

The obligation should be a result of a past event, rather than simply something which may or may not arise in the future.

Illustration 3

ABC Co. would have to provide for a potential legal case arising from an employee who was injured at work in 2018 due to faulty equipment. This is because the event arose in 2018 which could lead to an obligation.

Suppose, if ABC Co. has to pay to install new safety equipment in the factory in 2019, there is no present obligation to do this in 2018, so no provision is required. ABC Co. could delay the work until 2019.

5.2.3 Measurement of provisions

The amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period.

The estimate is made by the judgement of the entity's management using the past experience and the surrounding circumstances. Generally, the amount of provision is measured by using the following methods:

i) Expected value method.

If the obligation involves large number of population of items or a number of expected outcomes, the provision is estimated by weighting all possible outcomes by their associated probabilities, i.e. expected value.

ii) The most likely outcome

If the obligation involves single outcome or item, such as the court case, the most likely outcome method is used. Generally, if the chance of having the obligation is more than 50%, we recognize the provision.

Illustration 4 - best estimate:

ABC Co. has received legal advice that the most likely outcome of the court case from the employee is that, they will lose the case. The Company's legal advisor thinks that there is an 80% chance of paying Nu.10m, 12% chance of having to pay Nu. 12m, and 8% chance of paying nothing.

In this case, ABC Co. would provide Nu. 10m, being the most likely outcome. It will not be uncommon to take the Nu. 12m, thinking that the worst-case scenario should be provided for.

Illustration 5 – expected value:

ABC Co. gives a year's warranty with all goods sold during the year. Past experience shows that ABC Co. needs to do no repairs on 85% of the goods. On average, 10% need minor repairs, and 5% need major repairs. ABC Co's manufacturing manager has calculated that if minor repairs were needed on all goods, it would cost Nu. 100,000 and major repairs on all goods would cost Nu. 1m.

Here, the provision would be measured at Nu. 60,000. The expected cost of minor repairs would be Nu. 10,000 (10% of Nu. 100,000) and the expected costs of major repairs is Nu. 50,000 (5% of Nu.1m). This is because there will not be a one-off payment, so ABC Co. should calculate the estimate of all of the likely repairs.

d. Probable outflow

There is no specific list of what percentage of likelihood is required for an outflow to be probable. A probable outflow simply means that the probability an event will occur is greater than the probability that it will not.

Illustration 6 – Likelihood:

ABC Co's legal advisors continue to believe that ABC Co. will lose the court case against the employee and have to pay out Nu. 10m. However, it has come to light that ABC Co. may have a counter claim against the manufacturer of the machinery. The legal advisors believe that there is an 80% chance that the counter claim against the manufacturer is likely to succeed, and believe that ABC Co. would win Nu. 8m. In this case, ABC Co. would include a provision for the Nu.10m loss in liabilities.

5.2.4 Effect of time value of money on provision

Where the effect of the time value of money is material, the amount of a provision should be the present value of the expenditure required to settle the obligation. An appropriate discount rate should be used.

Illustration 7

Suppose ABC company constructed a manufacturing plant on a 5 years period of a leased land. The company has a practice of cleaning up all environment after it ceases the operations in the place. The company lawyer estimated a cost of Nu.2.5 million. The provision to be made now will be the present value of Nu. 2.5 million in 5 years time. Assuming the relevant discount rate in this case as 10%.
The provision to be made for the current year will be:

2,500,000 x 0. 621 (10% discount rate) = Nu. 1,552,500

The following year provision will be:

2, 500,000 x 0. 683 = Nu. 1,707,500

The difference of Nu. 155,000 (i.e. 1,552,500 – 1,707,500) will be charged to income statement.

This is called the unwinding of the discount. This is accounted for as a finance cost.

1st year

Income statement a/c	Dr	1,552,500		
To provision for environmental clean cup			1,552,500	

2nd year

Finance cost a/c	Dr	155,000		(IS)
To Provision for environmental cleanup a/c			155,000	(SOFP)

The unwinding of the discount effectively increases the provision each year to reflect the passage of time. After one year has passed, Nu. 1,552,500 is no longer sufficient to settle the Nu.2, 500,000 liability in four years' time. The value of Nu.2, 500,000 after one year would now be Nu.1, 707,500. Therefore, the entity must increase the provision by Nu. 155,000 in the second year (i.e. the difference between first year and second year), and so on till the last year of the provision.

The provision must be reviewed at each reporting date and adjusted to reflect the current best estimate. If it is no longer probable that an obligation will be required to settle, the provision should be reversed.

Provision for environmental cleanup Dr
To Income statement

5.2.5 Use of provisions

A provision should be used only for expenditures for which the provision was originally recognised. Meeting expenditures against a provision that was originally recognised for another purpose would mislead the financial statements.

5.2.6 Future operating losses

Provisions should not be recognised for future operating losses. They do not meet the definition of a liability and the general recognition criteria set out in the standard. Therefore, it is inappropriate to set provision for future doubtful debts and an expected decrease in the value of inventories.

5.2.7 Provisions should not be exaggerated

As discussed in the previous sections, the amount of provision should be the best estimate at the reporting date of the amount necessary to settle the obligation. When creating a provision, the entity must consider risks and uncertainties. The entity must make sure that they do not create excessive provisions to deliberately overstate the liability and understate the reported profits. This issue is discussed in the beginning of the chapter.

5.2.8 Onerous contracts

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

If an entity has a contract that is onerous, the present obligation under the contract should be recognised and measured as a provision. For example, if ABC company has entered in to a lease contract for 5 years and required to pay a lease rent of Nu. 100,000 per year. The lease contract provides that the lease if terminated before the lease period, the entity will pay the full lease payment for 5 years as if the contract has been honoured. What if ABC company decide to terminate the lease after one year? In that case, ABC company is said to have entered into an onerous contract. This would require ABC company to pay a total lease rent of Nu. 400,000 for remaining 4 years as a penalty for terminating the lease contract. Therefore, ABC company must create a provision to meet this expenditures.

5.3 Contingent Liabilities

Contingent liabilities are defined as:

a. a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or
b. a present obligation that arises from past events but is not recognized because:
    i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
    ii) the amount of the obligation cannot be measured with sufficient reliability.

Contingent liabilities should not be recognized in financial statements but should be disclosed as notes unless the possibility of an outflow of resources is remote. The disclosure must provide:

a. A brief description of the nature of the contingent liability,
b. An estimate of its financial effect,
c. An indication of the uncertainties that exist, and
d. The possibility of any reimbursement.

Generally, probable means more than 50% likely. If an obligation is probable, it is not a contingent liability. Instead, the entity must set a provision.

Contingent liabilities are assessed continually to determine whether an outflow of resources embodying economic benefits has become probable. If it becomes probable that an outflow of future economic benefits will be required for an item previously dealt with as a contingent liability, a provision is recognized in the financial statements of the period in which the change in probability occurs (except in the extremely rare circumstances where no reliable estimate can be made).

b) Contingent Liabilities

There are contingent liabilities for transactions arising in the normal course of banking operations.

	31-Dec-18	31-Dec-17
Liability for Acceptances Endorsements and other Obligations	771.38	1,467.23
Guarantees issued and outstanding and bill payable	5,906.43	3,085.92
Total	**6,677.81**	**4,553.15**

Guarantees have been provided for loans owing by subsidiary and associate companies amounting to Nu. 6,677.81 million (2017: Nu 4,553.15 million). No loss is expected on these guarantees.

DHI's investments totaling Nu. 3,460.00 million (2017: Nu. 3,460.00) in some of the subsidiaries have been pledged in support of the guarantee.

Various companies have outstanding legal claims totaling Nu 82.37 million (2017: Nu 82.37 million). Provision for payment hasn't been in included in these financial statements as no liability is anticipated.

During the year 2013, DHI's contingent liability went up by Nu. 533 million on account of guarantees provided to Bhutan National Bank Ltd. for working capital loan extended to Dungsam Cement Corporation Ltd. The outstanding balance of the loan as on 31 December 2018 is Nil.

Table 5.1 Summarizes the key requirements of BAS 37 in relation to contingent liabilities

Obligation/Probability	Treatment
Obligation and probability of outflow of economic benefits	Accounting treatment in accordance with BAS 37
Present obligation that probably requires an outflow of resources	A provision is recognized.
Present obligation that may (but probably will not) require an outflow of resources	Disclosed as a contingent liability.
Present obligation where the likelihood of outflow of resources is remote	No disclosure required.
Possible obligation	Disclosed as a contingent liability.

Illustration 8 - Provision Vs Contingent Liabilities:

During the year 2011, ABC Co. was sued by the community for health related issues due to contamination. At the end of the year, the lawyer advised that it is likely the company would not be found liable.

The above case implies possible obligation. Hence, it should be disclosed as contingent liability unless the chance of payment is remote.

At the end of 2012, the lawyer advised ABC Co. that due to further developments in the case, it became probable that the company would be found liable.

Here the present obligation exists, hence, a provision is recognized if the amount of damages can be reliably estimated. (Dr. Expenses, Cr Provision)

However, if the amount of damages cannot be reliably estimated, it should be disclosed as contingent liability unless the chance of payment is remote.

It is important to know the difference between provisions and contingent liabilities

and be able to apply it correctly when producing financial statements. A provision is a liability with uncertain timing or amount but it satisfies the definition of a liability and most importantly, it satisfies the recognition criteria.
A contingent liability on other hand either does not satisfy the definition of a liability or recognition criteria of liability.

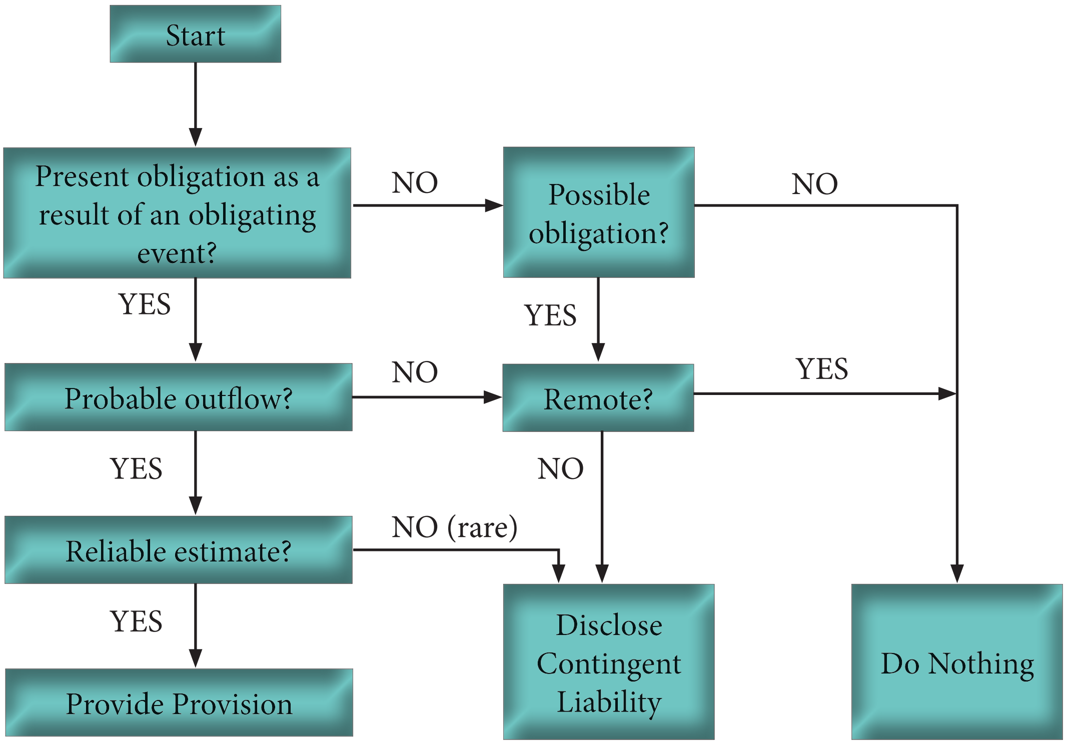


Figure 5.2 Decision Tree to summarize the main recognition requirements of the BAS 37.

5.4 Contingent Assets

Contingent Assets are possible assets whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.
Contingent assets are not recognized in the statement of financial position. They are disclosed in the notes to the financial statements. An example of contingent asset is a claim that an entity is pursuing through legal processes, where the outcome is uncertain.

Illustration 9

Jattu Transport Company lost a consignment worth Nu.3 million during transit of goods from Thimphu to Kolkata. It is however, covered by an insurance policy from RICBL. Before year-end, Jattu Transport Company received a letter from RICBL that a Cheque was in the mail for 90% of the claim.

Kendhen Co. that entrusted Jattu Transport Company with the delivery of the consignment has filed a lawsuit for Nu.3 million along with consequential damage of Nu. 1 million resulting from delay. According to the legal advisor of Jattu Transport Company, it is probable that the company has to pay Nu. 3 million, but it is a remote possibility that it would have to pay additional Nu. 1 million since it was not mentioned in the contract.

Requirement:

What provision or disclosure would Jattu Transport Company need to make?

Solution:

The Jattu Transport Company need to recognize contingent asset of Nu.2.7 million (Nu.3 million X 90%), that is the amount which is virtually certain. Further, it also needs to make a provision of Nu.3 million towards the claim of Kendhen Co. However, the probability of claim of Nu.1 million is remote; hence, no provision or disclosure would be required.

Illustration 10

During 2019, ABC limited company gives a guarantee of certain borrowings of XYZ limited company, whose financial condition at that time is sound. During 2020, the financial condition of XYZ limited company gets worse and at 31 December 2020, XYZ limited company files for protection from its creditors.

What accounting treatment is required in the books of ABC limited company:

a. At 31 December 2019
b. At 31 December 2020?

Solution

a. At 31 December 2019, there is a present obligation as a result of a past obligating event. The obligating event is the giving of the guarantee, which gives rise to a legal obligation. However, at 31 December 2019, no transfer of resources is probable in settlement of the obligation. No provision is recognised. The guarantee is disclosed as a contingent liability unless the probability of any transfer of resource is regarded as remote.

b. At 31 December 2020, as above, there is a present obligation as a result of a past obligating event, namely the giving of the guarantee. At 31 December 2020, it is probable that a transfer of resources will be required to settle the obligation as XYZ limited company is seeking protection from creditors. Therefore, there is a need to recognize a provision for the best estimate of the obligation.

Table 3.2 Summary of the key requirements of BAS 37 in relation to contingent assets:

Probability	Treatment
Probability of inflow of economic benefits	Accounting treatment in accordance with BAS 37
Virtually certain	When the realization of income is virtually certain, the asset is not a contingent asset and it is appropriate to recognize the asset.
Probable (but not virtually certain)	If future benefits are probable, but not virtually certain, contingent asset is disclosed.
Not probable	If, inflow of economic benefits are not probable; no disclosure is required for the contingent assets.

5.4.1 Disclosure

Contingencies are disclosed in the form of notes in the financial statements while provisions are recognized in the statement of financial position. Table XXX is the sample of financial report of Indian Oil Corporation Limited, 2017 -2018 exhibiting how contingencies and provisions are treated.

BALANCE SHEET AS AT MARCH 31, 2018

(In Crore)

Particulars	Notes No.		March-2018	March-2017
Current Liabilities				
a) Financial Liabilities				
i) Borrowings	21	**36,807.56**		30,072.76
ii) Trade Payables	22	**33,106.05**		30,134.29
iii) Other Financial Liabilities	17	**40,815.69**		36,348.12
b) Other Current Liabilities	20	**10,991.38**		12,775.47
c) Provisions	18	**14,161.60**		18,924.73
d) Current Tax Liabilities (Net)	7	-		56.97
			135,882.28	128,312.34
Total			**280,739.91**	**259,213.27**

NOTE-18: PROVISIONS

		Non Current			Current	
		March-2018	March-2017		March-2018	March-2017
Provision for Employee Benefits		2,019.66	2,923.38		293.03	373.69
Decommissioning Liability	A	3.66	3.60		-	-
		-	-	32,320.69		36,418.41
		-	-	18,452.12		17,867.37
					13,868.57	18,551.04
TOTAL		2,023.32	2,926.98		14,161.60	18,924.73

B. CONTINGENT LIABILITIES

B.1 Claims against the Company not acknowledged as debt

Claims against the Company not acknowledged as debt amounting to 8025.58 crore (2017: 9251.66 crore)

D. CONTINGENT ASSETS

(in Crore)

		March-2018	March-2017
a.	A customer had lodged a claim against the company challenging the pricing mechanism of utilities provided. The matter was referred to arbitration and award was given in favour of the company. During the year Customer has approached Honourable High court challenging the award of arbitration and the case is pending with Honourable High court for final adjudication. Honourable High court vide its interim orders dated 28.08.2017 and 19.04.2018 has directed the customer to deposit the principal amount and interest amount respectively in the Registry of the court. Court has also directed that the amount deposited by the customer shall be released to the company upon furnishing an unconditional Bank Guarantee of the equivalent amount. The management has treated a portion of the same as contingent asset pending adjudication of matter with Honourable High Court.	112.98	96.00
b.	Contingent Asset in respect of M/s Khazana Projects and Industries (P) Ltd. for the amount of risk & cost claim along with 15% supervision charges admitted by the Arbitrator in favour of the company.	3.48	3.36

Indian Oil Corporation Limited. (2018). Annual report

Exercises:

Choose the correct answer

1. In relation to provisions, for a present obligation to exist, which one of the following factors must be present?
   - A The entity must have a legal obligation.
   - B There should be a future outflow of economic benefits.
   - C The obligation must be capable of being reliably measured.
   - D The entity must have no realistic alternative to settling the obligation.

2. ABC Co. is involved in legal dispute with a supplier. The supplier is seeking damages of Nu. 100,000. ABC's lawyers have advised that it is 90% probable that the entity would not be found liable. Which one of the following is most appropriate option for ABC Co. when preparing its financial statements?
   A Do nothing.
   B Disclose it as contingent liability.
   C Recognize it as a provision in a financial statement.
   D Recognize it as a contingent liability in a financial statement.

3. An oil industry causes contamination and operates in a country where there is no environmental legislation. However, the enterprise has a widely published environmental policy in which it undertakes to clean up all contamination that it causes. The enterprise has the record of honoring this published policy.
   Which one of the following is most appropriate option for oil industry when preparing its financial statement?
   A Do nothing since there is remote possibility of payment.
   B Disclose it as a contingent liability since there is no legal obligation to make a payment.
   C Disclose it as a provision in the notes of the financial statements since there is no legal obligation.
   D Recognize it as a provision since there is an obligating event, which give rise to a constructive obligation.

4. An entity is taking legal action against its competitor for patent infringement relating to a patent that had been granted to the entity on one of its products. The outcome of the case is uncertain. However, it is probable that the court will order the competitor to pay damages to the entity.
   Which one of the following is the best option for the entity?
   A Neither asset should be recognized nor contingent asset, should be disclosed.
   B Recognize it as an asset since it is virtually certain that it will receive economic benefits.
   C Disclose it as a contingent asset since inflow of economic benefits is probable, but not virtually certain.
   D Recognize it as a provision since there is a chance that the court would rule in favour of the competitor.

5. A company sells goods with a warranty for the cost of repairs required in the first two months after purchase. Past experience suggests:
   88% of the goods sold will have no defects
   7% will have minor defects
   5% will have major defects

If minor defects were detected in all products sold, the cost of repairs will be Nu. 24,000; if major defects were detected in all products sold, the cost would be Nu. 200,000. What amount of provision should be made?

A Nu. 1,680
B Nu. 10,000
C Nu. 11,680
D Nu. 197,120

Extended Learning Question

1. The following are likely to be provisions within the scope of BAS 37. Justify.
   a. Obligation to repair or replace goods sold if found defective.
   b. Warranty provided for a car sold by a supplier.
2. Paldon Electronics faces 100 warranty claims relating to sale of mobile phones. For each claim, there is a 20% chance that it will not cost the entity anything. There is 80% chance that the cost of each claim will be Nu.100. Using the expected value method, calculate the best estimation of provision.
3. Sonam Electronics faces warranty claims relating to sale of mobile phones. It is determined that there is a 20% chance that it will not cost the entity anything. There is 80% chance that it will cost Nu. 100. Calculate the amount of provision.
4. Do you believe that the reporting of contingent assets will have an effect on the decisions of stakeholders? Why?
5. A retail store has a policy of refunding purchases made by dissatisfied customers. Even though it is under no legal obligation to do so, its policy of making refunds is generally known. Should provision be recognized? Justify using the recognition criteria.

Case Study 1

SDP shop in Thimphu receives a claim for Nu. 50,000 from a customer in respect of injuries suffered when the customer slipped on the wet floor of the shop. The claim is submitted at the court. The shop's defense was that there was a wet floor signpost to warn the customers. However, since the shop floor was poorly lighted, all customers blamed that the signpost was hardly visible. The legal opinion is that the damages could range from Nu.5,000 to Nu. 7,000 depending on the court's opinion on the extent of blame to be attached to the SDP shop.

Required:

1. Differentiate between 'liability' and 'provision'.

2. Discuss whether there is a present obligation arising from past event in the above case.
3. Should provision be recognized?

Case Study 2

Sheka Enterprise deals with cosmetic products located in Haa. Dawa is a regular customer who buys face cream from Sheka Enterprise. Of late, Dawa had sued Sheka Enterprise, seeking damages for skin burn sustained from using the cream. Sheka Enterprise disputes liability on grounds that the customer did not follow directions in using the product.

Up to date, the board approved the financial statements for the year ending 31 December 2011; and the entity's lawyers advised that it is probable Sheka Enerprise will not be found liable. However, when the enterprise prepares the financial statements for the year ending 31 December 2012, its lawyers advised that, owing to developments in the case, it is now probable that the entity will be found liable.

Required:

1. Should provision be recognized on 31 December 2011? Why?
2. Should provision be recognized on 31 December 2012? Why?

Chapter 6
Accounting for Equity Shares and Debt Finance

Learning Objectives:

- Explain the concept of equity capital and the characteristics of equity shares
- Differentiate between equity shares and preference shares,
- Explain the concept of debt finance and the characteristics of debt securities,
- Differentiate between equity and debt securities,
- Discuss the advantages and disadvantages of debt finance, and
- Record equity (including issue of bonus and rights shares) and debt capital transactions and report them in the financial statements.

6.1 Conceptual Background

Let us recall the knowledge of accounting equation that we have learnt in chapter 3 in Class XI Accountancy. Accounting equation presents three aspects in business. These are: (i) assets, on one side of the equation (ii) equity and (iii) liabilities on the other side of the equation. This equation is balanced at any point of time. That means, the total of the economic resources of the business is equal to the sum of owners contribution and the contributions made by others other than the owners or members of the business. The contribution from member or owner represents equity and the latter part of the contribution from others represent debt finance of the business.

So far, we have covered many items of assets, liabilities, income and expenses related to the business. Especially in the introductory part of class XI Accountancy we discussed quite at length the recording of those items. That time we used mostly the term transaction or events rather than assets, liabilities, equity, income and expenses. However, as we progress on to class XII, our discussion focus more on these aspects of economic resources and claims against the business from the resource providers. Recall the objectives of financial accounting and financial reporting in business. Business entities are economic units that organize resources and carry out economic activities and at the year end the business entity must report their performance to those resource providers or the equity and debt providers, particularly if the business entity is not operated by the owner himself/herself. Assets are present economic resources which are expected to be used by business to generate income either by itself or to be combined with other assets to generate income for the business. Liabilities are present obligations for providing economic resources or services to the business. These liabilities are also time bound obligations, that means, business must settle these obligations within a certain time period. When business settle these liabilities, there will be an outflow of economic resources which will result in to a decrease of assets in the business. Thus, a business will see a continuous change in the amount of assets and liabilities as and when it carries out economic activities which we have been calling it as business transactions or events.

Also, reflect on those assets and liabilities in the business. Not all the assets in the business are the same. Similarly, liabilities differ from one to another. For example, property, plant and equipment is an asset. However, by nature and so by definition, PPE is a physical asset which is used in the production of goods or providing of services to the customers, or a business uses such asset to as owner occupied for administrative functions or to earn a short term rental income. PPE can be clearly differentiated from the inventory. Inventory is also an asset with physical substance. However, inventory is held by a business for the purpose of sale or used in the production of another type of inventory. What about intangible assets such as purchased brand, patent, legal rights etc.? These are also assets but the major difference with the former assets is that intangible asset does not have a physical substance and some of the intangible assets do not have a finite life such as brand and trademarks.

Now let us think about a case where a business is acquiring some shares or securities issued by another business entity or by a government (e.g. a government treasury bond). Many business entities also continuously depend on the borrowed funds either from banks or other money lenders. If a business has surplus cash, it might decide to invest in corporate bonds, commercial papers and other loan notes, as well as invest in fixed term deposits with commercial banks. We will not touch on complex financial arrangements that create a lot of financial products which we will call it later as financial assets and financial liabilities. In this chapter, we will introduce some of the important concepts on financial instruments, financial assets and financial liabilities. And accordingly, we will discuss and illustrate the accounting methods for these types of assets and liabilities in line with the current accounting standards.

6.2 Financial Instrument

Before we discuss the concepts on financial assets and financial liabilities, let us understand the concept of financial instrument. Financial instruments are notes, document or certificates that carry a promise to pay or receive certain amount of money after a certain period of time. Financial instrument thus involve two or more than two parties because one party will promise to pay and another party will have the right to receive that amount from a party who promises to pay the amount on a certain time. The promise to pay and the right to receive the payment thus give rise to a contract, that is, an agreement that one party promises to pay and the other party has the right to receive the payment on a certain time. Once the contract is created, then it becomes legally enforceable especially under the contract act of the country. For example, in Bhutan, such contracts can be enforceable under The Contract Act of the Kingdom of Bhutan 2013 (འབྲུག་གི་འགན་འཛིན་བཅའ་ཁྲིམས་ སྤྱི་ལོ་ ༢༠༡༣).

The Contract Act of the Kingdom of Bhutan 2013 defines contract as:

An agreement shall amount to a contract and shall be enforceable at law if it is made with the free consent of competent parties for a lawful consideration and for a lawful object and is not declared to be void or illegal by this Act or by any other law in force in the Kingdom of Bhutan (Para 16).

A contract is an agreement between two or more parties that creates enforceable rights and obligations. Enforceability of the rights and obligations in a contract is a matter of law. Contracts can be written, oral or implied by an entity's customary business practices. The practices and processes for establishing contracts with customers vary across legal jurisdictions, industries and entities.

6.2.1 Definition of Financial Instrument

Financial instrument (also called securities) is a contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.
This definition underlines the importance of a contract in accounting for a financial instrument. Without a valid contract we cannot account a financial instrument. When a business enters in to a contract with its customer to sell a goods, business entity promises to deliver the goods as agreed and the customer promises to make the payment or consideration to the business entity. This leads to a formation of a contract and the parties to the contract are expected to perform their obligations as agreed in the contract. In this contract, once the business entity delivers the promised goods to the customer, customer will become liable to make the payments, i.e. the consideration; and the business entity will become entitled to receive the payments. Therefore, the business entity will have the contractual right to receive the consideration and the customer will have the contractual obligation to pay the fixed amount of consideration to the business entity. For a business entity, the contractual right to receive a fixed amount of money from the customer is a financial asset; and for a customer, the contractual obligation to pay a fixed amount of money to the business entity is a financial liability. Since in the contract there is a financial asset for a business entity and a financial liability for a customer, this satisfies the definition of a financial instrument.

Once the contract gives rise to a financial instrument, the parties to the contract will need to account these financial assets and financial liabilities in their books of accounts.

Let us consider the following case.
On 15 April 2020, a business entity sold goods to a customer and a customer promises to pay Nu. 120,000 as a consideration after 3 months. In this case, you will see a business promises to deliver the goods to the customer and a customer promises to pay the consideration of Nu. 120,000 after a period of 3 months. Therefore, business will have the contractual right to receive Nu. 120,000 on 15 April 2020 and the customer will have the contractual obligation to pay Nu. 120,000 after three months from the date of sale.

Thus on 15 April 2020 business entity will recognize a financial asset as follows:

Trade receivables	Dr	120,000	
Revenue from sale of goods	Cr		120,000

Trade receivables is a financial asset and it will be reported as current asset in the statement of financial position of the business entity. The customer will account a financial liability as follows:

Inventory	Dr	120,000
Trade payables	Cr	120,000

Trade payables is a financial liability and this will be reported under current liabilities in the statement of financial position of the customer.

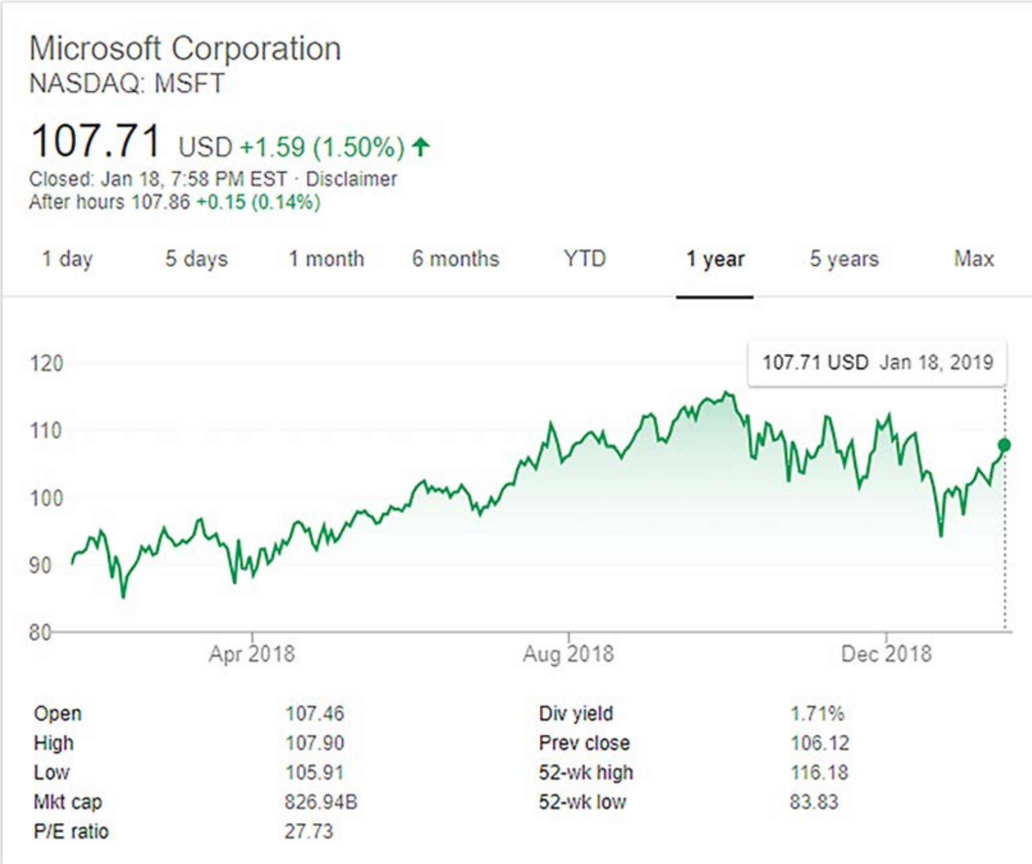
When we apply the definition of a financial instrument in business, it will cover not only those contracts related to sale of goods or services, but also many other contracts such as the issue of equity shares and preference shares to the public, issue of bonds and commercial papers, purchases of other companies' shares and bonds, borrowing short term and long term funds from banks and lending money to other borrowers on a commercial borrowing rates. All these contracts will give rise to financial instruments which we will discuss in the following sections.

6.3 Issue of Equity Shares and Preference Shares

Shares are units of ownership of a business entity measured as a number of units sold in the market or subscribed at the time of formation of a business entity. Each share is measured by putting a value to it at the time of formation of a business entity or when the entity is listed on the stock exchange. The value of shares are calculated as total amount of capital intended to be raised divided by the number of shares to be issued to the subscribers. For example, if a business entity want to raise Nu. 20 million through issue of 100,000 shares, the value of each share will be calculated as Nu. 20 per share. The business entity issue a share certificate to the buyer of shares and he/she becomes the shareholder of the business entity.

A business entity may issue either an equity shares or a preference shares to raise the intended amount of capital from the investors. Equity is defined as the residual interest in the asset of the business after deducting the liabilities (Asset – liabilities = Equity).

6.3.1 Nature of equity shares



6.1 Share price in the stock market

Equity shares come with a higher risk of investment. This means, the investors do not have the right to claim returns on their investment if the business entity fails to generate sufficient income to pay back the equity shareholders. The return on equity investment comes in different forms. Firstly, the general and the most common return on equity investment is paid in the form of a dividend to the investor. Secondly, the equity investor may sell a whole or a part of investment in the market when the share price is favourable. For example, an investor purchases 1,000 number of shares of a business at Nu. 20 on 1 March 2020. His investment amounts to Nu. 20,000 on 1 March 2020. If this investor wish to sell half of his shares in the market when the share price rose to Nu. 25, he gets a return of Nu. 2,500. The equity investor may also be benefitted by issue of rights shares by the business entity. This will be discussed in the later part of the chapter.

Equity investors may be paid a dividend. Dividend is a share of profit earned by the business for the year. The amount of dividend paid to the investor will depend on the amount of distributable profit earned by the business during the financial year. The equity investors do not have the right to claim dividend in case the business has not generated sufficient profit during the year. The business cannot borrow funds from others to pay dividend to its equity investors. Also, we must understand and appreciate that business may not pay dividend to equity investors even if the business entity has generated sufficient profit because the business entity may like to retain the distributable profit in the business and invest the fund in other profitable business projects. Some equity investors would support this investment decision of the business which would generate income or economic benefits to the business in future; while some equity investors might prefer to be paid dividend to them. The later type of equity investors are normally called short term investors. These investors are driven by their short term investment goals rather than seeking growth opportunities of business.

Equity shares carry voting rights that enable the investors vote in the annual general meeting and other forums to make a decision for the business. The equity shareholders of a registered company uses such voting rights to elect the board of directors, auditors and other key managerial personnel as per the Companies Act of the country. We will discuss the method of accounting for dividend in the later part of the chapter.

6.3.2 Preference shares and class of preference shares

As the name suggest, preference shares are shares that carry certain preferential rights in terms of dividend payment and the repayment of investors' money at the time of liquidation of the business entity. We must understand that unlike equity shares, preference shares are classified as redeemable preference shares and non-redeemable preference shares. Redeemable preference shares are issued with the intention to redeem the shares after certain time period. Therefore, redeemable preference shares are treated as a debt finance or a liability. You will learn this in detail in the following sections. On the other hand, non-redeemable preference shares are treated same as equity shares with the difference that preference shares may not carry voting rights.

The redeemable preference shares carry a right to the investors to claim a dividend as a fixed income even at the time when the business entity fails to generate sufficient income to pay the dividend. As such, preference dividend is a fixed charge or an expense to the business entity.

At the time of writing this text, we did not find any business in Bhutan that has issued any type of preference shares though it has several advantages to the business.

6.4 Financial Asset, Financial Liability and Equity Instrument

Let us recall the concept of a financial instrument in the previous sections. Financial instrument is a contract that give rise to a financial asset of one entity and a financial liability or equity instrument of another entity. Take an example of a company that issues a bond on the Royal Securities Exchange of Bhutan Limited (RSEBL) to raise a capital amount of Nu. 30 million. These bonds are issued for a period of 10 years. Can you analyse this contract and see whether there is a financial instrument if the investors have subscribed these bonds.

Obviously, there is a contract between the bond issuing company and the investor when the investor subscribed to these bonds. The issuing company will have received a fixed amount of cash. This creates a contractual obligation to the issuing company to repay not only the principal amount of investment but also an interest what we normally call as 'coupon' on a regular basis (say monthly, quarterly, half yearly) as agreed in the contract. At the same time, the investor will have a contractual right to receive the coupon interest and the principal amount on the date of redemption of the bond, that is, after 10 years. For the issuing company, they will recognise a financial liability while the investor will recognize a financial asset. Therefore, there is a financial instrument in this contract. The issuing company will account financial liability in their accounting system including the coupon interest paid to the investor, and report these expense and financial liability in the financial statements.

a) **Definition of a financial asset**

Financial assets are:

- Cash,
- Equity instruments of another entity (e.g. shares), and
- Contractual right to receive cash or another financial asset of another entity (e.g. trade receivable).

The definition of a financial asset is quite explanatory by itself. However, we must understand that financial assets include cash in hand and cash at bank, investment in other company's shares.

b) **Definition of a financial liability**

Financial liability is a contractual obligation to deliver cash or another financial asset to another entity. This would include issue of bonds, commercial borrowings, issue of other loan notes and commercial papers, trade payables etc.

c) **Equity instruments**

Equity instruments are shares issued by the entity for public subscriptions. Note that we have also discussed about equity instruments of other companies. These equity instruments are financial assets.

d) **Recognition of financial assets, financial liabilities and equity instruments**

An entity should recognise a financial asset or financial liability when the entity becomes a party to the contractual provisions of the instrument rather than when the contract is settled. Financial assets and financial liabilities are derecognized when the contract is settled or when an entity ceases to be a party to the contract.

e) **Issue of bonds and other loan notes**

Bonds or loan notes are financial instruments that carry a promise to pay to the investor a periodic fixed interest called 'coupon' and the principal amount on the date of maturity. Thus, bonds or loan notes are issued for a certain time period and carry a fixed charge of interest like a commercial borrowing. Unlike equity shares, bonds are normally issued at a denomination of Nu. 100 or Nu. 1,000 or more, and are quoted at a fixed coupon interest rate such as 7% Nu. 1,000 bonds. That means, each bond is issued at a nominal value of Nu. 1,000, and that bonds carry 7% coupon interest payable to the investor. Coupons or bond interests are usually paid quarterly, half yearly or annually. Though most of the bonds are issued with a coupon interest, some bonds are issued without coupon payments. These bonds are called deep discount bonds and they are repaid either at par or at a premium. Bonds and other loan notes may be issued as secured or unsecured. A secured bonds are issued with the issuer's pledge of a specific asset (such as an equity shares of another company). In the event of default, the investor can recover the investment from the asset.

f) **Effective interest rate**

We must understand the difference between coupon interest rate and the effective interest rate in the issue of bonds and loan notes. While the coupon interest is a periodic interest payment made to the investor on calculated on the nominal value of the investment, effective interest rate is the rate of return expected by the investor on his investment which is calculated as a compound interest or an internal rate of return (IRR). For the calculation of the effective interest rate, an entity estimates the expected cash flows considering all contractual terms including any fees, transaction costs, and other premiums or discounts. Because transaction costs are included as part of the initial carrying amount of the financial instrument, the recognition of these costs in profit or loss is spread over the term of the instrument through the application of the effective interest method.

Financial assets can be categorized in to two types.

Financial Assets

- **Debt Instrument**
  (Contractual right to receive fixed amount of cash)
- **Equity Instrument**
  *(**No** contractual right to receive fixed amount of cash)*

Figure 6.2 Classification of financial assets

6.4.1 Classification and Accounting of Financial Assets

Financial assets can be acquired either in the form of a debt asset (e.g. an investment in bonds, trade receivables) or an equity instrument of other entity. Financial assets must be classified and accounted by following one of three methods:

1) amortised cost,
2) Fair Value Through Profit or Loss (FVTPL) or
3) Fair Value Through Other Comprehensive Income (FVTOCI)

In this text we will discuss and apply the first two methods. By default, all financial assets that are debt instruments are classified and accounted as at amortised cost method and financial assets that are equity instruments are classified and accounted as at FVTPL method.

Financial assets that are classified as at amortised cost are initially measured at fair value plus transaction costs. Subsequently, the financial asset is accounted using the amortised cost method. See the example below.

Example:

Company A purchased bonds of company B with a nominal value of Nu. 1,000 at the beginning of 2020 for Nu. 1 million. Transaction cost in relation to the purchase of bonds was Nu. 5,000. Company B paid 8% coupon annually. The bond matures in three years. Effective interest rate is 10%.

In the above example, Company A has the contractual right to obtain a fixed coupon payment for three years paid annually as well as the principal amount after three years when the bond (debt instrument) matures. Company B has the contractual obligation to deliver cash for three years paid annually in the form coupon interest and the principal amount when the bond matures. Thus, Company A recognizes a financial asset and Company B recogises a financial liability.

The financial asset will be initially measured as follows:

Nominal value	Nu. 1,000,000
Transition cost	Nu. 5,000
Total amount	**Nu. 1,005,000**

On the date of purchase of debt instrument, Company A will pass the following entry.

Financial asset Dr 1,005,000
Cash Cr 1,005,000

Table 1: Accounting in the subsequent years (after initial recognition)

Year	Cost	Effective interest (10%)	Coupon interest (8%)	Carrying Amount
2020	1,005,000	100,500	80,000	1,025,500
2021	1,025,500	102,550	80,000	1,048,050
2022	1,048,050	104,805	1,072,855	

At the end of third year, Company A will be repaid Nu. 1,072,855. This include the amount of investment plus any interest payable on the investment. See the total effective interest over three years is Nu. 307,855 whereas the total coupon interest paid over three years is Nu. 240,000. This means, Company A has received only Nu. 240,000 interest out of Nu. 307,855 interest. The difference of Nu. 67,855 is accounted and received along with the initial investment made in the bond (inclusive of transaction cost) as a repayment at the end of third year, i.e. 1,005,000 + 67,855.

At the end of first year, Company A will recognize an income of (equivalent to effective interest) of Nu. 100,500 and receive a coupon interest of Nu. 80,000. These will be recorded as follows:

Financial asset Dr 100,500
Interest on financial asset Cr 100,500

Cash Dr 80,000
Financial asset Cr 80,000

Similarly, in the second year, Company A will recognize Nu. 102,550 as interest income while it will receive a coupon cash interest of Nu. 80,000.

Financial asset Dr 102,550
Interest on financial asset Cr 102,550

Cash Dr 80,000
Financial asset Cr 80,000

In the third year, when the bond matures, Company A will be paid Nu. 1,072,855. This will be recorded as follows:

Financial asset Dr 104,805
Interest on financial asset Cr 104,805

Cash Dr 1,072,855
Financial asset Cr 1,072,855

6.4.2 Accounting of financial asset (Equity instrument)

When a business entity acquires equity shares of another entity, this will be treated as acquiring an equity instrument. By default, equity instruments are classified and accounted as at FVTPL. When FVTPL method is applied, the equity shares must be remeasured subsequently at the fair value. Fair value of equity shares can be obtained from the stock exchange if the shares are actively traded on the stock exchange. Otherwise, entity must apply other alternative ways to obtain a fair value for such shares. The alternative method may include valuation of equity shares by using discounted cash flow or dividend methods. The valuation method will not be covered in this text.

When the equity shares are remeasured at fair value, the difference between fair value of equity and its carrying amount will be treated in the income statement. That is why, this method is called fair value through Profit or loss method. If the business entity chooses this method, any change in the fair value of the equity instrument will immediately affect the performance of the entity.

Example:

KCT Company acquired 10,000 equity shares of LNT Company at Nu. 20 per share in April 2020. These shares were traded at Nu. 23 on the stock exchange in December 2020 and KCT Company measured the shares on 29 December 2020 when the company was finalizing its accounts for 2020. It cost KCT Company Nu. 5,000 as acquisition cost.

In this example, KCT Company will measure the equity instrument initially at Nu. 200,000 that is the fair value of the shares.

Financial asset (equity instrument)	Dr	200,000	
Cash	Cr		200,000

Shares acquisition expense	Dr	5,000	
Cash	Cr		5,000

Subsequently, equity shares will be remeasured at fair value and the difference between carrying amount and fair value will be posted to the income statement.

Carrying amount of equity shares	Nu. 200,000
Fair value (as per stock market)	Nu. 230,000
Change in fair value (difference)	Nu. 30,000

Financial asset	Dr	30,000	
Income due to change in FV	Cr		30,000

In the statement of financial position as at 31 December, the financial asset (equity instrument) will be reported at Nu. 230,000 instead of Nu. 200,000.

6.4.3 Classification and accounting of financial liabilities

Financial liabilities by default are classified and accounted as at amortised cost. This means, the carrying amount of the debt is not adjusted for a change in the market interest rate. However, the carrying amount of the debt is increased by the effective interest rate and reduced by the amount of coupon interest rate paid to the investor. Unlike FVTPL method as discussed in the previous section, amortised cost method ignores change in the fair value of the financial liability and thus does not affect the income statement. Effective interest is treated as a finance cost for raising the capital.

Financial liabilities are initially recognized at fair value less transaction costs.

Example:

A Construction Company (CC) raises finance by issuing Nu. 2 million 6% four-year bonds on the first day of the current accounting period. The bonds are issued at a discount of 10%, and will be redeemed after four years at a premium of Nu. 111,469. The effective rate of interest is 12%. The issue costs were Nu.10, 000.

In this example, Construction Company (CC) has received cash from the investor and thus creates a financial liability that it need to repay. The liability will be classified and accounted for at amortised cost unless it is indicated to be classified as fair value through profit or loss (FVTPL), and, thus, initially measured at the fair value of amount received less the transaction costs. The initial measurement will be done as follows:

Nominal value of bond	2,000,000	
After discount value	1,800,000	(90% of 2,000,000)
Less: Transaction cost	(10,000)	
Initial recognition amount =	**Nu. 1, 790,000**	

Year: Beginning

Cash	Dr	1,790,000	
Financial liability	Cr		1,790,000

Year	Cost	Effective interest (12%)	Coupon interest (6%)	Carrying Amount
Year 1	1,790,000	214,800	120,000	1,884,800
Year 2	1,884,800	188,480	120,000	1,953,280
Year 3	1,953,280	195,328	120,000	2,028,608
Year 4	2,028,608	202,861	120,000	2,111,469

Year 1: Year end

Finance cost	Dr	214,800	
Financial liability	Cr		214,800

Financial liability	Dr	120,000	
Cash	Cr		120,000

The accounting treatments of the finance cost and coupon interest will remain same for the remaining three years. In fourth year, Construction Company will need to repay a total amount of Nu. 2,111,469 (2,000,000 nominal value + 111,469 premium).

Finance cost	Dr	202,861	
Financial liability	Dr		202,861

Financial liability	Dr	2,111,469	
Cash	Cr		2,111,469

The total effective interest of Nu. 801,469 can be verified as follows:

Coupon interest paid	480,000
Discount allowed	200,000
Transaction cost	10,000
Premium paid	111,469
	801,469

6.5 Regulations of Bonds Issue

The issue of bonds are regulated by the financial or capital market authorities. In Bhutan, the Regulations for Issue of Corporate Bond, 2012 guides the issue of bonds. It defines 'bond' as a long term debt sold to the investors by the issuer. Corporate bonds in Bhutan are secured and issued at a face value of Nu. 1,000. These bonds are so far issued at 6-10% coupon rate and for a period of 7-10 years. Ownership of a bond certificate carries certain rights. The regulations of corporate bond issue protect the interest of investors and ensure efficient market for issue of bonds. On purchase of bonds, individual bondholders acquire two rights:

i) The right to receive the face value of the bond at a maturity date, and

ii) The right to receive periodic interest payments, usually semi-annually or yearly, at a specified percent of the bond's face value.

The use of corporate bonds to raise long term debt finance in Bhutan is a recent development as indicated by the increasing number of companies issuing bonds. As of August 2019, there are 19 companies that have issued corporate bonds on the Royal Securities Exchange of Bhutan Limited (RSEBL).

Table 3: Listed bond in RSEBL

Sl.No.	Name	Maturity Period (Year)	Rate (%)	Effective date	Maturity date
9	TBL DEBTS (G021)	10 Years	6.00	2014-04-09	2024-04-08
10	BDBL DEBTS (G020)	10 Years	6.00	2014-04-09	2024-04-08
11	BNBL DEBTS (G018)	10 Years	6.00	2014-04-09	2024-04-08
12	RICB DEBTS (G017)	10 Years	6.00	2014-04-09	2024-04-08
13	BIL DEBTS (G016)	10 Years	6.00	2014-04-09	2024-04-08
14	DPNB DEBTS(G015)	10 Years	6.00	2014-04-09	2024-04-08
15	DAC BONDS - I (G013)	10 Years	9.00	2014-02-28	2024-02-27
16	RICB BONDS - III (G012)	7 Years	9.50	2014-01-15	2021-01-14

Box 6.1 Issue of bond

Dungsam to raise another Nu 1.5B in bond

Bond: The Dungsam Cement Corporation Limited (DCCL) has floated its third series of bond worth Nu 1.5B (billion) at eight percent coupon rate to prepay the company's high interest bearing loans.

However, Nu 1.2B of the total issue size has been privately placed to commercial banks. Bank of Bhutan was allotted Nu 935M (million), Druk PNB was allotted Nu 250M and Bhutan Insurance Limited was allotted Nu 15M. This leaves behind Nu 300 for public issue.

An official from Druk Holding and Investment (DHI), Dungsam's parent company, said private placement of bond was issued because the market cannot absorb the total size of bond issued. "We are not quite sure whether Nu 300M would be fully subscribed or not," he said.

This was because the coupon rates are competitive. Royal Insurance Corporation of Bhutan Limited (RICBL) has also issued Nu 1.5B corporate bond at 9.5 percent coupon rate. Both DCCL and RICBL have the same face value of Nu 1,000 a unit with maturity of seven years.

This, the official said has attracted some financial institutions and individual investors. He said a meeting was held with all the financial institutions in February this year and most of them were committed to invest in the bond. But when RICBL's fourth series of bond was issued, few banks chose to invest in RICBL.

DCCL has an outstanding debt of Rs 1.13B availed from a consortium financing of State Bank of India, Union Bank, Punjab National Bank, Export and Import bank of India. With the bond issued, the company expects to prepay Rs 1.05B.

This according to official would lower the cost of borrowing. For the same, DCCL also borrowed about Nu 530M from Druk Green Power Corporation at five percent interest.

In an earlier interview, the chairman of DHI, Dasho Sangay Khandu said this is an inter-corporate borrowing approved by the DHI board to reduce the cost of borrowing by pre paying some high interest bearing loans.

DHI also serves as a guarantor for the bond issued and is liable if the obligations are not met. This is because bond is a debt instrument issued by a company when it wants to raise money from the public to invest in various areas or to meet its debt obligation.

Unlike shares, which are equities, bonds are debt instruments. When an individual subscribes to a bond, he does not hold any ownership in the company, rather the company is obliged to pay back the investment made by the individual with interest.

Bonds are less risky, as they are secured against a company's assets.

Dungsam floated bonds worth Nu 700M in October last year and another bond worth Nu 1.2B in March, the same year. The second series bond of Nu 700M was used to pre-pay the loan with NPPF.

Kuensel, May 20, 2015

6.6 Treasury Bills

Treasury bill is a debt instrument issued by the Government to mobilize fund from the market. It is a market instrument which can be negotiated and traded freely. As per Operation Guidelines of the Government regarding the issue of treasury bills, the maturity period varies between 30 days to 364 days. Generally, it can be used for financing temporary revenue shortfalls in the government budget. This approach is a market based system practiced internationally that supports the development of domestic debt and money market. The treasury bills are usually issued at discounted rate and repaid at face value. For example, if the face value is Nu.100 and interest rate 5%, it will be issued at Nu.95 repayable at Nu.100.

Treasury bills with short term maturity of less than 90 days qualify as cash equivalents of a business entity which can be converted into a known amount of cash without a significant risk. The other treasury bills with maturity dates of more than 3 months should be treated as current liabilities.

Investment in Treasury Bills

Financial asset (TB) Dr (Net of discount, if any)
 To cash

Financial asset (TB) Dr (interest income)
Interest income

Cash Dr (Interest received)
Financial Asset Cr

Cash Dr
Financial asset Cr (redemption of TB)
Accrued interest on investment

6.7 Commercial Papers

Commercial Paper (CP) is a money market instruments that are issued for a specified amount and are payable on a fixed date. The CP shall be issued for a maximum maturity period of one year (Guidelines for public issue of Commercial Papers, 2017). Companies may raise short term capital through issuance of commercial papers, if:

i. The net worth of the company is not less than Nu. 5 million as per the latest audited financial statements.

ii. Instrument is backed by collaterals such as time deposits, receivables, inventories and other qualified assets alternatively. The company may also seek corporate guarantee from its holding company; or financial guarantee or standby credit facility from any financial institutions, provided that the issuer and the financial institutions are not related parties as defined in the Financial Services Act, 2011.

The Guidelines further stipulates that:

i) Commercial papers are issued in a denomination of Nu. 100,000 and multiples thereof.

ii) CPs shall be issued for a maximum maturity period of one year from the date of issue.

iii) The size of the CP to be issued shall not exceed more than the value of the collateral, or the extent of the guarantee or standby credit facility provided.

Box 6.2: Treasury bill auction notice by RMA

Treasury Bills of Nu. 3,000 million in the name of the Royal Government of Bhutan is offered for sale. The Bills shall be auctioned under Multi-price Method and issued through the Royal Monetary Authority of Bhutan.

Submission of Tenders : Tenders must be submitted in sealed envelope to Director, Department of Banking, RMA not later than 9:30 AM on JUNE 24, 2020 and tenders shall be irrevocable after submission.

Treasury Bills No.	R 322
Auction/Settlement Date	JUNE 24, 2020
Days to Maturity	41
Maturity Date/Settlement Date	AUGUST 04, 2020
Amount	Nu. 3,000 million

Eligibility : Any Bhutanese persons including firms, companies, corporate bodies, financial institutions, trusts etc. can subscribe the Bills.

Need for and advantages of debt finance

The debt finance increases the return on common stock which directly benefit shareholders. However, the use of debt also has risks and costs. Debt increases solvency risk, and therefore it may hamper the required return to shareholders. Further, net income is reduced by interest paid on debt. The cost of debt finance can also be negotiated with the lending institutions. The interest expense on debt finance provides a tax shield to the borrowing entity.

6.8 Accounting of Commercial Loan and Loan Amortization

A business entity may enter in to contract with commercial banks and other financial institutions to borrow funds at a certain interest rate. The difference between a commercial loan and bond is that bond is traded on the stock exchange and is denominated like a share called a nominal value. Bonds also carry a coupon interest rate which may or may not be equal to an effective interest rate. Commercial loans are more common than the issue of bonds in the market. In the following example, we will illustrate how a business entity account a commercial loan through loan amortization over the loan period.

Example:
Lucky Company took Nu. 3.5 million commercial loan from AB Bank at 7 % interest rate. The loan will be repayable within 5 years.

How do we approach the loan repayment? Before we recognize a loan interest expense and amortise the loan, we need to find out the loan installment payment amount.

Given:
The loan amount of Nu. 3.5 million
Loan period of five years, and
Loan interest rate of 7 %
Go to annuity table and find out the annuity factor for 7% interest for 5 years.
Annuity factor = 4.100

Loan instalment amount = 3,500,000/4.100 = Nu. 853,659

Year	Loan Amount	Installment Payment	Interest Component	Principal Amount	Carrying Amount
Year 1	3,500,000	853,659	245,000	608,659	2,891,341
Year 2	2,891,341	853,659	202,393.90	651,265	2,240,077
Year 3	2,240,077	853,659	156,805.38	696,853	1,543,224
Year 4	1,543,224	853,659	108,025.66	745,633	797,591
Year 5	797,591	853,659	55,831.36	797,827	(236)

Accounting entries in the first year:

Bank Dr 3,500,000

Financial liability (loan) 3,500,000

Financial liability (loan repayment) Dr 608,659

Finance cost (loan interest) Dr 245,000

Cash Cr 853,659

Accounting entries in the subsequent years will remain same for recognition of finance cost or loan interest and the loan repayment till fifth year. For reporting in the financial statements, the proportion of loan amount payable within the next accounting year should be presented as current liability and the remainder will be presented as non-current liability. In the above example, the financial statements in the first year should split the carrying amount of Nu. 2,891,341 into current and no-current portion of liability. Of the carrying amount of Nu. 2,891,341, Nu. 651,265 should be presented as current liability and Nu. 2,891,341 as non-current liability.

6.9 Terminologies Used in Share Capital

Companies Act normally provides different nomenclature for shares of the company. These are referred to as authorised, issued, called-up and paid-up share capital. Students must be familiar with these nomenclatures.

Authorised (or legal) capital. This is the maximum amount of share capital that a company is empowered to issue. The amount of authorised share capital varies from company to company, and can change by agreement. For example, a company's authorised share capital might be 2,000,000 ordinary shares of Nu. 10 each. This would then be the maximum number of shares it could issue, unless the maximum were to be changed by agreement.

Issued capital. This is the par amount of share capital that has been issued to shareholders. The amount of issued capital cannot exceed the amount of authorised capital. Continuing the example above, the company with authorised share capital of 2,000,000 ordinary shares of Nu 10 might have issued 1,000,000 shares. This would leave it the option to issue 1,000,000 more shares at some time in the future. When share capital is issued, shares are allotted to shareholders. The term 'allotted' share capital means the same thing as issued share capital.

Called-up capital. When shares are issued or allotted, a company does not always expect to be paid the full amount for the shares at once. It might instead call up only a part of the issue price, and wait until a later time before it calls up the remainder. For example, if a company allots 500,000 ordinary shares of Nu. 10, it might call up only, say, 75 cents per share. The issued share capital would be Nu. 5,000,000, but the called-up share capital would only be Nu. 3,750,000.

Paid-up capital. When capital is called up, some shareholders might delay their payment (or even default on payment). Paid-up capital is the amount of called-up capital that has been paid. In the statement of financial position, companies report the paid up capital.

NOTE 5.22- SHARE CAPITAL

	As at 31.12.2018	As at 31.12.2017	As at 01.01.2017
AUTHORISED CAPITAL			
100,000,000 Shares of Nu. 100 each	10,000,000,000.00	10,000,000,000.00	10,000,000,000.00
ISSUED AND PAID-UP CAPITAL			
	30,000,000,000.00	30,000,000,000.00	30,000,000,000.00

* Out of the above, 27,000,000 shares of Nu. 100 each were issued as fully paid Bonus shares by way of capitalization of Reserves.

Source: Annual Report, BOBL 2018

6.9.1 Issue and transfer of shares

Shares of a public limited companies or a listed companies can be transferred from one investor to another through a stock exchange trade facilitations. Companies listed on stock exchange, for example, Royal Securities Exchange of Bhutan Limited are quoted, which means the market value of the shares are quoted. Market value of shares is the price at which an investor is prepared to purchase shares of the company from the current shareholders. Let us say a shareholder of company A is currently holding 1000 shares at Nu.10 and he intends to sell these shares at Nu.11 each. This transfer of shares from one investor to another will not affect the financial position of company A. Apart from updating the shareholders register, company A need not bother with the transfer of shares from one to another investor. As such, a company need not make any accounting records for transfer of shares. Shares in private companies do not change hands very often, hence their market value is often hard to estimate.

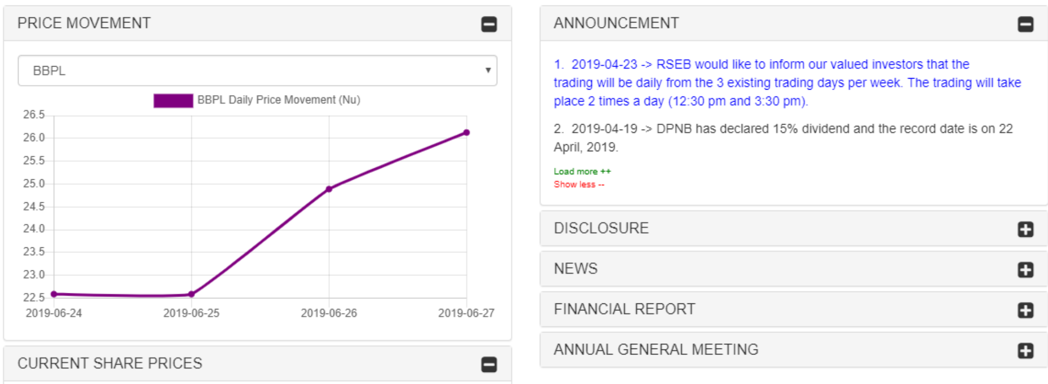


Figure 6.3 Share price movement

There are twenty one listed companies on the securities exchange as of August 2019. The shares of these companies are traded on the securities exchange facilitated by the stock exchange brokers. The market value of shares and the trading volumes of shares are accessible on the securities exchange.

Entity raising finance must be able to classify the financial instrument either as financial liability (debt) or equity instrument (shares). This distinction is so important as it will directly affect the calculation of the debt equity or a gearing ratio. Debt equity ratio measures the proportion of debt finance in the overall capital structure of the entity. Too much of debt finance will erode the equity value and increase the financial risk. The business will also have huge interest cost to service the debt. The distinction will also affect the measurement of profit as the finance costs associated with financial liabilities will be charged to the income statement, thus reducing the reported profit of the entity, while the dividends paid on equity shares are an appropriation of profit rather than an expense.

Equity instruments are initially measured at fair value less any issue costs. Usually equity shares are recorded at a nominal value, with the excess amount received recorded in a share premium account and the issue costs being written off against the share premium.

Example:

A Company issues 1,000,000 equity shares at Nu. 10 for cash consideration of Nu.12.50 each. Issue costs are Nu.100, 000.

In the above example, the company has raised finance (received cash) by issuing financial instruments. Equity or ordinary shares have been issued, thus the entity has no obligation to repay the monies received; rather it has increased the ownership interest in its net assets. As such, the issue of ordinary share capital creates equity instruments.

The issue costs are written off against share premium.
The issue of ordinary shares can be recorded by making the following entries.

Cash	Dr	12,400,000			
Ordinary shares			Cr	10,000,000	[Nominal value]
Share premium	Cr			2,400,000	

The cash amount of Nu. 12,400,000 is after deducting the issue cost of Nu. 100,000. The nominal value of Nu. 1,000,000 equity multiplied by Nu. 10 i.e. Nu. 10,000,000 is recognized as ordinary share capital and Nu. 2,400,000 (after deducting the issue cost) is credited to share premium account. The share premium money may also be used for issue of bonus shares. However, it cannot be used for all purposes.

If the shares being issued were redeemable, such as redeemable preference shares, then the shares would be classified as financial liabilities (debt) as the issuer would be obliged to repay back the monies at some stage in the future.

6.9.2 Measurement of equity instruments

Equity instruments are NOT re-measured. Any change in the fair value of the shares is not recognised by the entity, as the gain or loss is experienced by the investor, the owner of the shares. Equity dividends are paid at the discretion of the entity and are accounted for as reduction in the retained earnings, so have no effect on the carrying value of the equity instruments.

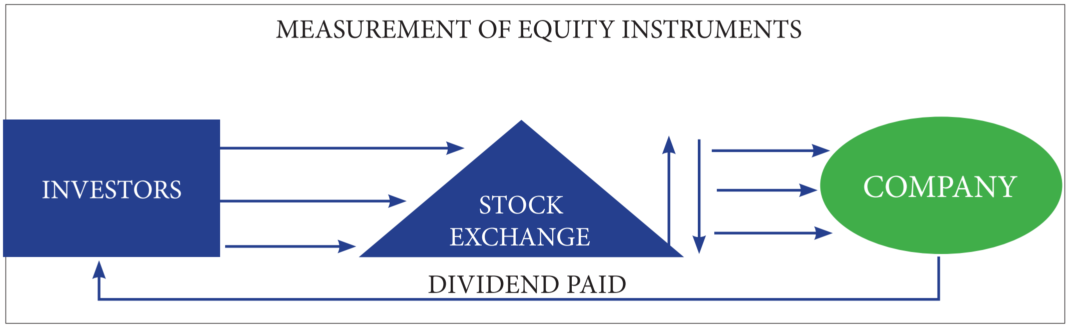


Figure 6.4 Measurement of equity instruments

6.9.3 Components of equity

The equity of the business entity consists of paid up share capital, reserves and retained earnings. Share capital is the permanent investment of business owners in the business. Shareholders are the owners or members of the company as long as they continue to hold those shares they subscribed on formation of the company or subscribed later from the primary and secondary markets.

6.9.4 Reserves

Reserve means an appropriation of profits or other surpluses to strengthen the liquid resources of the business entity. The company may create any type of reserve forming a part of the equity or shareholders' fund. General reserve is one that is often used in companies which represent the part of shareholders' fund. General reserve may be used for both known and unknown future obligations. There are also other types of reserves such as revaluation reserves that arise from the upward revaluation of non-current assets. The revaluation reserves are capital in nature and it cannot be used to pay dividends to shareholders. The creation of reserves depend on the company's financial management policies and attitude towards risk. Most of the reserves are created by transferring profit from retained earnings. The entry for transferring profit from retained earnings to reserve is given below.

Retained earnings a/c Dr
To general reserve/reserve a/c
(Recognition of general reserve/reserve)

The significance of this is that the management of the company want to signal to shareholders and others that they do not intend to pay profits as dividends but apply such funds in growth and development projects.

The above entry will not change the shareholders' fund position as this is simply a transfer from one component to another component of shareholders' fund. The statement of changes in equity requires management to show all changes in equity resulting from profit or loss, contributions by and distribution (dividends) to owners during the reporting period.

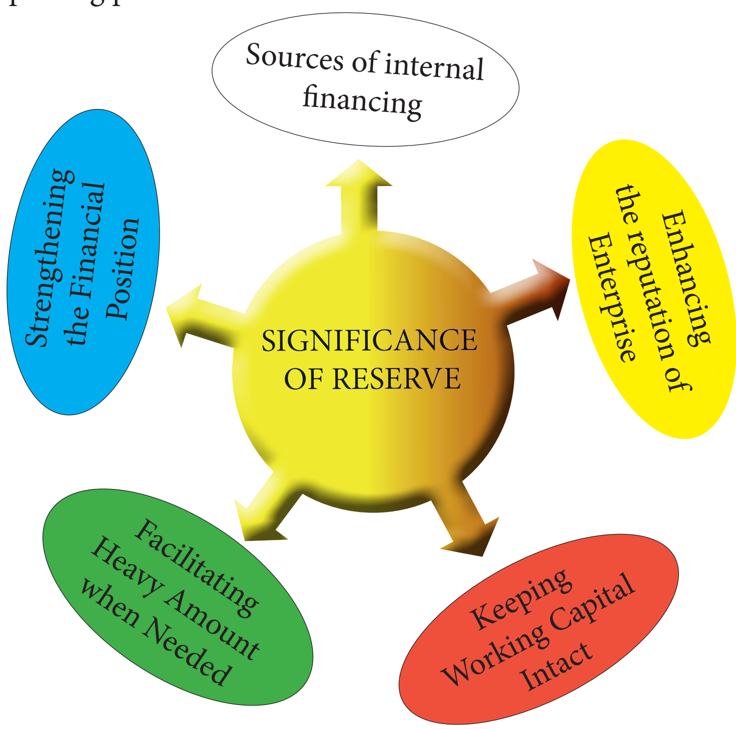


Figure 6.5 Significance of reserves

6.9.5 Retained Earnings

Retained earnings represent the net income earned by a company over its life that has not been distributed as dividends to shareholders. In fact, the total shareholders' fund is equal to the share capital contributed by shareholders and the retained earnings. Various reserves are created out of retained earnings.

Shareholders' fund = Share capital + Retained earnings

Retained earnings is an amount of net income accumulated over the entire life of the company and does not represent net income and dividends of a specific year. The amount of retained earnings does not mean that shareholders have the right to claim.

Retained earnings link income statement with the statement of financial position. That is, the net income from income statement is transferred to retained earnings and after deducting dividends (and any amount transferred to reserves), the balancing figure is transferred to statement of financial position in the equity section. This is depicted in the diagram below.

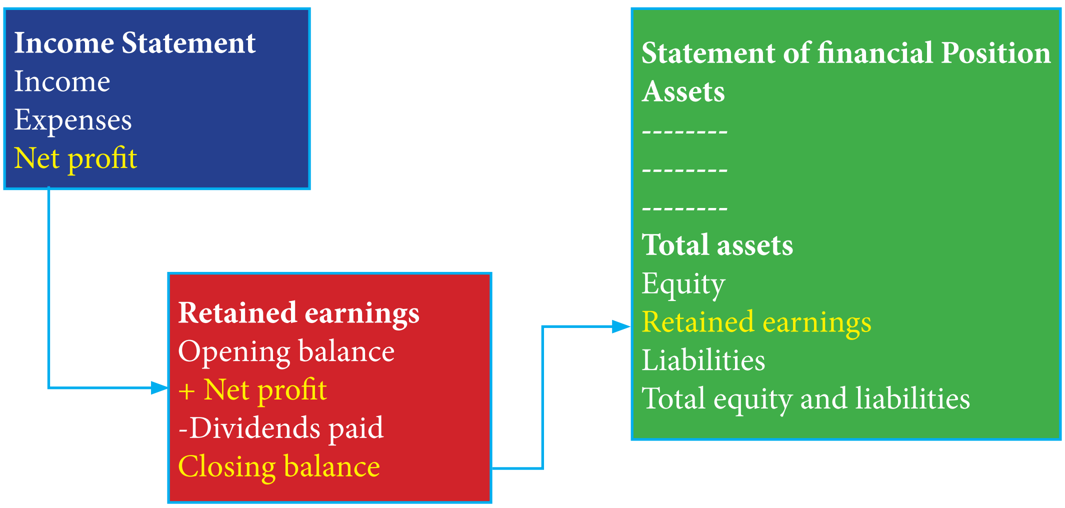


Figure 6.6 Link between income statement and statement of financial position

6.9.6 Issue of bonus shares

Sometimes a company issues new shares called bonus shares which is also called scrip issue to its existing shareholders without consideration. Literally, this means shares are issued without receiving any cash payment from the shareholders. Does that make any commercial sense? Yes, there are number of reasons why companies issue bonus shares even though no cash or consideration is received from issue.

Some of these reasons are explained below.

i. Bonus shares can be issued to existing shareholders in place of cash dividend. This means, if the company has shortage of cash, company can use scrip issue or bonus shares to reward their shareholders.

ii. Bonus shares has the effect of increasing the number of issued shares in the market. This will prevent increase in share price which will promote new investment for the company.

iii. Bonus shares issue will also boost confidence of shareholders when the company invest cash resources for new investment projects without disbursing to the shareholders as dividend payments.

iv. Bonus share issue will also retain the control of the company within the existing shareholders rather than splitting the control over increasing number of shareholders.

The number of bonus shares issued will depend on the number of shares already issued. Generally, a proportion or a ratio is used to decide the number of issue of bonus shares. For example, a company may use proportions such as 'one for three' or 'one for five'. This means, for every three or five shares owned by the shareholder one new share will be issued. This will be recorded as follows:

Share premium or retained earnings a/c Dr
    To share capital Cr

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T BANK   T BANK LIMITED

Your Personal Bank

TBL/HQ-CSCO/RSEBL/5-2018/974   **13 March 2018**

Chief Executive Officer
Royal Security Exchange Bhutan Limited
Thimphu
Bhutan.

Dear Sir,

Subject: T-Bank Limited – Bonus Issue

Referring to the RMA's letter no. RMA/FRSD/34/2016-17/2391 dated December 2016, all the banks are required to increase the minimum paid-up capital to Nu.600 million by 1st January 2019. To comply with the above directive, the bank has approached RMA for approval of issuance of bonus share and right issue.

Accordingly, RMA vide it letter no. RMA/FRSD/28/2017-2018/4431 dated 7th March 2018 (enclosed) has approved issuance of bonus share at the ratio of 3:1.25 (amounting to Nu.125 million from the General Reserve) and remaining of the capital through right offer. The proposal also discussed and approved during the 36th Board Meeting held on 9th March 2018 and was ratified by all the shareholders during the 8th ADM held on 9th March 2018 to issue bonus share at the ratio **of 3:1.25** to the shareholders.

In line with your rules Governing the Official Listing of **Securities Chapter 6, subsection 9**, we would like to request you to kindly accord necessary approval accordingly and also to set the record date as **21st March 2018** for the eligibility of bonus share.

Example

A company raised Nu. 200 million five years ago by issuing 20 million shares at Nu. 10 each. In order to keep up the dividend culture of the company, the company management decided to issue bonus shares of 3 for 8 in the current accounting period. Company has a share premium amount of Nu. 80 million which will be used to pay the bonus shares.

In the above example, a company is issuing bonus shares at the ratio of 3:8.

Total number of shares in issue	= 20,000,000 shares
Number of bonus shares issued	= 20,000,000 x 3/8 = 7,500,000 shares
Nominal value of shares	= Nu. 10

Therefore, bonus share capital = 10 x 7,500,000 = Nu. 75,000,000

As per the management decision, share premium will be used to issue bonus shares. This will be recorded as:

Share premium	a/c	Dr 75,000,000	
To share capital			75,000,000

The balance of share premium in the statement of financial position is now reduced to Nu.5 million.

6.9.7 Rights issue

Companies also issue shares in the form of rights issue to its existing shareholders but for a consideration or a price money. However, the rights issue is made at a price below current market value. This encourages existing shareholders to invest in company's shares so that it can help company to meet its demand for fund. As discussed in bonus shares, rights issue can also help companies to retain its control in the hands of the existing shareholders by increasing their shareholdings. The rights issue is made on the same basis as bonus shares among the existing shareholders using the fixed ratio such as 'one for two' or 'two for five' shares owned by the shareholders. However, unlike bonus shares, the shareholders have the option as to whether to buy the new shares or not. Though rights issue is made at a price below market value, the share price will definitely be above the nominal value which may not attract shareholders to make additional investment in the same company. If the shareholders choose not to buy the new shares, company may not be able to raise share capital through such rights issue. Thus, there is no guarantee that company can raise funds through rights issue.

3.1M unsubscribed DPNB rights issues goes for auction

June 14, 2018 News Leave a comment 1,917 Views

About 3.1M unsubscribed rights issue of Druk PNB (DPNB) shares is on auction in the market.

This is the first time that unsubscribed shares are put up for auction in the market. Earlier the company took back the unsubscribed rights issue.

Rights issue is an issue of shares offered at a special price by a company to the shareholders in proportion to their holding of old shares.

The DPNB Bank last month announced rights Issue of 9:5, meaning for every 9 shares, the shareholders can purchase 5 shares at Nu 15 per share against the market price of Nu 26.

Example

A limited company makes a right issue to its existing shareholders for 2 for 5 shares at Nu. 12 per share. These shares are currently traded at Nu. 15 on the market. Shares were originally issued at Nu. 10. There were 3 million shares on issue.

In the above example, company will issue 3 shares for every 5 shareholding of the existing shareholder.

Existing shares issue = 3 million (Nu. 30 million)
Rights issue = 2 for 5 shares
Number of right shares = 2/5 x 3,000,000 = 1,200,000 shares (= Nu. 12 million)

Bank	Dr	14,400,000	
Share capital	Cr		12,000,000
Share premium	Cr		2,400,000

After issue of rights shares, company's share capital will be Nu. 42 million (30 million + 12 million). Total equity will be Nu. 44.4 million.

Box 6.3: Right issue

DPL shares oversubscribed in the rights auction

Despite suffering losses for the sixth consecutive year, the Dungsam Polymer Limited shares in the auction was oversubscribed by 7,315 number of shares. The DPL issued 7,000,000 rights shares to raise Nu 70 million at the face value of Nu 10 per share at the ratio 8:7 (For every 8 shares, 7 rights shares). The subscription opened from October 22 to November 14 this year.

By the end of the subscription period, 668 existing shareholders subscribed a total of 3.8M shares. The remaining 3.15M unsubscribed shares was auctioned in the secondary market. On the closing date of the rights auction, a total of 25 bidders placed orders for 3.16M shares at multiple pricing starting from Nu 11 to Nu 23 a share. Rights offer is an issue of shares offered at a special price by a company to its existing shareholders in proportion to their holding of old shares.

Unlike in the past where the company offering rights issue took back the unsubscribed shares, the Royal Securities Exchange of Bhutan (RSEB) has developed new regulation to auction the unsubscribed shares through its online platform. This makes it possible for individuals who don't own DPL shares to participate. However, the company can only claim the initial offer price, which is Nu 10 a share. Anything above Nu 10 goes to the existing shareholders who did not subscribe to the rights issue since it culminates into selling their rights to others.

For instance, if an existing DPL shareholder has one share and that person did not subscribe the rights issue, his rights will be put up in the auction. If it is sold at Nu 15 in the auction, Nu 10 will go to the company and this shareholder will get to keep the remaining Nu 5. This new practice, according to the officials from the RSEB would provide everyone an opportunity to participate in share trading. Consequently, the total market value of shares in the country has increased from Nu 28B in mid-June to Nu 31.29B in August this year, up by over Nu 3B in a period of about two months. This further increased to more than Nu 36 as of yesterday.

This also means that the stocks of 21 listed companies are worth Nu 36B, according to the figures from the Royal Securities Exchange of Bhutan. With no initial public offerings (IPO), this drastic increase in market capitalisation is attributed to improvement of share trading in the secondary market, especially the rights and bonus issue. According to RSEB, share trading in the secondary market has increased by about 300 percent in the first five months this year compared with the same period in 2017.

Record show that as of May this year, shares worth Nu 125M was traded in the secondary market. Last five years data (as on May for each year) revealed that there is a huge improvement in transaction pattern in the secondary market. The improvement in the secondary market could be due to change in the trading process from continuous to call market, which discouraged the negotiated trade as practiced earlier.

Kuensel, December 19, 2018

6.9.8 Accounting for dividends

Dividend is one of the returns on investment in equity and preference shares. In other words, dividend is a portion of company's profit that is distributed to the current shareholders of the company. Dividend can be viewed in two forms.

6.9.9 Proposed dividend

Company directors may propose a dividend for the year after finalizing the accounts and knowing the profit of the company for the year before the annual general meeting. If the financial statements are prepared after the directors' proposal of the dividend, the proposed dividend will be disclosed in the notes of the financial statements. The proposed dividend will not be recognized as an expense or a liability because the proposed dividend still need to be discussed and endorsed in the annual general meeting. Obligation of dividend will arise only when the dividend is endorsed (declared) in the annual general meeting of shareholders.

6.9.10 Declared dividend

Dividend once endorsed or declared in the annual general meeting will be an obligation to the company to the current shareholders. Thus, declared dividend is recognized as an expense that is deducted from the retained earnings or equity, and the same is also recognized as a current liability in the statement of financial position.

Dividend expense	Dr	[SOCE]
To dividend payable		[current liability]

Retained earnings	Dr	[SOCE]
To paid up dividend	Cr	[SOCE]

6.9.11 Preference dividends

Preference shareholders have the right to receive dividends before ordinary shareholders, if any dividend is proposed or declared for ordinary shares. If it is redeemable preference shares, the preference dividend is accounted as expense in the Statement of Income and a dividend liability is recognized as current liability.

Preference dividend expense (finance cost)	Dr
To preference dividend liability	

6.10 Presentation of Equity and Debt Finance in the Financial Statements

The paid up share capital and other components of equity such as reserves and retained earnings are presented under the heading 'Equity'. Debt finance in any form such as bonds, term loans and commercial papers are presented under the heading 'Liabilities'. Depending on the maturity dates of those debt finance, liabilities are further classified and presented as 'non-current liabilities' and 'current liabilities'. This is given in the following annual report of Bhutan Telecom Limited for 2018.

8 Statement of Financial Position for the year ended 31st December, 2018

Amount in Nu.

Particulars	Note no.	As at 31st December, 2018	As at 31st December, 2017
I. ASSETS :			
(a) Non-current assets			
Property, plant and equipment	2(a)	3,035,956,265	3,353,676,890
Intangible assets	2(b)	1,129,198,308	1,337,580,391
Capital work-in-progress	2(c)	83,416,952	15,077,015
Financial Assets			
- Investment in associate	3	-	92,308,400
- Investments	4	190,682,583	124,734,293
Deferred tax assets (net)	5	27,892,024	9,659,869
Other non-current asset	6	1,282,729	-
Total non-current assets		**4,468,428,861**	**4,933,036,858**
(b) Current assets			
Inventories	7	98,877,104	107,008,946
Financial Assets			
- Trade receivables	8	108,911,295	127,062,333
- Cash and bank balances	9	633,519,824	172,043,086
- Other receivables	10	3,286,083	2,860,642
Other current asset	11	6,574,163	4,115,127
Non-current asset held for sale	12	99,285,178	-
Total current assets		**950,453,648**	**413,090,134**
TOTAL ASSETS		**5,418,882,509**	**5,346,126,992**
II. EQUITY AND LIABILITIES :			
(a) Shareholders Fund			
Equity share capital	13	854,082,000	854,082,000
Retained earnings & reserves		2,903,751,554	2,938,916,121
Total shareholders fund		**3,757,833,554**	**3,792,998,121**
(b) Deferred government grants	14	87,633,714	110,957,565
(c) Non-current liabilities			
Financial liabilities			
- Long term borrowings	15	602,627,144	648,615,398
- Other non-current liabilities	16	155,400,000	194,250,000
Deferred tax liability (net)	5	-	-
Long term provision	17	57,164,638	67,340,966
Total non-current liabilities		**815,191,782**	**910,206,364**
(d) Current liabilities			
Financial liabilities			
- Trade and other payables	18	154,896,426	102,953,902
- Other current liabilities	19	96,526,009	96,092,203
Short term provision	20	236,623,130	207,138,914
Other current liabilities	21	270,177,894	125,779,922
Total current liabilities		**758,223,459**	**531,964,941**
Total liabilities (b+c+d)		**1,661,048,955**	**1,553,128,871**
TOTAL EQUITY & LIABILITIES		**5,418,882,509**	**5,346,126,992**

Bhutan Telecom, Annual Report 2018

Exercises:

a. Discuss in group how companies like DGPC, FCB and BPC raise capital without issuing shares in the market. Present the discussion outcome to the class.

b. A reporting entity issued Nu. 3 million 10% coupon bonds in the beginning of the year 2020. The bonds will be redeemed after 7 years at par. Effective interest rate is 12%. It cost Nu. 200,000 as issue cost. Company applies amortization cost method to account such bonds. Analyse the transactions and provide an appropriate accounting treatment for the same.
   Present the items in the financial statements for the year ended 31 December 2020.

c. A company chose to make a rights issue to raise Nu. 25 million. There are 100 million shares in issue at present. Shares were originally issued at Nu. 10 eight years ago. Company incurred Nu. 0.5 million to issue the shares earlier. Company management makes an offer of 1 for 10 shares to the shareholders. Only 60% of the rights offered to the existing shareholders were subscribed. The remainder of the rights issue was made to the public on 1 July 2020. Shares were traded at Nu. 20 when the rights issue was made to the public. The rights issue made to the public were fully subscribed.
   Discuss in group and propose how the rights issue will be accounted and presented in the financial statements.

d. 'Company should use scrip or bonus shares in place of cash dividend'. Organize a class debate 'for' and 'against' this statement.

e. A company issuing an equity instrument is not required to remeasure the fair value of the equity instruments at the time of preparing the financial statements.
   Explain why you think remeasurement is not required.

TABLE 4 Present value interest factor of an (ordinary) annuity of $1 per period at i% for n periods, PVIFA(i,n).

Period	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%	11%	12%	13%	14%	15%	16%	17%	18%	19%	20%
1	0.990	0.980	0.971	0.962	0.952	0.943	0.935	0.926	0.917	0.909	0.901	0.893	0.885	0.877	0.870	0.862	0.855	0.847	0.840	0.833
2	1.970	1.942	1.913	1.886	1.859	1.833	1.808	1.783	1.759	1.736	1.713	1.690	1.668	1.647	1.626	1.605	1.585	1.566	1.547	1.528
3	2.941	2.884	2.829	2.775	2.723	2.673	2.624	2.577	2.531	2.487	2.444	2.402	2.361	2.322	2.283	2.246	2.210	2.174	2.140	2.106
4	3.902	3.808	3.717	3.630	3.546	3.465	3.387	3.312	3.240	3.170	3.102	3.037	2.974	2.914	2.855	2.798	2.743	2.690	2.639	2.589
5	4.853	4.713	4.580	4.452	4.329	4.212	4.100	3.993	3.890	3.791	3.696	3.605	3.517	3.433	3.352	3.274	3.199	3.127	3.058	2.991
6	5.795	5.601	5.417	5.242	5.076	4.917	4.767	4.623	4.486	4.355	4.231	4.111	3.998	3.889	3.784	3.685	3.589	3.498	3.410	3.326
7	6.728	6.472	6.230	6.002	5.786	5.582	5.389	5.206	5.033	4.868	4.712	4.564	4.423	4.288	4.160	4.039	3.922	3.812	3.706	3.605
8	7.652	7.325	7.020	6.733	6.463	6.210	5.971	5.747	5.535	5.335	5.146	4.968	4.799	4.639	4.487	4.344	4.207	4.078	3.954	3.837
9	8.566	8.162	7.786	7.435	7.108	6.802	6.515	6.247	5.995	5.759	5.537	5.328	5.132	4.946	4.772	4.607	4.451	4.303	4.163	4.031
10	9.471	8.983	8.530	8.111	7.722	7.360	7.024	6.710	6.418	6.145	5.889	5.650	5.426	5.216	5.019	4.833	4.659	4.494	4.339	4.192
11	10.368	9.787	9.253	8.760	8.306	7.887	7.499	7.139	6.805	6.495	6.207	5.938	5.687	5.453	5.234	5.029	4.836	4.656	4.486	4.327
12	11.255	10.575	9.954	9.385	8.863	8.384	7.943	7.536	7.161	6.814	6.492	6.194	5.918	5.660	5.421	5.197	4.988	4.793	4.611	4.439
13	12.134	11.348	10.635	9.986	9.394	8.853	8.358	7.904	7.487	7.103	6.750	6.424	6.122	5.842	5.583	5.342	5.118	4.910	4.715	4.533
14	13.004	12.106	11.296	10.563	9.899	9.295	8.745	8.244	7.786	7.367	6.982	6.628	6.302	6.002	5.724	5.468	5.229	5.008	4.802	4.611
15	13.865	12.849	11.938	11.118	10.380	9.712	9.108	8.559	8.061	7.606	7.191	6.811	6.462	6.142	5.847	5.575	5.324	5.092	4.876	4.675
16	14.718	13.578	12.561	11.652	10.838	10.106	9.447	8.851	8.313	7.824	7.379	6.974	6.604	6.265	5.954	5.668	5.405	5.162	4.938	4.730
17	15.562	14.292	13.166	12.166	11.274	10.477	9.763	9.122	8.544	8.022	7.549	7.120	6.729	6.373	6.047	5.749	5.475	5.222	4.990	4.775
18	16.398	14.992	13.754	12.659	11.690	10.828	10.059	9.372	8.756	8.201	7.702	7.250	6.840	6.467	6.128	5.818	5.534	5.273	5.033	4.812
19	17.226	15.678	14.324	13.134	12.085	11.158	10.336	9.604	8.950	8.365	7.839	7.366	6.938	6.550	6.198	5.877	5.584	5.316	5.070	4.843
20	18.046	16.351	14.877	13.590	12.462	11.470	10.594	9.818	9.129	8.514	7.963	7.469	7.025	6.623	6.259	5.929	5.628	5.353	5.101	4.870
25	22.023	19.523	17.413	15.622	14.094	12.783	11.654	10.675	9.823	9.077	8.422	7.843	7.330	6.873	6.464	6.097	5.766	5.467	5.195	4.948
30	25.808	22.396	19.600	17.292	15.372	13.765	12.409	11.258	10.274	9.427	8.694	8.055	7.496	7.003	6.566	6.177	5.829	5.517	5.235	4.979
35	29.409	24.999	21.487	18.665	16.374	14.498	12.948	11.655	10.567	9.644	8.855	8.176	7.586	7.070	6.617	6.215	5.858	5.539	5.251	4.992
40	32.835	27.355	23.115	19.793	17.159	15.046	13.332	11.925	10.757	9.779	8.951	8.244	7.634	7.105	6.642	6.233	5.871	5.548	5.258	4.997
50	39.196	31.424	25.730	21.482	18.256	15.762	13.801	12.233	10.962	9.915	9.042	8.304	7.675	7.133	6.661	6.246	5.880	5.554	5.262	4.999

Chapter 7
Accounting for Partnership Firm

Learning Objectives:

- Explain the meaning of partnership business and partnership agreement
- Allocate salary, profits and losses and interest in the capital account
- Describe the effects of the entries at the time of admission and withdrawal of a partner
- Prepare relevant accounts upon the dissolution of partnership firm

Bhutan has seen a tremendous change in economy over a period of time right from barter system to modern economy. At present most business undertakings in Bhutan are predominated by small and medium scale businesses in the form of sole trading and partnership. However, in spite of the fact that Bhutanese economy is driven by small and medium scale businesses, Bhutan lacks relevant business act in place to govern the activities, especially that of partnership firms which is still popular. Robust partnership agreements have substituted the requirement of partnership act in resolving the issues up to certain degree at present. While Bhutan still waits for a partnership act, key aspects of the financial statements of partnership firm are secured under Bhutanese Accounting Standards.

This chapter will focus on accounting treatment of partnership capital, allocation of profits and losses, interest and salary. Additionally, the accounting treatment relating to admission and withdrawal of partners and liquidation of partnership firm will be discussed in brief. Since Bhutan lacks explicit and common standard of partnership law, very little aspects of partnership accounting can be discussed.

7.1 Meaning of Partnership

A partnership business is a business owned by more than one person carried out with the motive to earn profit. Each partner holds the power to legally bind all other partners by his or her actions in the interest of the partnership and is liable for all partnership debts up to the extent of personal assets.

Since partnership business operates on the basis of mutual trust, value and commitment, the need for partnership agreement is crucial in resolving issues arising in normal operation of the business. Despite the fact that agreement can be verbal, written agreement would be generally preferred to avoid any future legal complications. Partnership agreement can be defined as a written agreement between two or more partners to carry out legal business.

7.2 Partnership Accounting

Although the presentation of asset and liability in statement of financial position is similar to incorporated business, the presentation of the equity section differs as follow:

Partnership		Corporation	
Partner's Capital		Shareholder's Equity	
A's Capital	50,000	Share Capital	50,000
B's Capital	30,000	Retained Earnings	30,000
Total	**80,000**	Total	80,000

In partnership accounting, partner's capital account and partner's drawings account for each partner is maintained in the general ledger.

Practical Problem 1

In a team, discuss and share the differences between Sole Trading, Partnership and Incorporated businesses.

7.2.1 Partnership capital accounts

Partnership capital account comprises of individual capital account of partners and records of their capital contributions. For instance, the following journal records contribution of Nu. 1,000 by Mr. A.

Cash A/c Dr	1,000	
To A's Capital A/c		1,000

(Being the capital contribution made by Mr. A)

If assets are contributed instead of cash, then respective asset account will be debited instead of cash account.

7.2.2 Partnership drawings account

Partnership drawings account records any withdrawals from the business. Each partner maintains his/her drawing account. The following journal entry records A's drawing of Nu. 1,000 made during the year;

A's Drawing A/c Dr	1,000	
To Cash A/c		1,000

(Being the amount withdrawn from the business by A)

If a partner withdraws asset instead of cash, then respective asset account is credited in place of cash account. At the year end, each partner's drawing account is closed to their capital account. The following journal entry records A's drawing to his capital account provided there are no further drawings.

A's Capital A/c Dr	1,000
To A's Drawings A/c	1,000

(Being the A's Drawing account transferred to his capital account)

7.2.3 Interest on Drawings

The partnership deed provides provision to charge certain interest on drawings made by the partners. It discourages partners from withdrawing excessive amount from the partnership business. The method of charging interest is decided by partners and is specifically mentioned in partnership agreement. This chapter deals with simple interest method of charging interest computed as;

$$Interest = Total\ amount\ withdrawn \times Rate \times Time$$

7.2.4 Allocation of partnership profits and losses

Profits and losses in partnership business are distributed as per the agreed ratio mentioned in the partnership agreement. However, if nothing is mentioned in the partnership deed, it is assumed that distributions are made evenly.

7.2.5 Salary and interest allocations

Salaries are normally paid to the partners based on time and effort devoted by individual partners to the business. Interest on capital is usually paid to compensate the difference in capital contribution made by the partners. In nutshell, salary and interest allocations are required in order to maintain equity among the partners before distributing the profit. The mode of salary and interest allocation is stated in partnership deed. In any case, if the partnership deed do not explicitly mention anything on salary and interest allocation, then no salary and interest allocation is permissible.

7.2.1 Profit and loss appropriation account

A profit and loss appropriation account is prepared in order to allocate salary, interest and profit and loss to partners. Therefore, profit and loss appropriation account shows how profits and losses of the partnership firm are distributed among the partners. It does not include items which are charged against the profit of the firm. It is a nominal account in nature.

Illustration 1 demonstrates how salary, interest and profit and loss allocations are made to the partners.

Illustration 1

On 1st January 2018, A and B with Nu.10,000 each as capital agreed to share remaining profits and losses in the ratio of 3:2 after allocation of salary and interest. During the year ending 31^{st} December 2018, they earned net profit of Nu. 200,000. On 1st July 2018, A withdrew Nu. 20,000 and B withdrew Nu. 10,000 from the business for personal use. The partnership deed provides that:

i) interest on capital to be allowed at 10% p.a.,

ii) interest on drawing to be charged at 10% p.a. using simple interest method, and

iii) salary of Nu. 5,000 p.m. to be paid to Mr A and Nu. 6,000 p.m. to be paid to Mr B.

Required

Show how interest, salary and profits or losses are allocated to A and B.

Solution

Profit and Loss Appropriation Account (Apply Nominal Account Rule)					
Particulars	Amount	Amount	Particulars	Amount	Amount
To Salary:			By Net profit		200,000
A: 5,000 X 12	60,000		By Interest on Drawing:		
B: 6,000 X 12	72,000	132,000	A: 20,000 X 10% X 6/12	1,000	
To Interest on Capital:			B: 10,000 X 10% X 6/12	500	1,500
A: 10,000 X 10%	1,000				
B: 10,000 X 10%	1,000	2,000			
Net Divisible Profit:					
A: 69,000 X 3/5	40,500				
B: 69,000 X 2/5	27,000	67,500			
TOTAL		201,500	TOTAL		201,500

A statement of partner's capital is calculated after preparing profit and loss appropriation account.

A and B Partnership			
Statement of Partner's Capital			
For the Year Ended December 31, 2018			
	A (Nu)	B (Nu)	Total (Nu)
Bal. on 1/1/18	10,000	10,000	20,000
Add: Net Divisible Profit	40,500	27,000	67,500
Add: Salary	60,000	72,000	132,000
Add: Interest on Capital	1,000	1,000	2,000
Add: Additional Capital	-	-	-
Less: Drawings	(20,000)	(10,000)	(30,000)
Less: Interest on Drawings	(1,000)	(500)	(1,500)
Bal. on 31/12/18	90,500	99,500	190,000

The capital balance then will appear in statement of financial position as;

Partner's Capital	
A's capital	Nu. 90,500
B's capital	Nu. 99,500
Total partners' capital	Nu. 190,000

Practical Problem 2

a. Considering information provided in illustration 2, what would happen if there was no partnership agreement between A and B? Prepare statement of partner's capital to show how it would appear in statement of financial position.

b. Pema and Dema want to start a software solution business. Pema is willing to contribute Nu. 100,000 but will not be working. Dema on other hand will not be contributing any capital but will be working full time. They have agreed to split profits equally. As a commerce student you are approached to confirm their thoughts. What do you recommend?

7.3 Admission of Partners

When a new partner is admitted, a new partnership agreement will be required since the provisions of old partnership agreement will no longer be valid.

The existing partner may consider the change in the value of assets and liabilities. Hence, revaluation of assets and liability may be required. Any gain or loss on revaluation will be transferred to capital account of existing partners. However, it becomes problematic for some because this leads to a deviation of the financial statement of partnership from historical cost principle. Others contend that revaluation isn't an issue since when a new partner is admitted, the existing partnership is dissolved and a new partnership is formed. For this chapter, it will be assumed that revaluation of assets and liabilities does not take place.

New partner can be admitted either by purchasing an existing partner's interest or by investing in partnership business.

7.3.1 Purchasing an existing partner's interest

Under this method a new partner acquires the interest of existing partner. Such transactions are private in nature and they do not have any effect on the assets and total capital of the partnership firm. The following journal entry is recorded in the books:

Existing Partner's Capital A/c Dr	XXX
To New Partner's Capital A/c	XXX

(Being the existing partner's interest bought by new partner)

Assume A and B are partners with the capital balance of Nu.10,000 and Nu.5,000 respectively. C is admitted as a new partner and purchases half of the B's share. The following journey will be recorded in the books;

B's Capital A/c (5,000 / 2) Dr	2,500
To C's Capital A/c	2,500

(Being C admitted by purchasing half of B's share)

7.3.2 Investment in the partnership

Under this method, a new partner brings in cash or other assets instead of buying existing partner's interest. It increases both the net asset and the total capital of partnership firm.

Assuming that A and B are partners with the capital balance of Nu.150,000 each. C is admitted as a new partner and brings Nu.75,000 for 20% share. The book value of new partner's share of capital is calculated as follow:

Total capital of A and B (150,000 + 150,000)	300,000
C's investment	75,000
Total Capital	375,000
C's share of capital (375,000 X 20%)	75,000

Since, C's share of capital is equal to C's investment in the business, the following journal entry will be recorded in the books of accounts:

Cash A/c Dr	75,000
To C's Capital A/c	75,000

(Being cash or other assets brought in by the new partner)

Sometimes, the share of capital of new partner may not be equal to the new partner's investment. In such case, the bonus method or goodwill method may be adopted. For this chapter, bonus method will be followed since BAS 38 restricts recognition of internally generated goodwill.

7.3.3 Bonus to the new partner

The partnership may want to add a new partner who can bring certain specialized skills, management abilities, or some other desirable business strengths. A bonus is paid to new partner when the share of new partner's capital is greater than the new partner's investment in the partnership business. In such case, the bonus amount is debited to existing partner's capital account in profit sharing ratio.

Illustration 2 explains the treatment of bonus paid to new partner.

Illustration 2

A and B are partners sharing profits and losses equally. C is admitted as new partner and brings cash of Nu.4,000 for one-fifth share in the partnership firm. The following is the Capital balance of A and B before admitting C.

Capital Account	Amount
A's Capital	10,000
B's Capital	10,000
Total	20,000

Required

Prepare a journal entry to record the amount of bonus paid to the new partner.

Solution:

Total capital of A and B (10,000 + 10,000)	20,000
C's investment	4,000
Total Capital	24,000
C's share of capital (24,000 X 1/5)	4,800

From the above calculation we can conclude that C is actually required to bring in Nu. 4,800 for one-fifth share instead of Nu. 4,000. Therefore, the difference amount of Nu. 800 (4,800 – 4,000) will be debited to A and B's capital account in profit sharing ratio. The following journey entry is recorded;

Cash A/c Dr	4,000
A's Capital A/c Dr	400
B's Capital A/c Dr	400
To C's Capital A/c	4,800
(Being bonus paid to C on admission)	

7.3.4 Bonus to the existing partner

If the partnership business is particularly successful and profitable, the existing partners may require the new partner to pay them a bonus as compensation. A bonus is paid to existing partner when the share of new partner's capital is less than the new partner's investment in the partnership business. In such case, the bonus amount is credited to existing partner's capital account in profit sharing ratio.
Illustration 3 will briefly discuss on treatment of bonus paid to the existing partner;

Illustration 3

A and B are partners sharing profits and losses equally. C is admitted as new partner and brings cash of Nu. 13,000 for one-fourth share in the partnership firm. The following is the Capital balance of A and B before admitting C.

Capital Account	Amount
A's Capital	10,000
B's Capital	10,000
	20,000

Required

Prepare a journal entry at the time of admitting C.

Solution:

Total capital of A and B (10,000 + 10,000)	20,000
C's investment	13,000
Total Capital	33,000
C's share of capital (33,000 X 1/4)	8,250

From the above calculation we can conclude that C is actually required to bring in Nu. 8,250 for one-fourth share instead of Nu. 13,000. Therefore, the difference amount of Nu. 4,750 (13,000 – 8,250) will be credited to old partners' capital account according to profit sharing ratio. The following journey entry is recorded;

Cash A/c Dr		13,000	
To A's Capital A/c	2,375	2,375	
To B's Capital A/c	2,375	2,375	
To C's Capital A/c	8,250		8,250

(Being the bonus paid to A and B on admission)

Practical Problem 3

Considering the information from illustration 3, show the change in the statement of financial position of the partnership firm after C's admission.

7.4 Withdrawal of Existing Partner (Retirement)

When the existing partner withdraws from a partnership, settlement of outgoing partner's ownership is made in accordance with the provisions mentioned in the partnership deed.

The accounting treatment during withdrawal of existing partner involves sale to new partner, sale to one or more existing partners and through a payment of partnership assets to the withdrawing partner.

7.4.1 Sale to new partner

Under this method, the payment for the ownership interest is a private transaction and the existing partner must approve it. Such transaction does not have any effect on assets and total capital of the partnership firm.

Suppose A, B and C are partners with a capital balance of Nu.5,000, Nu.4,000 and Nu.3,000 respectively. C withdraws from the firm and sells it to D who will be admitted as a new partner. In this case, the following journal entry will be recorded in the books of accounts;

C's Capital A/c Dr	3,000
To D's Capital A/c	3,000

(Being C's capital transferred to D)

a) Sale to remaining partner

Here, the remaining partner acquires the partnership interest of withdrawing partner. Such transaction is private in nature and do not have any effect on assets and total capital of the partnership firm.

Assuming A, B and C are partners with a capital balance of Nu. 5,000, Nu.4,000 and Nu. 3,000 respectively. C withdraws from the firm and sells his partnership interest to the remaining partner equally. In this case, the following journal entry will be recorded in the books of accounts;

C's Capital A/c Dr	3,000
To A's Capital A/c	1,500
To B's Capital A/c	1,500

(Being C's capital transferred to A and B)

7.4.2 Payment from partnership assets

Under this method, the asset of the partnership firm is used to pay off the withdrawing partner's interest. This method reduces the net assets as well as total capital of the partnership firm. Some partnership agreements provide that the book value of assets should be revalued with the fair value of the assets at the time of partner's withdrawal. However, this would violate the historical cost principle and going concern assumption.

For this topic, asset revaluations will not be recorded, instead, a bonus method approach will be used.

7.4.3 Bonus to withdrawing partner

A bonus is paid to withdrawing partner when the amount paid to withdrawing partner is greater than the withdrawing partner's capital balance. In such case, bonus paid to withdrawing partner is debited in remaining partner's capital account in their profit sharing ratio. Illustration 4 explains the treatment of bonus paid to withdrawing partner.

Illustration 4

A, B and C are partners sharing profits and losses in the ratio of 3:2:1. C retires from partnership firm and is paid Nu. 12,000. The following is the statement of financial position of A, B and C:

Assets	
Cash	53,000
Other Assets	50,000
	103,000
Capital and Liabilities	
A's Capital	11,000
B's Capital	11,000
C's Capital	11,000
Loans	70,000
	103,000

Required

Prepare a journal entry to record C's withdrawal

Solution:

Since C is paid excess of Nu. 1,000 (Nu. 12,000 – Nu. 11,000), the excess amount is a bonus to the withdrawing partner and will be debited to A and B's capital account in the ratio of 3:2. The following journal entry is recorded:

C's Capital A/c Dr	11,000	
A's Capital A/c Dr	600	
B's Capital A/c Dr	400	
To Cash A/c		12,000
(Being the bonus paid to C)		

Suppose, if the partnership firm do not have adequate amount to pay C's share of interest, C's loan account is credited instead of cash.

7.4.4 Bonus to remaining partners

A bonus is paid to remaining partners when the amount paid to withdrawing partner is less than the withdrawing partner's capital balance. In such case, the bonus amount is credited to remaining partners' capital account in their profit sharing ratio. Illustration 5 explains the treatment of bonus paid to remaining partners.

Illustration 5

Considering the information provided in illustration 4, what would happen if C was paid Nu.9,000 instead of Nu.12,000?

Solution:

If C is paid Nu.9,000 then the difference of Nu.2,000 (11,000 – 9,000) will be treated as bonus to the existing partner and will be credited to A and B's capital account in the ratio of 3:2. Therefore, the following journal entry will be recorded:

C's Capital A/c Dr	11,000	
To A's Capital A/c		1,200
To B's Capital A/c		800
To Cash A/c		9,000
(Being the bonus paid to A and B)		

Practical Problem 4

a. List down various reasons why would a partnership firm pay bonus to the withdrawing partner?
b. Why would a partnership firm pay bonus to the remaining partners?
c. Considering the illustration 5, show the change in the statement of financial position of the partnership firm after C's withdrawal.

7.5 Death of a Partner

In case of death of a partner, partnership gets dissolved and all accounts are closed to ascertain the net income earned till the date of death. The partnership agreement may demand audit and revaluation of assets. The balance of the deceased partner's capital account is then transferred to death partner's executor account as a liability.

Remaining partners may continue or liquidate partnership firm. If the partnership continues, the mode of payment to death partner's executor account is same as withdrawal of partner. However, for this chapter, the death of partner will not be further discussed.

7.6 Liquidation of Partnership Firm

Liquidation of partnership firm means complete termination of the firm. All assets are sold except for cash and cash equivalents since they are already in liquid form or can be easily converted into cash in short period of time. All liabilities are paid off and after disposal of assets and payment of liabilities, the remaining cash or any unsold assets are distributed to the partners in profit sharing ratio. For this purpose, realisation account is prepared to ascertain the profit or loss incurred during the process of liquidation. Realisation account is nominal account in nature.

7.6.1 Cash Equivalents

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. Example of cash equivalent includes treasury bills and short term investments.

Illustration 5 examines the accounting treatment at the time of dissolution;

Illustration 6

A, B and C are partners sharing profits and losses in the ratio of 5:3:2. The following is the statement of financial position of A, B and C partnership firm on 31st December 2018.

Assets	
Cash	53,000
PP&E	50,000
	103,000
Capital and Liabilities	
A's Capital	11,000
B's Capital	11,000
C's Capital	11,000
Loans	50,000
Trades Payable	20,000
	103,000

On 1st January 2019, the partnership was dissolved and assets realized amounted to Nu. 80,000. Liabilities were paid off and realization expenses amounted to Nu. 2,000. Identify accounting treatment required at the time of dissolution of the firm.

Solution:

Step I

Prepare realisation account to convert all non-cash assets to cash and pay off all the liabilities.

Realisation Account (Apply Nominal Account Rule)					
Particulars	Amount	Amount	Particulars	Amount	Amount
To Assets			By Liabilities		
Property, Plant & Equipment		50,000	Loan	50,000	
			Trades Payable	20,000	70,000
To Cash A/c (Liability Paid)		70,000	By Cash A/c (Assets Sold)		80,000
To Cash A/c (Realisation Expenses)		2,000			
To Capital A/c					
A's Capital A/c (28,000X5/10)	14,000				
B's Capital A/c (28,000X3/10)	8,400				
C's Capital A/c (28,000X2/10)	5,600	28,000			
Total		**150,000**	**Total**		**150,000**

In case, if the assets are taken over by the partners, the following journal entry is recorded:

Partner's Capital A/c Dr XXX	
To Realisation A/c XXX	
(Being the asset taken over by old partners in their profit sharing ratio)	

If the liability is taken over by old partners, the following journal entry is recorded:

Realisation A/c Dr XXX

To Partner's Capital A/c XXX

(Being the liability taken over by old partners in their profit sharing ratio)

Step II

Prepare Capital statement of partners to calculate amount payable to the partners.

Capital Statement of A,B and C				
	A (Nu)	B (Nu)	C (Nu)	Total (Nu)
Capital balance	11,000	11,000	11,000	33,000
Profit on realization	14,000	8,400	5,600	28,000
Loss on realization (Less)	-	-	-	-
Assets taken over by partners (Less)	-	-	-	-
Liabilities paid by partners (Add)	-	-	-	-
Balance (Credit)	25,000	19,400	16,600	61,000

Step III

Prepare Cash account to ascertain cash balance available.

Cash and Cash Equivalent A/c (Apply Real Account Rule or Asset Rule)			
Particulars	Amount	Particulars	Amount
To balance b/d	53,000	By Realisation A/c (Liabilities Paid)	70,000
To Realisation A/c (Assets Sold)	80,000	By Realisation A/c (Realisation Expense)	2,000
		Balance (Debit)	61,000
Total	133,000	Total	133,000

Step IV

Pass the following journal entry in the books of accounts to settle the amount due to the partners;

A's Capital A/c Dr 25,000
B's Capital A/c Dr 19,400
C's Capital A/c Dr 16,600
To Cash/Bank A/c 61,000
(Being the amount paid to partners in full settlement)

Sometimes, the sale of partnership may result in debit balance in one of the partner's capital account after allocation of losses. Partner with a debit capital balance need to bring cash equivalent to the amount of debit capital balance or partners with credit capital balance have to bear the deficit capital balance as per the profit and loss sharing ratio. However, this method will not be covered up in this chapter.

Practical Question 5

Considering the information from illustration 5, prepare realization account, statement of capital account, cash account and pass journal entry to settle the account of partners' capital account if:

i) property, plant and equipment worth Nu. 5,000 is taken over by A,

ii) remaining property, plant and equipment is sold for Nu. 75,000,

iii) loan amount of Nu. 3,000 is paid by B,

iv) remaining liability paid fully, and

v) realisation expenses amounted to Nu. 2,000.

Exercises:

1. On 1st January 2018, Sonam and Karma decided to form a partnership firm. The partners agreed to the following terms;

Partners	Capital Contribution	Salaries	Profit Sharing Ratio
Sonam	200,000	30,000	60%
Karma	100,000	20,000	40%

Interest on capital is charged @10% p.a. on the opening balance of capital every year. During the year, each partner withdrew Nu.25,000 from the firm.

With reference to the above information, answer the following questions:

a. Assume that at the end of 2018, the partnership firm reported net profit of Nu.150,000. Which of the following amount would be reported for Sonam's Capital?
   A Nu. 267,000
   B Nu. 133,000
   C Nu. 200,000
   D Nu. 130,000

b. Assume that at the end of 2018, the partnership firm reported net profit of Nu.100,000. Which of the following amount would be reported for Karma's Capital?
   A Nu. 240,000
   B Nu. 113,000
   C Nu. 123,000
   D Nu. 237,000

c. Suppose if Dorji is admitted as a new partner for 20% share on 1st January 2019 and brings Nu.100,000 as cash, which of the following amount would be reported for Dorji's Capital if the partnership reported net profit of Nu. 100,000 at the end of 2018?
   A Nu. 100,000
   B Nu. 90,000
   C Nu. 80,000
   D Nu. 70,000

d. Dorji is admitted as a new partner for 20% share on 1st January 2019 and brings Nu. 80,000 as cash. The partnership reported net profit of Nu. 100,000 at the end of 2018. What would be the new capital balance of Sonam after admission of Dorji assuming that Dorji and Sonam are equal partners?
   A Nu. 232,000
   B Nu. 233,000
   C Nu. 234,000
   D Nu. 235,000

2. Druk, Dhom and Tag are partners sharing profits and losses in the ratio of 5:2:3. Their capital balances at the end of December 2016 are Druk; Nu. 200,000, Dhom; Nu. 120,000 and Tag; Nu. 150,000

On 1st January 2017, Druk decided to withdraw from the partnership firm. You are required to prepare journal entries to record Druk's withdrawal if;

i) Druk is paid Nu. 200,000

ii) Druk is paid Nu. 180,000

iii) Druk is paid Nu. 250,000

3. Yangchen and Sheldon are partners sharing profits and losses in the ratio of 2:1. Their capital balance on 1st January 2012 are: Yangchen – Nu. 200,000 and Sheldon – Nu. 100,000.

   The partnership agreement provides that the profits and losses to be shared in the ratio of 2:1. Interest of 10% p.a. to be allowed on the opening capital balance and salary allowance of Nu. 40,000 and Nu. 30,000 to be paid to Yangchen and Sheldon respectively.

   During the year, Yangchen and Sheldon withdrew Nu. 50,000 each for private purpose and the net income earned before charging interest and salary amounted to Nu. 80,000.

   On 1st January 2013, Keldon was admitted as a new partner and contributed Machinery worth Nu. 120,000 for one-fourth share. The bonus method was used to admit Keldon. A new partnership agreement was amended as follows;

   i) Interest of 12% p.a. on the opening capital balance.

   ii) Annual salary of Nu. 30,000 and Nu. 20,000 to Yangchen and Sheldon respectively.

   iii) Profits and losses to be shared in the ratio of capital balance of Yangchen, Sheldon and Keldon on 1st Jan 2013.

   During the year 2013, the partnership firm earned a net income of Nu.150,000 before charging interest and salary.

   Prepare appropriation account, necessary journal entries and statement of partners' capital account from 1st January 2012 to 31st December 2013.

4. Apa, Ama and Bum are partners sharing profits and losses in the ratio of 5:3:2. They decided to liquidate their business on mutual agreement, moreover Apa wanted to sue Ama and Bum since they have been misusing the partnership firm property. The following is the statement of financial position of Apa, Ama and Bum partnership firm on 31st December 2018 before the dissolution of a firm.

Assets	
Cash	100,000
Trades Receivable	50,000
Inventory	50,000
Land	100,000
	300,000
Capital and Liabilities	
Apa's Capital	90,000
Ama's Capital	80,000
Bum's Capital	60,000
Loans	20,000
Trades payable	50,000
	300,000

On 1st January 2019, the partnership was dissolved. Only 90% of the trade receivables were realized and inventory worth Nu. 20,000 were taken over by Ama at Nu. 15,000, only 80% of the remaining inventory was realized. Land was sold for Nu. 100,000. Trade payables were paid off @ 10% discount. Bum decided to pay off loan and Realisation expenses amount to Nu. 10,000.

Required:

i) Identify any two factors that could lead to dissolution of a firm from the case.

ii) What would happen if partnership distributes non-cash assets to partners to liquidate the firm instead of selling it?

iii) Prepare realisation account, cash account, and partners' capital statement and provide journal entries to settle the amount due to partners.

Case Study 1

Tashi and Sonam are partners sharing profits and losses equally and runs restaurant situated in Thimphu. Their business has been performing well beyond their expectation and most of the customers are employees working under different organizations. Tashi wanted the business to grow further in terms of profit and even sacrificed her lunch time to cater the needs of regular customers while Sonam, on the other hand, took longer lunch hours. Furthermore, Sonam makes significantly larger withdrawals compared to Tashi and contends that he generally maintains proper drawing's account. Sonam's drawings to date are double of Tashi's.

Required:

i) Who are the stakeholders in this situation?

ii) Identify the problems with Sonam's actions and discuss the ethical considerations.

iii) How might the partnership agreement be revised to accommodate the differences in Tashi and Sonam's work and withdrawal habits?

Case Study 2

Pema, Tashi and Dorji graduated with a bachelor's degree in Commerce from Gedu College of Business Studies in the year 2017. They always wanted to start a garment business which requires initial capital investment of Nu.1 million. Three of them choose to arrange the required capital from friends and relatives and were successful in acquiring the finance. A trade license was obtained online within two days. On 1st January 2019, they started a garment business with initial capital investment of Nu. 1 million as follow:

Pema – Nu. 500,000
Tashi – Nu. 300,000
Dorji – Nu. 200,000

They consulted the legal firm and have developed partnership agreement which contained the following provisions;

i) Any profits or losses arising out of conduct of business were to be shared in the ratio of 5:3:2.

ii) Annual salary of Nu. 12,000, Nu. 10,000 and Nu. 8,000 to be paid to Pema, Tashi and Dorji respectively.

iii) 10% p.a. interest to be allowed on opening capital balance only.

Most of the marketing strategies were developed by Pema since she possessed expertise in marketing area. Tashi and Dorji always expected that their business may reach an end without Pema. Moreover, Tashi and Dorji knew that their personal property would be at greater risk to meet the liabilities of the creditors.

During the year, Pema, Tashi and Dorji withdrew Nu.10,000 each for personal use. On 1st July 2019, Pema introduced additional capital of Nu. 20,000. The net income for the year ended December 31, 2019 amounted to Nu. 100,000.

Required:

i) Identify two advantages and disadvantages of partnership business from the case.

ii) Do you think that interest of 10% p.a. on the opening balance of the capital is fair enough? Why?

iii) If Pema withdraws from the partnership firm, what strategies can be adopted by Tashi and Dorji to continue the partnership firm?

iv) Prepare Profit and Loss Appropriation Account showing the division of net income among the three partners.

v) Prepare a Statement of Partner's Capital Account to ascertain the balance of capital on 31st December 2019.

Chapter 8
Financial Statements of a Limited Company

Learning Objectives:

- Explain the purpose of adjusting entries
- Explain the concept of financial statements and company's annual report
- Prepare statement of income with proper analysis of expenses based on the nature or the function
- Prepare statement of financial position
- Prepare statement of cash flows
- Prepare statement of changes in equity
- Calculate basic earnings per share and disclose the information in the financial statements
- Explain and draft short accounting notes and accounting policies

As you will recall from class XI, business entities prepare financial statements to report their performance and financial position at the year-end to its capital providers (shareholders in terms of companies) and other stakeholders. The management of the entity also reports other aspects of its business to its shareholders and other stakeholders. These other aspects of reporting include management financial review, directors' report, corporate governance report, and auditors report. All these information along with financial statements of a company is compiled in a single document called an 'annual report' of a company. Company's annual report, thus informs shareholders and other stakeholders not only about company's financial matters but also the overall affairs of the company.

This chapter is a continuation of chapter 10 of class XI Accountancy text. The basic concepts and other underlying theories related to financial statements are covered in class XI. In this chapter, you will gain further understanding of company's financial statements and learn the techniques of preparing financial statements in line with the current financial reporting standards. The chapter also introduces a basic concept and reporting of earnings per share in the financial statements.

8.1 Approach to Preparing Financial Statements of a Limited Liability Company

As you know financial statements of an entity are a primary source of information to many investment decision makers and regulatory authorities. The management of an entity must therefore engage professional skills and knowledge to prepare financial statements and to ensure that financial statements present true and fair view of the entity's financial performance and the financial position. The preparation and presentation of financial statements is a part of financial reporting of the entity. *BAS1 Presentation of Financial Statements* provides essential guidelines to entities who prepare financial statements to the external users.

It is important for the student to understand the procedures and the principles used in the preparation and presentation of financial statements of an entity.

A summary of this process is presented in the diagram below.

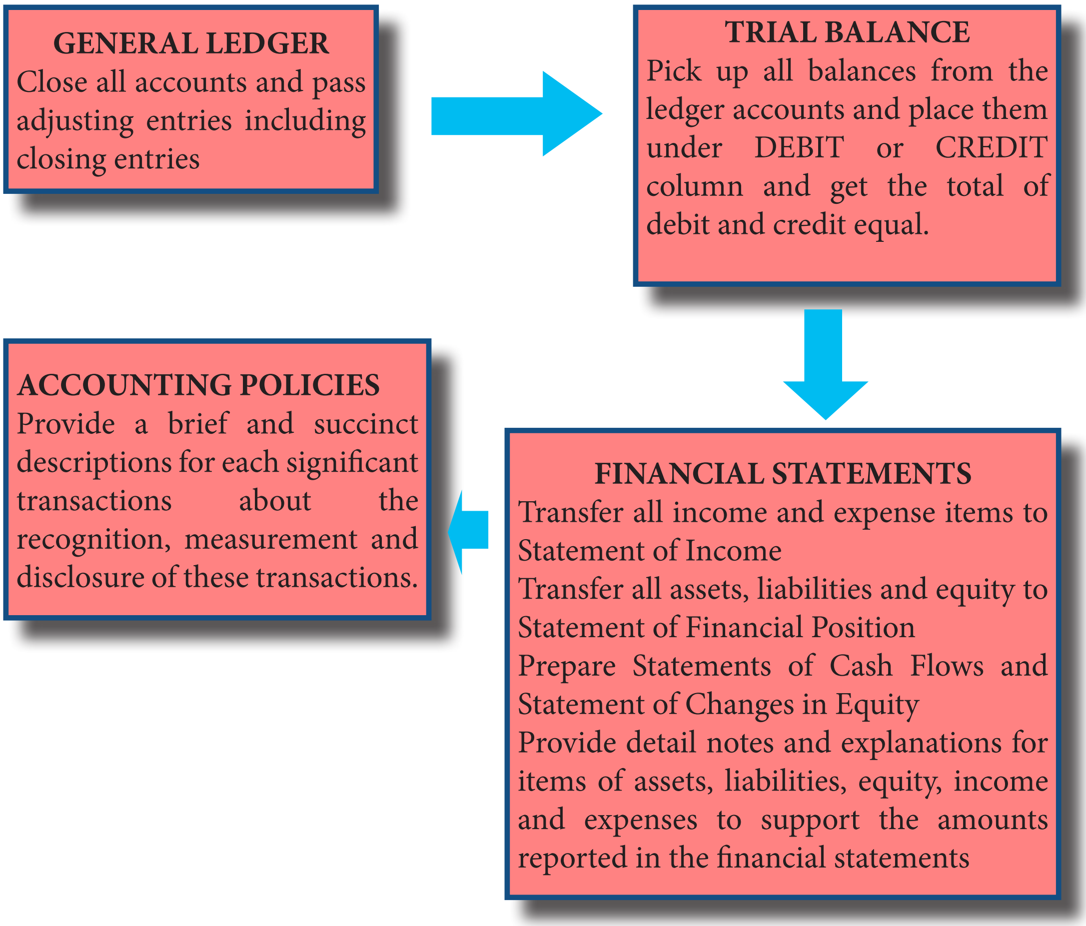


Figure 8.1 Process of preparing financial statements

You would have gained some knowledge and skills of identifying business transactions and recording them, and later posting them to ledger accounts in class XI. You have also learnt the concept of trial balance and steps to prepare trial balance including an adjusted trial balance. All now you have to do is to gain further knowledge and skills in the preparation of financial statements with the trial balance given to you. Before we discuss in some details on the preparation and presentation of financial statements, let us review the purpose of trial balance and its limitation so that we are not carried away by the purpose of trial balance.

8.1.1 Trial balance and its purpose

Trial balance presents a list of account balances of assets, liabilities, capital, income and expenses extracted from general ledger and arranged in 'debit' and 'credit' columns for which we expect the total of debit column equals the total of credit column.

We expect the total of debit should equal the total of credit because we used double entry system when recording the transactions in the journal. For every debit we have a credit account with the same amount. What if the debit column and credit column are not equal? In principle, this indicates some error in recording of transactions in the journal or posting of transactions to the ledger accounts. Entities where internal control system is weak, errors can occur at any time and in any part of bookkeeping process. Trial balance is prepared to detect such errors in the bookkeeping process so that the errors are rectified prior the preparation of financial statements. Remember only when the total of debit and the credit columns are different the preparer of financial statements will seek to search for errors. The trial balance will still show the amounts of debit and credit columns equal despite having errors in the accounting records and ledger accounts. That is the limitation of trial balance.

A detail discussion on errors and the rectification of errors can be read in chapter 5 of class XI Accountancy text. Also, you must understand the steps discussed in the same chapter how to prepare trial balance.

In the computerized accounting system, trial balance is automatically generated by the system. Trial balance prepared for the preparation of financial statements can be of two types:

i) Unadjusted trial balance, and

ii) Adjusted trial balance.

These are actually not different types of trial balance but because entities have some adjusting or updating entries to be passed before closing of accounts and preparation of financial statements for the year, the trial balance before passing these entries is named as unadjusted trial balance. The adjusted trial balance is used for the preparation of financial statements. The trial balance of the entity also gets updated during the audit of the financial statements for any observations and findings of the auditors that require additional recognition or rectification of the existing entries. For example, if the auditor has observed that the entity has undercharged depreciation of an asset, he would ask management to provide additional depreciation that will result in passing an additional entries to adjust the depreciation expense. The trail balance gets updated with such auditor's observations before it is finalized and use to prepare the financial statements which will be issued to the shareholders and others.

8.1.2 Adjusted trial balance

The trail balance prepared before passing adjusting entries is called unadjusted trial balance. This means, the unadjusted trial balance contains account balances of only those transactions and events that are recorded and posted during the accounting period. You have learnt in the previous lessons that there are other categories of transactions and events in accounting which are implicit in nature. These implicit transactions such as accruals and prepayments, irrecoverable debts and depreciation do not occur like other transactions and events. These transactions also do not generate any source documents or physical evidence to show that transactions have occurred. Since the bookkeeper does not receive any external notification (in the form of documents), these transactions are usually recorded at the year-end as adjusting entries. Adjusting entries are necessary in accrual accounting to ensure that income and expenses for the year are recognized as required by the accounting standards.

Illustration 1

The following question illustrates the concept and the process of writing up the adjusted trial balance.
A reporting entity prepared a trial balance as at 31 December 2019 as follow.

	Debit	Credit
Sales		1,420,000
Purchases	650,450	
Property, plant and equipment- land	600,000	
Property, plant and equipment- buildings	513,600	
Property, plant and equipment, equipment	230,500	
Accumulated depreciation – building		171,200
Accumulated depreciation-equipment		138,300
Investment	600,000	
Inventory	323,350	
Trade receivables	500,000	
Trade payables		400,000
Interest on borrowed funds	100,100	
Loans		300,000
Share capital		1,166,500
Retained earnings		452,000
Interest income		120,000
Salary and wages	350,000	
Cash	200,000	
Bank balance	100,000	
	4,168,000	4,168,000

During the closing time of the year, the following information have been provided to the accounts executives:

i) Salary and wages payables Nu. 85,000

ii) Accrued income from interest Nu. 50,000

iii) Management assessed at the year-end the condition of the inventory and reported Nu.200,000 inventory as immoveable and no sales value is expected from this inventory.

iv) Company legal office has been informed by the district court that a compensation of Nu. 120,000 has to be paid to an employee who has suffered from injury at work.

v) In the current economic scenario, company will continue to face difficulty to collect its debts. An allowance of 10% is estimated for the current year on the total trade receivables.

vi) An inventory of Nu.60,000 was distributed as donations to Disabled Persons Association. This was not recorded earlier.

vii) Paid insurance premium of Nu.55,000 in advance.

viii) A credit note issued in favour of a customer who returned goods valued Nu. 110,000 has been misplaced. This must be provided for accordingly.

ix) Buildings and equipment are depreciated over a useful life of 30 years and 5 years respectively using straight line method.

Required:

Prepare the adjusted trial balance for the year ending 31 December 2019.

Solution

The trial balance given in the question is an unadjusted trial balance. This trial balance has been prepared from the general ledger account balances before the adjusting entries. As you see in the illustration, there are still some transactions that need to be recorded at the year-end before preparation of the draft financial statements. However, not all transactions recorded at the year-end are adjusting entries. Adjusting entries ensure that all items of income and expenses of the year are recorded as per the accrual or matching principle.

Adjusting entries

i)	Salary and wages	Dr	85,000	
	To accrued salary and wages			85,000
ii)	Accrued interest- income	Dr	50,000	
	To Interest income			50,000
iii)	Immovable inventory written off	Dr	200,000	
	To inventory**			200,000
iv)	Administrative expense-compensation	Dr	120,000	
	To accounts payable			120,000
v)	Irrecoverable debt expenses	Dr	50,000	
	To Allowance for irrecoverable /doubtful debt			50,000
vi)	Administrative cost-donations	Dr	60,000	
	To inventory **			60,000
vii)	Prepaid insurance	Dr	55,000	
	To cash			55,000

viii) Sales return DR 110,000
    To Trade receivables 110,000

ix) Depreciation-buildings Dr
    To accumulated depreciation –buildings

x) Depreciation – equipment
    To accumulated depreciation-equipment

Inventory**

- Many entities use purchases account to record goods purchased for resale or materials purchased for industry production. The alternative approach is to record to inventory account and recognize them as a current asset. The journal entries will be written as follow:

On purchase of goods

Inventory Dr
    To Cash/Bank/Trade payables

On sale of goods/issue of materials

Cost of goods sold/cost of materials issued Dr
    To inventory

Adjusted trial balance

Particulars	Debit	Credit	Adjustment		Adjustment Balance	
			Debit	Credit	Debit	Credit
Sales		1,420,000				1,420,000
Purchases	650,450				650,450	-
PP&E - Land	600,000				600,000	-
PP&E - Buildings	513,600				513,600	-
PP&E - equipment	230,500				230,500	-
Accumulated depre- building		171,200		17,120		188,320
Accumulated depre- equipment		138,300		46,100		184,400
Depreciation- Building			17,120		17,120	
Depreciation - equipment			46,100		46,100	
Investment	600,000				600,000	
Inventory	323,350			260,000	63,350	
Trade receivables	500,000			110,000	390,000	
Trade Payables		400,000			-	400,000
Interest on borrowed funds	100,100				100,100	-
Loans		300,000			-	300,000
Salary and wages	350,000		85,000		435,000	-
Share capital		866,500				866,500
Retained earnings		452,000				452,000
Interest Income		120,000		50,000		170,000
Cash	200,000			55,000	145,000	
Bank	100,000				100,000	
Accrued salary and wages				85,000		85,000
Accrued incomes-interest				50,000		50,000
Other accounts payable				120,000		120,000
Administrative cost-compensation			120,000		120,000	
Irrecoverable debt expenses			50,000		50,000	
Allowances for irrecoverable/doubtful debt				50,000		50,000
Administrative cost-donations			60,000		60,000	
Prepaid insurance			55,000		55,000	
Sales returns			110,000		110,000	
Total					**4,286,220**	**4,286,220**

Recapitulation of adjusting entries

a) Accruals –accrued income and accrued expenses

The conceptual framework requires that the financial statements should be prepared on accrual basis except statement of cash flows that is prepared on cash basis. The essence of accruals is that income and expense should be recognized and recorded for as they occur in each accounting period and not as when the cash is received or paid. Accrued income is an income that has been earned or due to be received but the entity has not yet received at the time of preparing financial statements for the year. Similarly, the expense incurred but not yet paid until the next accounting period should be recognized as an accrued expense. Some entities use terms like 'outstanding' or 'dues' to denote such accruals. All accruals must be adjusted or accounted for in the current year's financial statements to ensure that financial statements faithfully represent the economic activities undertaken by the entity during the reporting year.

Illustration 2

Pema commenced a computer software development business in 2019 in Mongar. She drafted her first financial statements for her business for the year ending 2019 as presented below.

	Amount (Nu)
Sales	200,000
House rent	(30,000)
Salary for staff	(45,000)
Utility bills	(10,000)
Operating profit	**115,000**

At the time of preparing the financial statements for the year she finds that she need to pay two months' house rent and three months' staff salary. She also realizes that one month's telephone bill of Nu. 800 was unpaid. Pema has some income of Nu. 50,000 from her business saving account that is yet to be received.

Required:

Prepare the revised financial statement for Pema making the necessary adjusting entries.

Solution

Revised Statement of Income for the year ending 31 December 2019

	Note	Amount (Nu)
Sales	1	250,000
House rent	2	(36,000)
Salary for staff	3	(60,000)
Utility bills	4	(10,800)
Operating profit		**143,200**

Revised Statement of Financial Position of Pema as at 31 December 2019

	Note	Amount (Nu)
Current liabilities		
Accrued expenses	5	21,800

Notes	Amount (Nu)
(1) Income	
Income for sales of goods	200,000
Add: Accrued interest income	50,000
	250,000
(2) House rent adjustment	
Rent paid	30,000
Add: Rent accrued	6,000
Rental expense for the year	**36,000**
(3) Staff salary adjusment	
Salary paid	45,000
Add: Salary accrued	15,000
	60,000
(4) Utility bills	
Utility bills paid	10,000
Add: Bills accrued	800
	10,800

Note

(5) Accrued expenses

House rent	6,000
Staff salary	15,000
Telephone bills	800
	21,800

The T-shape accounts of accruals is presented below.

House rent account

Income Statement	36,000	Cash	30,000
		Accrued rent expense	6,000
	36,000		36,000

Staff salary account

Income expense	60,000	Cash	45,000
		Accrued salary expense	15,000
	60,000		60,000

Utility bills account

Income statement	10,800	Cash	10,000
		Accrued bills	800
	10,800		10,800

Accrued rent account

Balance c/d	6,000	Rental expense	6,000
	6,000		6,000

Accured staff salary account

Balance c/d	15,000	Rental expense	15,000
	15,000		15,000

Accrued Bills account

Balance c/d	800	Rental expense	800
	800		800

b) Prepaid expenses

In order to calculate the correct profit or loss for the year, the income earned during the year must be matched with the expense relating to that accounting year. That way the expense incurred for the year is matched with the economic benefits received by the entity during the year. What if the payment made during the year is expected to bring economic benefits in the following accounting period? As per the accruals and matching principle, since the economic benefits is expected to flow in the following accounting year, the recognition of the expense is deferred to the following accounting year. That means the amount paid this year is recognized as expense only in the following accounting period. As you remember, since the payment made this year will bring economic benefits in the subsequent years, a proportion or the entire amount of the payment made is recognized as an asset in the current financial statements.

Illustration 3

A fast food restaurant in the capital city made an agreement with the local municipality to lease a house where the restaurant will pay a monthly leased rent of Nu. 20,000. On 1 January 2019, when the agreement was signed the restaurant paid 360,000. The restaurant also further paid Nu. 1,000 as legal fees.

Required:

Show how the transactions will be recorded and presented in the financial statements

Solution

Journal entries

1 January 2019 (on payment of cash)

Prepaid rent	Dr	360,000	
To cash			360,000
Legal charges	Dr	1,000	
To cash			1,000

31 December 2019 (on closing of the year)

Rental expenses	Dr	240,000	
To prepaid rent			240,000

The ledger accounts are prepared as follows:

Rent account

Income statement	240,000	Prepaid rent	240,000
	240,000		240,000

Prepaid rent account

Cash	360,000	Rent	240,000
		Balance c/d	120,000
	360,000		360,000

Cash account

Opening cash balance	xxxx	Prepaid rent	360,000
Cash sales	xxxx	Legal charges	1,000
			361,000

Statement of income for the year ended 31 December 2019

	Amount (Nu)
Income	xxxx
Expenditure	
Opearting expenses	240,000

Statement of financial position as at 31 December 2019

Current Assets	**Amount (Nu)**
Prepaid expenses	120,000
Cash	xxxxx

c) Deferred income

In the previous section you have learnt that the expense incurred but not paid is recognized as current liabilities. The reason is that an entity has already consumed goods or services and created a present obligation to the service provider. What if an entity receives cash payment for the income to be received in the following years (the income is yet to be earned)? In this case, an entity has already received the economic benefits but it has not discharged its obligations or rendered services to earn that income. This is called deferred income as the amount received is deferred to the next accounting period for recognition as an income. In the current year, the amount is reported as a liability.

Illustration 4

Kezang car washing service in Thimphu received Nu. 100,000 from its customers on 1 July 2019. Some of these customers made the payments for future services as and when they require. On 31 December 2019 at the closing time, it was calculated that five customers have still not received the service that amounted to Nu. 35,000.

Required:

Make the adjusting entries and present the information in the financial statements.

Journal entries

At the time of receiving cash

Cash	Dr	100,000	
To deferred income			100,000

At the year-end

Deferred income	Dr	65,000
To sale income		65,000

Ledger accounts

Cash account

Deferred income	100,000	Balance c/d	100,000
	100,000		100,000

Sales account

Income statement	65,000	Deferred income	65,000
	65,000		65,000

Deferred income account

Sales income	65,000	Cash	100,000
Balance c/d	35,000		
	100,000		100,000

Statement of income for the year ending 31 December 2019

Income

Revenue	65,000

Statement of financial position as at 31 December 2019

Current Assets	
Cash	100,000
Current liabilities	
Deferred income	35,000

8.1.3 Financial statements – definition

Financial statements are defined as the general purpose financial statements 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.

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 (BAS1/IAS1).

Chapter 10 of class XI Accountancy provides a comprehensive discussion on the need, purpose and types of financial statements. It also gives you some fundamental principles underlying the financial statements. So the learner must revise those lessons thoroughly in order to successfully learn the lessons outlined in this chapter. Let us now begin with some basic questions. Who is responsible for financial statements? Why it is so important to discuss about the presentation of financial statements? How can the people responsible for financial statements ensure financial statements present true and fair view of the entity's financial performance, financial position and cash flows? This chapter will mostly focus on answering these questions through illustrations and student learning activities. You will appreciate that each practical illustration will address a specific concept or an issue related to financial statements which ultimately will help you to gain the necessary technical skills to prepare and present financial statements of the entity and, an analytical skills to identify issues in financial reporting.

8.1.4 Presentation of financial statements

BAS1/IAS1 requires that an entity shall present with equal prominence all of the financial statements in a complete set of financial statements. In the next section, we will briefly discuss what we have already learnt in class XI about the important features of financial statements.

a) Materiality and aggregation

In the presentation, an entity should present separately each material class of items and items of a dissimilar nature or function unless they are immaterial. In the following illustration, you will learn this requirement.

Illustration 5 (Materiality and aggregation)

Nagtsho Automobiles prepared an unadjusted trial balance before drafting its financial statements for 2019. You are required to prepare the statement of income for the year 2019 with proper classification and aggregation of items in the financial statement.

Amount (Nu)		
Interest on deposits	150,000	CR
Interest on non-government bonds	200,000	CR
Interest on bank loan	300,000	DR
Training and development	200,000	DR
Bank fees and other charges	85,000	DR
Machinery –	670,600	DR
Depreciation –machinery	230,500	DR
Sales revenue	4,100,000	CR
Cost of sales	607,500	DR
Bonus	100,000	DR
Income from government grants	116,000	CR
Dividend income	500,000	CR
Computer Software	345,200	DR
Amortisation –computer software	120,000	DR
Impairment –computer software	100,000	DR
Entertainment	120,000	DR
Income from sale of tender forms	56,400	CR
Gratuity	353,200	DR
House rent received from employees	198,000	CR
Repair and maintenance-office buildings	230,000	DR
Consultancy charges	150,000	CR
Repair and maintenance- computers	150,000	DR
Repair and maintenance- vehicles	110,000	DR
Travel	90,750	DR
Salaries and wages	300,000	DR
License fees	76,000	DR
Leave encashment	223,000	DR
Terminal benefits	125,600	DR
Brand management	230,500	DR

Furniture and fittings	560,000	DR
Deprecation –F&F	200,000	DR
Medical benefits	100,000	DR
Staff welfare costs	345,000	DR
Meeting expenses	75,400	DR
Office equipment	400,000	DR
Depreciation –OE	150,000	DR
Impairment – office equipment	60,000	DR

Statement of income of Nagtsho Automobiles for the year ended 31 December 2019

	Note	Amount (Nu)
Sales revenue		4,100,000
Other income	1	870,400
Total income		4,970,400
Cost of sales		(607,500)
Expenditures		
Employee remuneration and benfits	2	(1,746,800)
Repairs and maintenance costs	3	(490,000)
Depreciation and amortisation	4	(860,500)
Other expenses	5	(742,650)
Finance cost	6	(35,000)
Profit before tax		
Total expenditures		(4,482,450)
Profit before tax		487,950
Tax (30%)		(146,385)
Profit after tax		341,565

Notes

(1) Other income

Income from government grants	116,000
Dividend income	500,000
Income from sale of tender forms	56,400
House rent received from employees	198,000
	870,400

(2) Employee remuneration and benefits	
Salaries and wages	300,000
Training and development	200,000
Bonus	100,000
Leave encashment	223,000
Gratuity	353,200
Terminal benefits	125,600
Medical benefits	100,000
Staff welfare costs	345,000
	1,746,800

(3) Repairs and Maintenance cost	
Repair and maintenance-office buildings	230,000
Repair and maintenance- computers	150,000
Repair and maintenance- vehicles	110,000
	490,000

(4) Depreciation and amortisation	
Amortisation –computer software	120,000
Deprecation –F&F	200,000
Depreciation –machinery	230,500
Depreciation –OE	150,000
Impairment –computer software	100,000
Impairment – office equipment	60,000
	860,500

(5) Other expenses	
Travel	90,750
License fees	76,000
Brand management	230,500
Entertainment	120,000
Consultancy charges	150,000
Meeting expenses	75,400
	742,650

(6) Finance costs	
Interest from deposits	150,000
Interest on non governmnet bonds	200,000
Interest on bank loan	300,000
Bank fees and other charges	85,000
	(35,000)

b) Frequency of reporting

An entity presents a complete set of financial statements (including comparative information) at least annually. However, entities of government interest or a public limited companies may be required to issue an interim reports before the annual report. Interim reports are issued for a period less than 12 months.

c) Comparative information

Entities present comparative information of the preceding period for all amounts reported in the current period's financial statements. An entity must 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.

Particulars	Note No.	2018	2017
Income			
Electricity revenue	15	11,445,445,454.64	11,953,372,682.94
Interest earned	16	102,724,721.30	120,889,001.79
Other income	17	133,810,947.66	202,983,418.74
		11,681,981,123.60	**12,277,245,103.47**
Expenditure			
Wheeling charges		609,835,005.46	742,351,161.01
Insur		112,845,830.50	113,043,211.21
Runn	18	387,811,614.50	443,656,365.04
Empl	19	858,018,229.97	847,624,681.20
Finance cost	20	287,355,111.39	345,415,270.69

2018 and 2017 -2 years comparative information

Entities reporting in some jurisdictions may be required to present comparative information for more than one preceding year.

Group income statement
Years ended 31 December

	Note	2017 US$m	2016 US$m	2015 US$m
Consolidated operations				
Consolidated sales revenue	2,3	**40,030**	33,781	34,829
Net operating costs (excluding items shown separately)	4	**(26,983)**	(26,799)	(27,919)
Impairment charges	6	**(796)**	(249)	(2,791)
Net gains on disposal of interests in businesses	2,37	**2,344**	515	64
Exploration and evaluation costs	13	**(445)**	(497)	(576)
(Loss)/profit relating to interests in undeveloped projects	13	**(15)**	44	8
Operating profit		**14,135**	6,795	3,615
Share of profit after tax of equity accounted units	7	**339**	321	361
Profit before finance items and taxation		**14,474**	7,116	3,976
Finance items				
Net exchange (losses)/gains on external debt and intragroup balances	24	**(601)**	611	(3,538)
Net gains/(losses) on derivatives not qualifying for hedge accounting		**33**	(24)	(88)
Finance income	8	**141**	89	52
Finance costs	8	**(848)**	(1,111)	(750)
Amortisation of discount		**(383)**	(338)	(378)
		(1,658)	(773)	(4,702)
Profit/(loss) before taxation		**12,816**	6,343	(726)
Taxation	9	**(3,965)**	(1,567)	(993)
Profit/(loss) after tax for the year		**8,851**	4,776	(1,719)

2017, 2016 and 2015 -3 years comparative information

Source: Rio Tinto Annual Report 2018

d) Consistency of presentation

An entity should retain the presentation and classification of items in the financial statements from one period to the next unless:

i) there is a change in the nature of the entity's business operations or a review of the financial statements and such a change would be more appropriate, or

ii) an accounting standards requires a change in presentation.

Particulars	Note No.	2017	2016
Income			
Electricity revenue	15	11,953,372,682.94	12,602,988,785.09
Interest earned	16	120,889,001.79	159,258,446.38
Other income	17	202,983,418.74	120,695,148.21
		12,277,245,103.47	**12,882,942,379.68**
Expenditure			
Wheeling charges		742,351,161.01	617,472,078.88
Insurance		113,043,211.21	114,271,454.59
Running and maintenance expenses	18	443,656,365.04	309,814,013.87
Employees' remuneration and benefits	19	847,624,681.20	812,915,270.97
Finance cost	20	345,415,270.69	477,493,972.42
Depreciation/amortization	2	2,267,598,498.36	2,307,281,458.81
Other expenses	21	293,101,904.60	292,084,940.18
		5,052,791,092.11	**4,931,333,189.72**
Operating profit		**7,224,454,011.36**	**7,951,609,189.96**

Amount in Nu.

Particulars	Note No.	2016	2015
Income			
Electricity Revenue	18	14,385,687,591.04	14,058,058,253.05
Interest Earned	19	118,794,175.31	154,143,864.38
Other Income	20	119,567,678.07	45,883,343.91
		14,624,049,444.42	**14,258,085,461.34**
Expenditure			
Wheeling charges		617,472,078.88	592,984,484.74
Royalty Expense		1,560,196,169.87	1,520,595,229.77
Insurance		114,271,454.59	114,506,467.10
Running and Maintenance Expenses	21	341,880,068.90	333,746,047.11
Employees' Remuneration and Benefits	22	762,487,124.95	801,529,676.23
Purchase of Energy	23	222,502,636.08	314,512,552.02
Interest on Borrowings	24	476,514,602.15	622,014,081.21
Depreciation/Amortisation	1	2,307,189,845.73	2,306,848,808.20
Other Expenses	25	262,770,028.65	245,160,890.13
		6,665,284,009.80	**6,851,898,236.51**
Operating Profit		**,765,434.62**	**7,406,187,224.83**
		,284,009.80	**6,851,898,236.51**
Operating Profit		**,765,434.62**	**7,406,187,224.83**

Financial statements presented consistently over accounting year 2015-2017

Source: DGPC Annual Report 2017

In the following sections, you will learn about the details of each financial statement and the method to present each of these financial statements. Remember, the objective of preparing financial statements is to provide a relevant and faithful information to the information users who will depend on such information to make their investment and other economic decision.

8.2 Statement of Income

An entity presents a single statement of comprehensive income, with statement of income and other comprehensive income presented in two sections. The standard permits to use names like statement of profit or loss and other comprehensive income, statement of comprehensive income. Entities also simply use the name statement of income. However, in the industry, many entities both within and outside the country use the name 'statement of comprehensive income'. In our class XI and class XII texts, we deliberately chose to use the name 'statement of income' since we do not delve into other comprehensive income part at class XI and class XII.

An entity shall not present any items of income or expense as extraordinary items, in the statement of income or in the notes. An extraordinary item is an item of income or expense arising from events that are unusual and infrequent in nature. For example, an entity incurs a huge expense in 2019 due to restructuring or a fire in its factory. Earlier this type of expense or income was recognized as an extraordinary item in the financial statements. This presentation is no longer permitted by BAS/IAS. Extraordinary items are further explained in notes accompanying financial statements.

An entity must present the statement of income with a proper classification of items of income and expenses. BAS1/IAS1 specifies two types of presentation of income and expense items in the statement of income using a classification based on either their nature or their function within the entity, whichever provides information that is reliable and more relevant.

i. Nature of expense method
ii. Function of expense method (also called cost of sales method)

8.2.1 Nature of expense method

An entity using this method aggregates expenses within statement of income according to their nature (for example, depreciation, purchases of materials, transport costs, employee benefits and advertising costs), and does not reallocate them among functions within the entity. This method may be simple to apply

Revenue	X
Other income	X
Raw materials and consumables used	X
Changes in inventories of finished goods and work in progress	X
Employee benefits expense	X
Depreciation and amortisation expense	X
Other expenses	X
Total expenses	(X)
Profit before tax	X
Tax	(X)
Profit after tax	X

Materials consumed and consumables used = opening inventory of materials or consumables + purchases – closing inventory of materials

Remember that this is not the exhaustive list of classification. Student should read different entities' financial statements to understand how entities apply this method to classify and present expenses in the income statement. One of the examples is given below.

9 Statement of Comprehensive Income for the year ended on 31st December, 2017

Amount in Nu.

Particulars	Note no.	As at 31st December 2017	As at 31st December 2016
I. Income :			
Revenue from operations:			
Domestic	22	2,996,912,419.62	2,811,193,414.65
International	23	27,335,040.88	40,300,577.89
Other operating income	24	150,019,263.11	258,514,399.62
Gain on forex fluctuations		19,819,798.86	21,846,955.08
Total revenue		**3,194,086,522.47**	**3,131,855,347.24**
II. Expenditure:			
Stores and spares parts	25	59,904,615.38	60,886,233.92
Employees' remuneration and benefits	26	328,428,074.68	313,442,822.09
Repair & maintenance	27	193,182,263.19	182,833,263.97
Administrative and general expenses	28	516,284,420.59	443,298,681.44
International payments	29	193,866,488.52	185,081,304.95
Depreciation of property, plant & equipment	30	460,260,721.83	491,838,629.64
Depreciation and amortization	31	207,605,538.00	149,765,755.00
Loss on forex fluctuations		18,138,661.11	25,730,068.12
Total expenditures		**1,977,670,783.30**	**1,852,876,759.13**
Profit before tax		**1,216,415,739.17**	**1,278,978,588.11**
III. Add/(Less): Tax expenses :	32		
Previous tax			7,062,128.47
Current tax		403,952,707.54	393,857,779.75
Deferred income tax		(16,443,370.33)	8,954,645.83
Total tax expense		**387,509,337.21**	**409,874,554.05**
Profit after tax for the year		**828,906,401.96**	**869,104,034.06**
IV. Other comprehensive income			
Actuarial (gains)/losses on defined benefit plans		46,380.00	6,042,078.00
Income tax relating to component for other comprehensive Income			
Other comprehensive income, net of tax		46,380.00	6,042,078.00
Total comprehensive income for the year		**828,860,021.96**	**863,061,956.06**
Earnings Per Share	33	**970.52**	**1,017.59**
Summary of significant accounting policies	1		

For KASG & Co.
Chartered accountants
(Firm Reg. No. 002228C)

for and on behalf of board of directors

Source: Bhutan Telecom Limited Annual Report 2017

8.2.2 Function of expense method

Revenue	X
Cost of sales	(X)
Gross profit	X
Other income	X
Distribution costs	(X)
Administrative expenses	(X)
Other expenses	(X)
Profit before tax	X
Tax	(X)
Profit after tax	X

The second method classifies expenses according to their function as part of cost of sales or, for example, the costs of distribution or administrative activities. At a minimum, an entity discloses its cost of sales under this method separately from other expenses. In the next page, Kuensel Corporation Limited, for example, presents its income statement in this structure.

This method can provide more relevant information to users than the classification of expenses by nature, but allocating costs to functions may require arbitrary allocations and involve considerable judgment. An example of a classification using the function of expense method is as follow:

	No	December 2017	2016
Income			
Revenue	14	212,522,819.58	229,022,424.53
Interest Earned	15	923,708.50	980,298.31
Other Income	16	541,000.00	981,171.49
		213,987,528.08	**230,983,894.33**
Expenditure			
Cost of Sales	17	78,906,165.42	91,037,309.84
Employees' Remuneration and Benefits	18	77,014,115.65	77,004,813.01
Operating Expenses	19	21,929,267.55	19,603,628.27
Interest Expenses	20	-	12,667.69
Depreciation	2A	4,929,381.36	5,057,661.66
Other Expenses	21	681,882.92	907,229.53
		183,460,812.90	**193,623,310.00**
Operating Profit		**30,526,715.18**	**37,360,584.33**
Less:			
Prior Period Adjustments	22	266,132.10	47,686.50
Profit Before Tax		**30,260,583.08**	**37,312,897.83**
Less:			
Deferred Tax (Income)/Expense	23	1,090,261.26	1,150,929.53
Income Tax for earlier years		-	-
Provision for tax		9,394,552.39	10,805,869.65
Profit After Tax		**19,775,769.44**	**25,356,098.65**

Kuensel Corporation Limited Annual Report 2017

It is observed that most of the companies adopting BAS seem to be following the first method of presentation of statement of income (nature of expense method). Entities applying the second method present cost of sales but do not exactly classifies other expenses into functions as depicted in the example. This is permitted by the standards.

8.3 Statement of Financial Position

Before this statement was called 'balance sheet' and later on it was renamed as statement of financial position to emphasize on the financial reporting of the assets, liabilities and net assets of the reporting entity.

The statement of financial position should, at minimum, present the following line items of assets, liabilities and equity.

Assets

i) Property, plant and equipment

ii) Investment property

iii) Intangible assets

iv) Financial assets (excluding amounts shown under (vii)and (viii))

v) Biological assets

vi) Inventories

vii) Trade and other receivables; and

viii) Cash and cash equivalents

ix) assets classified as held for sale

Equity and Liabilities

i) Issued capital and reserves attributable to owners of the parent

ii) Financial liabilities (excluding amounts shown under (iv)

iii) Provisions

iv) Trade and other payables;

v) Liabilities for current tax,

vi) Deferred tax liabilities

An entity can 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. Read the statement of financial position presented in the next page to understand the way how assets and liabilities are classified and aggregated.

8 Statement of Financial Position for the year ended 31st December, 2017

Amount in Nu.

Particulars	Note no.	As at 31st December 2017	As at 31st December 2016
I. ASSETS :			
(a) Non-current assets			
Property, plant and equipment	2(a)	3,723,329,874.37	3,271,044,130.97
Intangible assets	2(b)	1,087,506,398.48	801,481,387.77
Capital work-in-progress	2(c)	15,077,014.66	191,736,666.62
Investment in associate	3	92,308,400.00	92,308,400.00
Investments	4	124,734,293.09	60,357,597.17
Deferred tax assets (net)	5	9,659,868.50	-
Other non-current asset	6	12,950,000.00	25,900,000.00
Total non-current assets		**5,065,565,849.10**	**4,442,828,182.53**
(b) Current assets			
Inventories	7	107,008,946.13	172,894,075.65
Trade receivables	8	131,277,802.84	130,871,143.62
Cash and bank balances	9	172,043,085.68	249,870,824.85
Other receivables	10	852,829.56	1,518,479.71
Other current asset	11	19,072,940.31	38,587,482.48
Total current assets		**430,255,604.52**	**593,742,006.31**
TOTAL ASSETS		**5,495,821,453.62**	**5,036,570,188.84**
II. EQUITY AND LIABILITIES :			
(a) Shareholders Fund			
Equity share capital	12	854,082,000.00	854,082,000.00
Retained earnings & reserves	13	3,370,263,346.44	3,229,146,589.11
Total shareholders fund		**4,224,345,346.44**	**4,083,228,589.11**
(b) Non-current liabilities			
Deferred government grants	14	88,166,156.74	89,608,076.08
Long term borrowings	15	648,615,398.01	300,000,000.00
Deferre tax liability (net)	16	-	6,783,501.83
Long term provision	17	67,340,966.40	54,164,193.08
Total non-current liabilities		**804,122,521.15**	**450,555,770.99**
(c) Current liabilities			
Short term borrowings	18	79,636,472.99	-
Trade and other payables	19	95,009,736.71	56,111,935.61
Short term provision	20	219,557,051.29	267,388,960.29
Other current liabilities	21	73,150,325.04	179,284,932.84
Total current liabilities		**467,353,586.03**	**502,785,828.74**
Total liabilities (b+c)		**1,271,476,107.18**	**953,341,599.73**
TOTAL EQUITY & LIABILITIES		**5,495,821,453.62**	**5,036,570,188.84**
Summary of significant accounting policies	1	0.00	-

The above accompanying notes are an integral part of the financial statements

Bhutan Telecom Limited Annual Report 2017

The Standard does not prescribe the order or format in which an entity presents items. An entity uses its own judgment about whether to present the items in the order of liquidity or long term assets. The financial institutions or financing companies may present the items in the order of liquidity due to the nature of their business, while manufacturing and trading companies may present the other way. An example of the liquidity approach can be seen in the statement of financial position of Bank of Bhutan Limited in the following page.

BANK OF BHUTAN LIMITED
STATEMENT OF FINANCIAL POSITION AS AT 31ST DECEMBER 2017

ASSETS	Note	As at 31.12.2017	As at 31.12.2016
Cash & Balance with RMA	2.1	11,385,835,097.67	14,078,764,442.75
Loans & Advances to Banks	2.2	3,239,673,269.02	3,297,561,164.06
Loans & Advances to Customers	2.3	26,386,692,805.47	20,725,407,844.74
Investment Securities	2.4-A	8,990,938,616.44	5,502,626,800.00
Investment in Associates	2.4.B	37,811,000.00	37,811,000.00
Investment in Portfolio Companies	2.4-C	80,193,710.45	80,193,710.45
Prepayments & Accrued Income	2.5	109,846,304.06	104,055,083.25
Deferred Tax Assets	2.6	55,530,549.64	49,259,265.00
Other Assets	2.7	181,190,715.02	303,621,892.46
Property, Plant & Equipment	2.8-A	404,120,309.17	396,952,980.02
Intangible Assets	2.8-B	126,315,866.38	117,161,990.36
Capital Work-in-Progress	2.8-C	134,131,375.43	79,952,768.26
TOTAL ASSETS		**51,132,279,618.74**	**44,773,368,941.34**
LIABILITIES			
Deposits by Banks	2.9	58,726,219.18	139,956,391.63
Customer Deposits	2.10	42,838,187,176.70	36,492,874,675.65
Subordinated Liabilities & Other Borrowed Funds	2.11	-	500,000,000.00
Provision for Liabilities & Charges	2.12	13,514,114.03	26,735,506.19
Retirement Benefit Obligations	2.13	133,541,219.98	123,836,170.00
Accruals & Deferred Income	2.14	1,366,552,100.09	1,143,994,251.44
Current Tax Liabilities	2.15	69,908,079.68	230,388,901.84
Other liabilities	2.16	752,677,112.67	609,393,028.26
TOTAL LIABILITIES		**45,233,106,022.33**	**39,267,178,925.01**
EQUITY			
Share Capital	2.17 A	3,000,000,000.00	3,000,000,000.00
Retained Earnings	2.18	1,360,321,072.38	1,330,145,266.27
Reserve Fund	2.18	1,333,120,806.30	979,362,937.39
Other Reserves	2.18	205,731,717.74	196,681,812.67
TOTAL EQUITY		**5,899,173,596.42**	**5,506,190,016.33**
TOTAL LIABILITIES & EQUITY		**51,132,279,618.75**	**44,773,368,941.34**

SOFP presented in liquidity order. Property, plant and equipment presented after liquid assets. Compare this presentation with Bhutan Telecom Limited.

BOBL Annual Report 2017

8.3.1 Current/non-current distinction

An entity should 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 should present all assets and liabilities in order of liquidity.

a) Current assets

An entity classifies an asset as current when:

i) it expects to realise the asset, or intends to sell or consume it, in its normal operating cycle (usually twelve or less than twelve months)*;

ii) it holds the asset primarily for the purpose of trading;

iii) it expects to realise the asset within twelve months after the reporting period; or

iv) the asset is cash or a cash equivalent.

All other assets are classified as non-current. The 'non-current' assets include tangible, intangible and financial assets of a long-term nature.

Current assets include assets (such as inventories and trade receivables) that are sold, consumed or realised as part of the normal operating cycle even when they are not expected to be realised within twelve months after the reporting period. For example, manufacturing of an aircraft would take longer than twelve months. So all inventories related to manufacturing of an aircraft will be treated as current assets even if inventories were to last for more than twelve months after the reporting date.

b) Current liabilities

An entity presents a liability as current when:

i) it expects to settle the liability in its normal operating cycle,

ii) it holds the liability primarily for the purpose of trading,

iii) the liability is due to be settled within twelve months after the reporting period, or

iv) it does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period. Example, the portion of a loan payable within the next accounting period.

All other liabilities are classified and presented as non-current.

There are some current liabilities, such as trade payables and some accruals for employee and other operating costs, which are part of the working capital used in the entity's normal operating cycle. An entity classifies such operating items as current liabilities even if they are due to be settled more than twelve months after the reporting period.

An entity discloses the following, either in the statement of financial position or the statement of changes in equity, or in the notes:

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; and

v) the rights, preferences and restrictions attaching to that class including restrictions on the distribution of dividends and the repayment of capital.

An entity without share capital, such as a partnership or trust, also disclose a similar information, showing changes during the period in each category of capital interests.

8.4 Statement of Cash Flows

It is important for the student to know the difference between cash flow and net profit. An entity may have high net profit without cash and vice versa. In reality, investors and many other stakeholders analyse cash flow statements since it provides a more valid information. Net profit could be sometimes manipulated by non-cash transactions such as depreciation, inventory obsolescence, revaluation of assets and various provisions.

Cash flow provides a very useful information about the ability of the entity to generate cash and cash equivalents and the needs of the entity to utilise those cash flows. IAS7/BAS 7 provides detail guidelines for the presentation and disclosure of cash flow information.

The statement of cash flows not only shows how much cash the entity generated over the year, but also how the cash was generated. For example the entity might generate cash flows out of increased sale, disposal of property, plant and equipment or taking a short-term or a long-term commercial borrowings. The assessment of cash flows is a significant investment decision for many investors. Therefore, it is critically important for the entity to prepare and present a statement of cash flows with the details of the sources and application of cash flows.

c) Cash and cash equivalents

The accounting standard recognizes cash as both 'cash' and 'cash equivalents'. Cash comprises cash on hand and demand deposits with banks. 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. The short-term investments in government treasury bills and other similar instruments with maximum of 3 months and less maturity days are considered as cash equivalents. Cash flows are inflows and outflows of cash and cash equivalents.

Cash and cash equivalents

CASH

CASH EQUIVALENTS

Cash in hand

BOB BANK OF BHUTAN

Demand deposits

Short term investment (< 3 months, e.g. RMA Treasury Bills)

d) Presentation of cash flows

IAS7/BAS7 specifies the structure of the statement of cash flows and requires to disclose cash flows by categorizing cash flows from:

i) operating activities;

ii) investing activities; and

iii) financing activities.

Types of cash flows

Operating activities

Investing activities

Financing activities

a. *Operating activities*

Operating activities are the principal revenue-producing activities of the entity and other activities that are not investing or financing activities. This is the cash and cash equivalents generated from the main revenue generating activities of the entity such as the sales of goods or inventory as opposed to revenue generated from sale of entity's property, plant and equipment or from issue of shares. For a business, this is the most important source of cash as it is directly related to the capacity and the competitiveness of the entity to earn revenues. As such, cash flows from operating activities of a business entity might largely differ from one to another entity. The cash flows from operating activities will also depend on the market competition, and management's ability to respond to such competition and other larger economic conditions.

Student must understand that different entities engage in different operating activities. For example, Penden Cement Authority Limited (PCAL) produces cement which is the main revenue generating activity of the company. Whereas, Druk Air Corporation Limited provides travel and freight services. Thus, PCAL generates cash flows from operating activities through production and sale of various types of cement grades such as Portland Slag Cement, Portland Pozzolana Cement and Ordinary Portland Cement. Druk Air Corporation Limited, on the other hand, generates cash flows from the sale of air tickets and freight services.

Operating activities generally are profit making activities which includes the following:

- 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;
- Cash receipts and cash payments of an insurance entity for premiums and claims, annuities and other policy benefits;
- Cash payments or refunds of income taxes unless they can be specifically identified with financing and investing activities; and
- Cash receipts and payments from contracts held for dealing or trading purposes.

b. 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 classified in investing activities are:

- Cash payments to acquire property, plant and equipment, intangibles and other long-term assets (including capitalized development costs and self-constructed PPE);
- Cash receipts from sales of PPE, intangibles and other long-term assets;
- Cash payments to acquire and cash receipts from sales of equity or debt instruments of other entities and interests in joint ventures (but not for trading or dealing purposes); and
- Cash advances and loans made to other parties, and cash receipts from their repayment (other than advances and loans made by a financial institution – these would go to operating part)

c. Financing activities

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:

- Cash proceeds from issuing shares or other equity instruments;
- Cash payments to owners to acquire or redeem the entity's shares;
- Cash proceeds from issuing debentures, loans, notes, bonds, mortgages and other short-term or long-term borrowings;
- Cash repayments of amounts borrowed; and

Cash flows from investing and financing activities are presented in gross amount. For example, the amount received from sale of property, plant and equipment item cannot be netted off with the purchase of a similar item of property, plant and equipment.

e) Reporting cash flows from operating activities

An entity may report cash flows from operating activities using either:

a. the direct method, whereby major classes of gross cash receipts and gross cash payments are disclosed; or
b. the indirect method, whereby profit or loss is adjusted for the effects of transactions of a non-cash and non-operating nature, and the movement in working capital.

a. Indirect method

In this method, the cash flows from operating activities is calculated by taking the profit or loss before tax (PBT) and then adjust for:

i) non-cash transactions (such as depreciation, unrealized gains and losses),

ii) non-operating activities (i.e. activities of investing and financing), and

iii) changes in working capital over the period (i.e. changes current assets and current liabilities except cash and cash equivalents).

Cash from operating activities	
Profit before tax (PBT)	xxxxx
Adjustments for non-cash items	
Non-cash gain/income	(xxxx)
Non-cash expense/losses	(xxxx)
Changes in working capital	
Increased inventories	(xxxx)
Increased receivables	(xxxx)
Increased payables	xxxx
Cash from operations	***xxxxx***
Interest paid	(xxxx)
Tax paid	(xxxx)
Net cash from operating activities	*xxxxx*

b. Direct method

When the direct method is used, cash from operating activities is calculated by taking the gross cash receipts and deduct gross cash payments from the receipts.

Cash from operating activities	
Cash receipts from customers	xxxxx
Cash paid to suppliers	(xxxx)
Cash paid to employees	(xxxx)
Cash from operations	*xxxxx*
Interest paid	(xxxx)
Tax paid	(xxxx)
Net cash from operating activities	*xxxxx*

c. Direct vs indirect method

Direct method provides more understandable information not disclosed under indirect method. However, in practice, entities prefer indirect method because it's easier to get the information based on the accounting records.

d. Interest and dividends

Cash flows from interest and dividends received and paid should each be disclosed separately. Each should be classified in a consistent manner from period to period as either operating, investing or financing activities. Read the statement of cash flows provided in the following page and note the interest and dividend reported under operating activities. In fact, an entity has a choice for presentation of each of these items as outlined below.

- Interest and dividends paid can be classified either as operating cash flow, or financing cash flow.
- Interest and dividends received can be classified either as operating cash flow, or investing cash flow.

What is important is that the entity must continue to use the same approach consistently over the years.

e. Taxes on income

Unlike cash flows of interest and dividend, cash flows arising from income taxes are classified as cash flows from cooperating activities unless an entity is able to identify taxes with financing and investing activities.

f. Reconciliation of cash flows

The cash and cash equivalents in the beginning and at the year-end should be reconciled.

Cash inflow for the year	xxx	(A)-(B)
Cash and cash equivalents in the beginning	xxx	(A)
Cash and cash equivalents at the year-end	xxx	(B)

DrukGreen

Statement of Cash flows

for the year ended December 31, 2018

Amount in Nu.

Particulars	2018	2017
Cash flows from operating activities		
Profit before taxation	6,679,062,222.35	7,224,454,011.36
Adjustment for		
Depreciation / amortization	2,301,679,892.39	2,267,598,498.36
Foreign exchange loss	197,729,976.76	(127,013,702.07)
Loss/(gain) on sale of property plant & equipment	(7,160,424.78)	(1,851,728.90)
Investment income	(102,724,721.30)	(120,889,001.79)
Interest expenses	287,355,111.39	345,415,270.69
(Increase)/decrease in trade receivables and other receivables	51,132,589.90	231,138,856.41
(Increase)/decrease in inventories	87,689,476.94	4,596,451.15
(Increase)/decrease in prepayments and advances	(118,959,632.25)	90,475,182.43
(Increase)/decrease in assets classified as held for sale	(1,459,732.80)	(294,185.37)
Increase/(decrease) in trade and other payables	(2,987,654.95)	63,289,869.34
Increase/(decrease) in other current liabilities	(166,259.43)	(192,854.40)
Increase/(decrease) in employee benefit obligation	49,096,646.48	62,419,143.87
(Increase)/Decrease in Other asset	(180,361.14)	(152,941.14)
Cash generated from Operation	**9,420,107,129.56**	**10,038,992,869.94**
Income tax paid	(2,257,686,446.22)	(2,627,327,762.52)
Net cash from operating activities	**7,162,420,683.34**	**7,411,665,107.41**
Cash flows from investing activities		
Purchase of PPE & intangibles assets	(1,035,724,340.41)	(1,134,494,242.22)
Sale of PPE & intangible asset	-	(84,730.01)
Payment for investments in subsidiaries and joint ventures	(1,165,592,363.48)	(911,044,894.36)
Proceeds from held-to-maturity investments	688,964,315.07	(12,771,974.07)
Interest received	(48,786,827.25)	153,572,383.31
Net cash used in investing activities	**(1,561,139,216.07)**	**(1,904,823,457.36)**
Cash flows from financing activities		
Issue of share capital	230,520,000.00	832,822,000.00
Repayment of loan	(1,510,039,544.60)	(1,556,664,756.55)
Interest paid	(244,461,538.19)	(351,238,360.67)
Dividend paid	(4,905,354,484.00)	(4,253,351,834.07)
Net cash used in financing activities	(6,429,335,566.79)	(5,328,432,951.29)
Net increase/(decrease) in cash and cash equivalents	(828,054,099.52)	178,408,698.76
Cash and cash equivalents at the beginning of the period	1,277,226,091.22	1,098,817,392.45
Cash and cash equivalents at the end of the period	**449,171,991.70**	**1,277,226,091.21**
Component of cash and cash equivalents		
Cash in hand	951,803.43	1,661,965.81
Balances in current accounts with banks	448,220,188.27	1,275,564,125.41
Total	**449,171,991.70**	**1,277,226,091.22**

Illustration 6

A reporting entity drafted its financial statements for the financial year ending 31 December 2017 as given below. Using the draft financial statements, you are required to prepare a statement of cash flows using a direct method and as per the current accounting standards for reporting cash flows.

Statement of income for the year ending 31 December 2017

	Amount (nu.
Sales revenue	2,460,000
Cost of sales	(1,780,000
Gross profit	680,000
Operating expenses	**(424,000**
Operating profit	256,000
Interest	(24,000
Profit before tax	**232,000**
Taxation	(48,000
Profit after tax	**184,000**

Statement of financial position as at 31 December 2017

	2017 Amount (Nu)	**2016 Amount (Nu)**
Non current assets		
Property, plant and equipment	720,000	540,000
Accu depreciation	(190,000)	(145,000)
Investments	140,000	115,000
Current assets		
Inventories	418,000	**315,000**
Trade receivables	438,000	412,000
cash and cash equivalent	51,000	48,000
	1,577,000	1,285,000
Equity and Liabilities		
Equity capital	800,000	600,000
Share premium	55,000	40,000
Retained earning	311,000	217,000
Non current liabilities		
12% Bank Loan	200,000	250,000
Current liabilities		
Trade payables	166,000	139,000
Taxation	45,000	39,000
	1,577,000	**1,285,000**

Statement of changes in equity for the year ended 31 December 2017

	Amount (Nu)
Accumulated profit	217,000
Profit after tax	184,000
Dividend paid	(90,000)
Accumulated profit c/f	**311,000**

Solution

Statement of cash flows for the year ended 31 December 2017

Cash flow from operating activities	**Amount (Nu)**	**Note**
Sales	2,434,000	1
Purchases	1,856,000	2
Expenses	379,000	3
Cash inflow from operation	199,000	
Interest	24000	
Dividend paid	90,000	
Tax paid	42000	4
	43,000	
Cash flow from Investing activities		
Purchase of new PPE	180,000	5
Additional cash Investments	25,000	6
Cash outflow from investing activities	**205,000**	
Cashflow from Financing activities		
Cash from Equity capital	200,000	7
Cash from Share premium	15,000	8
12% bank loan paid	50,000	9
Cash inflow from financing activities	**165,000**	
Cash inflow for the year	**3,000**	Reconciliation of cash and cash equivalent before and after year-end
Opening cash balance 1.1.2017	48,000	
Closing cash balance 31.12.2017	51,000	
Net cash inflow in the year	**3,000**	

Working Notes

(1) Calculation of Cash revenue

Trade receivables account

Bal b/f	412,000	**Cash**	2,434,000
Sales revenue	2,460,000	Balance c/d	438,000
	2,872,000		**2,872,000**

(2) Calculation of purchases

Cost of Sales

Opening inventory	315,000
Purchaes	1,883,000
Closing inventory	418,000
	(1,780,000)

COS= OS + P - CS

Calculation of cash purchases

Trade payables

Cash purchases	1,856,000	Balance b/f	139,000
Balance c/d	166,000	Purchases	1,883,000
	2,022,000		**2,022,000**

(3) Calculation of cash expenses

Expense account

Depreciation	45000	SOCI	424,000
Cash expense	379,000		
	424000		**424,000**

(4) Cash tax expense paid

Tax account

Tax payable	48000	SOCI	48000

Tax liability account

Balance c/d	45000	Bal b/f	39000
Cash tax paid	42000	Tax expense	48000
	87000		**87000**

(5) PPE

PPE Account

Balance b/f	40,000	balance c/d	720,000
Cash purchases	180,000		
	720,000		**720,000**

(6) Investment

Investment account

Balance b/f	115,000		
Cash investment	25,000	Balance c/d	140,000
	140,000		**140,000**

(7) Cash Equity Brought in

Equity account

		Additional cash	200,000
Balance c/d	800,000	Balance b/f	600,000
	800,000		**800,000**

(8) Share premium

Share premium account

		Balance b/f	40000
Balance c/d	55000	Cash paid	15000
	55000		**55000**

(9) 12 % Bank Loan

12 % Bank Loan

Loan paid	50,000	Balance b/f	250,000
Balance c/d	200,000		
	250,000		**250,000**

8.5 Statement of changes in equity

An entity presents a statement of changes in equity as required by the accounting standards. The statement of changes in equity includes the following information:

i) 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:
   a. profit or loss;
   b. other comprehensive income; and
   c. for each component of equity, the effects of retrospective application or retrospective restatement recognised in accordance with BAS 8;
   d. transactions with owners in their capacity as owners, showing separately contributions by and distributions to owners and changes in ownership interests in subsidiaries that do not result in a loss of control.

In class XI and XII, student will be required to present statement of changes in equity due to change in profit or loss of the entity.

An entity can 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. Dividend amount is not reported as part of statement of income.

11 Statement of Changes in Equity for the year ended 31st December, 2017

Amount in Nu.

Particulars	Equity share Capital	Retained Earnings	Group Investment Reserve	Total Equity
Balance at 1st January 2016	854,082,000.00	2,455,144,505.47	405,489,602.00	3,714,716,107.47
Changes in equity for 2016	-	-	-	-
Comprehensive Income for the year	-	863,061,956.06	-	863,061,956.06
Dividend for FY 2015	-	(490,806,576.42)	-	(490,806,576.42)
Free hold land transferred to DHI	-	(3,742,898.00)		(3,742,898.00)
Balance at 31st December 2016	**854,082,000.00**	**2,823,656,987.11**	**405,489,602.00**	**4,083,228,589.11**
Changes in equity for 2017	-	-	-	-
Comprehensive Income for the year	-	828,860,021.96	-	828,860,021.96
Dividend for the year	-	(372,199,941.63)	(313,181,202.00)	(685,381,143.63)
Free hold land transferred to DHI	-	(2,362,121.00)	-	(2,362,121.00)
Balance at 31st December 2017	**854,082,000.00**	**3,277,954,946.44**	**92,308,400.00**	**4,224,345,346.44**

Source: Bhutan Telecom Annual Report 2017

Reconciliation of carrying amount of equity at the beginning and at the end of the year

Carrying amount of equity at the beginning	X
Add: Net profit for the year	X
Add: Revaluation surplus	X
Less: Dividend paid	(X)
Less: Adjustment for previous year's errors/estimates (if there is)	(X)
Carrying amount of equity at the end of the year	X

Illustration 7

An entity reported a net profit of Nu. 2,450,000 for the year ended 2019. The statement of changes in equity as at 31 December 2018 showed the balances of each component of equity as follows:

Equity capital	Nu. 10,000,000
Retained earnings	Nu. 4,500,000
General reserve	Nu. 2,000,000

Management proposed and after some time declared a dividend of Nu. 800,000 for 2018. There was an error of Nu. 600,000 due to under charging of depreciation expense in 2018.

Required:

Prepare statement of changes in equity for the year ended 31 December 2019.

Solution:

	Equity capital	General reserve	Retained earnings	Total Equity
1-Jan-19	10,000,000	2,000,000	4,500,000	16,500,000
Net profit for 2019			2,450,000	2,450,000
Transfer to General Reserve		1,000,000	-1,000,000	0
Adjustmnet of previous year's errors (e.g depreciation)			-60,000	-60,000
Dividend paid for the previous year			-800,000	-800,000
31-Dec-19	10,000,000	3,000,000	5,090,000	18,090,000

8.6 Notes

Notes are an important part of financial statements. Notes present information about the basis of preparation of the financial statements and the specific accounting policies used. Notes provide justification of the amounts and items presented in the financial statements, thus it is relevant to an understanding of the financial statements.

8.7 Disclosure of Accounting Policies

An entity should 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.

It is important for an entity to inform users of the measurement basis or bases used in the financial statements (for example, historical cost, current cost, net realisable value, fair value or recoverable amount) because the basis on which an entity prepares the financial statements significantly affects users' analysis of the financial statements. In deciding whether a particular accounting policy should be disclosed, management considers whether disclosure would assist users in understanding how transactions, other events and conditions are reflected in reported financial performance and financial position.
An example of an accounting policy on contingent liabilities and contingent assets is given below:

Contingent Liabilities and Contingent Assets
Contingent liabilities are not recognized but disclosed for all possible obligations that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.
Contingent assets is also not recognized but disclosed for all possible assets that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

Source: DGPC Annual Report 2017

Illustration 8

Apple Company's statement of financial position is presented below.

	2017	2018
Noncurrent assets		
Property, plant and equipment	780,000	940,000
Current assets:		
Inventory	324,000	396,000
Trade receivables	438,000	412,000
Cash and cash equivalent	12,000	3,000
	1,341	**1,431**
Equity and liabilities:		
Equity shares	700,000	870,000
Retained earnings	74,000	90,000
Noncurrent liabilities:		
6% loan	200,000	150,000
Current liabilities:		
Trade payables	298,000	265,000
Taxation	42,000	45,000
Bank overdraft	-	11,000
	1,314	**1,431**

Further, the extract of the statement of comprehensive income is given below:

Operating profit	103,000
Interest	(12,000)
Profit before tax	**91,000**
Taxation	(45,000)
Profit after tax	**46,000**

Accumulated depreciation of property, plant and equipment for 2017 and 2018 are Nu. 240,000 and Nu. 320,000 respectively.

Required:

i) Explain the purpose of preparing statement of cash flows.

ii) Prepare a statement of cash flows for the year ended 31 December 2018 using the indirect method.

Solution

i) **Purpose of preparing statement of cash flows**

All business transactions involve cash. Cash is used to procure all goods or services needed for the entity. Besides, cash is also used to pay all utility bills, employee remunerations and government tax without which the business entity cannot operate. Cash is also required to support entity's capacity development such as training and development, development of organizational processes and further to acquire property, plant and equipment. The decision related to financing and investment projects involve cash.

It is very important for management to keep proper records of all cash transactions and report to the investors. A large group of investors actually prefer the report on cash flows over the income statement as they think income statement prepared under accrual accounting is subject to manipulation and distortion. There are corporate cases that support this apprehension of the investors.

Statement of cash flows as required by the current accounting standards (IAS7/ BAS7) provides a comprehensive information on cash inflows and cash outflows for the reporting year. Further, cash flows are presented as cash flows from operating, investing and financing activities of the entity. This helps investors to assess the sources and application of cash resources in the entity and get the necessary confidence to invest or discontinue the investment in the entity.

(ii): Preparation of cash flow statement

	Amount
Cash flows from operating activities	
Operating profit	103,000
Add: Depreciation	80,000
Changes in working capital	
Less: Increase in inventory	72,000
Add: Decrease in receivables	26,000
Less: Increase in payables	33,000
Interest paid	12,000
Dividend paid	30,000
Tax paid	42,000
Net cash flow from operating activities	20,000
Cash flow from investing activities	
Purchase of PPE	160,000
Cash flow from financing activities	
Equity capital	170,000
Loan paid	50,000
Net cash from financing activities	120,000
Net cash outflow	-20,000
Opening cash balance	12,000
Cash and cash equivalent (31.12.2018)	**-8,000**
Cash and cash equivalent (31.12.2018)	3,000
Bank overdraft (31.12.2018)	11,000
Net cash and cash equivalent (31.12.2018)	**-8,000**

Workings

2018	2017	Difference
320,000	240,000	80,000
396,000	324,000	72,000
412,000	438,000	26,000
265,000	298,000	33,000

Movement of retained earnings

Opening balance	74,000
Profit for 2018	46,000
Dividend paid (bal fig)	30,000
Closing balance	90,000

940,000	780,000	160,000
870,000	700,000	170,000
200,000	150,000	50,000

Illustration 9

On completion of his first year of business as a dealer in traditional arts and crafts, Sangay prepared his financial statements as shown below. The only mistake he has made is that he has failed to take into account the unsold items costing Nu. 121,000 remaining in hand on 31 December 2019.

Statement of comprehensive income for the year ended 31 December 2019

Sales	640,000
Cost of goods sold	(516,000)
Gross Profit	124,000
Other Expenses	(94,000)
Profit	**30,000**

Statement of financial position as at 31 December 2019

Noncurrent assets	240,000
Loan to staff	15,000
Cash and cash equivalent	75,000
	330,000
Equity capital	300,000
Retained earnings	30,000
	330,000

Required:

i) Define inventory as per BAS2 and provide recognition entry for sale of inventory.

ii) Redraft the financial statements correctly.

Solution

Definition of inventory and cost of goods sold entry

BAS2 defines inventory as assets:

i) held for sale in the ordinary course of business (e.g. vehicles in automobile show rooms)

ii) in the form of materials or supplies to be consumed in the process of production or rendering of services (e.g. raw materials in cement manufacturing company or items of stationery to be consumed)

Revised financial statements

Stament of income for the year ended 31 December 2019

Sales		640,000
CoGS	516,000	
Less: Inventory	121,000	395,000
Gross profit		245,000
Other expenses		94,000
Net profit		151,000

iii)

Statement of financial position as at 31 December 2019

Noncurrent assets	240,000
Current assets	
Invetory	121,000
Loan to satff	15,000
Cash and cash equivalent	75,000
	451,000
Equity capital	300,000
retained earnings	151,000
	451,000

Exercises:

1. Identify the impact of each of the following accounting errors on the trial balance.
   i) Nu. 150,000 received from customer has not been entered in the cash book
   ii) Nu. 5,500 paid for servicing a vehicle has been posted to the motor vehicle account.
   iii) Nu. 10,000 given as a loan to the employee has been posted to the salaries account.
   iv) Nu. 14,000 paid as rent has been entered in the cash account but has not been posted.

2. Bhutan Agro Industries Limited (AGIL) produces canned fruits, and juices, pickles and bottled water for local and international markets. All these products are produced under strict quality control and manufacturing facilities such as hotline fill, hot fill pet blowing machine and canning line. The company recognises revenue when it transfers all risks and rewards of ownership of goods to the customer.

   A total sales of Nu. 3, 567,000 was made in 2019. The company management provides the following information on costs and expenses incurred during the accounting year.

Purchase of raw materials	Nu. 870,000
Opening raw materials	Nu. 500,000
Closing raw materials	Nu. 120,000

Salaries and wages paid to the staff (60 % staff work in the factory)	Nu. 670,500
Depreciation of PP&E (50 % of expense is allocated to factory)	Nu. 200,000
Some customers paid advance payment	Nu. 345,000
Insurance premium was paid (includes 2 months prepaid)	Nu. 280,000
Audit and other monitoring cost	Nu. 100,000
Management entertainment cost	Nu. 80,000
Board remunerations paid	Nu. 120,000
Income from investment in other entities shares	Nu. 543,500
Interest expense on borrowed fund	Nu. 123,000
Other factory cost	Nu. 90,000
Depreciation on marketing van (recently purchased)	Nu. 50,000
Sales promotion and trade fair	Nu. 200,000

A dividend of Nu. 320,000 was proposed. Currently, 30% of corporate tax is levied on the book profit.

Required:

i) Explain the need of accounting policies for the reporting entity.

ii) Prepare statement of comprehensive income classifying the expenses by its function.

3. Phunsum Souvenirs Shop (PSS) provides printing and photo copy services to students. It employs five students on part time basis and a full time manager to run its day to day operation. PSS reports to its stakeholders on a yearly basis by preparing financial statements.

Purchases and sales system

The main purchases of PSS consist of computer papers, cartridge and loose tools. The purchases are expensed when the items are issued. A proper matching of income earned with expense incurred during the accounting period is made in order to ensure a faithful representation of the financial reporting. In 2018, PSS purchased 150 reams of papers from Harayana stores, Phuntsholing at Nu. 450 per ream. By the year end, 60% purchases were issued for printing and photo copies.

PSS charged Nu.5 per paper for both printing as well as photo copy. Each ream of paper contains 300 pages. There were no record of any misuse or waste of paper in the process of printing and photo copy. The 25% of the sales were achieved in the month of November.

The shop receives online print orders from students before 24 hours. The print or photo copy orders are then sorted out by names and left in alphabetical order to be picked up for printing. Once the printing is done, the printed materials are kept on the shelves for collection and payment. The student customers make payments using mBoB system to prevent administrative errors and mishandling of cash. PSS made a significant progress in digitalizing its business. Generally PSS gives its student customers a credit period of 90 days. However, once the invoice accumulates Nu. 5,000, a reminder is send to the customers. PSS has also worked out with the college management a clearance system whereby all students sitting for the examination/graduation/withdrawing from the college must obtain a clearance from the service centers. This mechanism has actually helped PSS to reduce its irrecoverable debt.

Property, plant and equipment

PSS purchased 2 photocopy machines in 2011 at Nu. 150,000 each and 2 HP Laser Jet printers for Nu. 30,000 each. Until 2013, PSS did not keep any records of its properties, it was only in 2014 January that PSS began to maintain a system of recording and developed its accounting policies as per the Bhutanese Accounting Standards for SMEs. Accordingly, PSS adopted historical basis of measurement and a straight line method to account its properties and equipment. The useful life of the photo copy machines and printers were estimated as five years. No scrap value is expected for these properties.

Intangible assets

PSS purchased an accounting system at Nu. 120,000 on 1 March 2018. The system has an estimated useful life of 5 years. Non-current assets acquired during the year are depreciated/amortised on time proportion. The total cost of Nu. 100,000 was incurred in advertisement during the year. PSS management intends to capitalize this cost since they expect that this will bring in additional sales of about 30% in the next 3 years.

Accruals

PSS has Nu. 40,000 of employee salary payable at the year-end. They received Nu. 70,000 from customers in advance.

PSS adopted calendar year as its accounting period.

Required:

Prepare an extract of statement of income and statement of financial position of PSS business for the year ended 2018.

4. Rinchen furniture house trades in all types of furniture at a price set always at 20% above cost. The 2018 year-end trial balance of his business appears as stated below. He did not take year-end inventory but reports that he has taken for his own use inventory costing Nu.7,000 and has given free to his old school's library furniture costing Nu.15,000.

	Debit	Credit
Inventory (1.1.2018)	228,000	
Staff salary	34,000	
Sales		900,000
Rental charges	48,000	
Purchases	688,000	
Noncurrent assets	180,000	
Cash and bank	12,000	
Capital		300,000
Drawings	10,000	
	1,200,000	**1,200,000**

Required:

i) Explain the purpose of preparing trial balance.

ii) Prepare a statement of income for the year ended 31 December 2018.

iii) Prepare a statement of financial position as at 31 December 2018.

Chapter 9
Analysis and Interpretations of Financial Statements

Learning Objectives:

- Explain the need to analyse and interpret financial statements
- Perform some basic financial statement analysis using ratio analysis and common size analysis
- Calculate accounting ratios and provide basic interpretations of these ratios
- Discuss the limitations of accounting ratios
- Explain the concept and purpose of common size analysis
- Perform basic common size analysis of income statement, financial position and cash flows.

Financial Statement analysis involves assessing the performance of the entity by applying the financial statement analysis tools. Financial statement analysis can be made by management to obtain critical information for management decision making, as well as by the external investors who would make investment decisions. Banks and insurance companies might do the same analysis of company's financial statements in order to advance loans and enter into contracts with insurance clients.

This chapter will explain the purpose of financial statements analysis and illustrate how financial statement analysis tools such as common size statements, trend analysis and accounting ratios are applied to assess business performance and make other related interpretations. In the introductory part of class XI text, a brief analysis of a financial statements was included to raise this importance.

9.1 The Need and The Purpose of Financial Statement Analysis

Financial statement analysis is an application of commercial sense with some financial tools to financial statements of an entity to obtain some valid information which can be used to make business or investment decision. Financial statements analysis performed by management is basically to gather management information that is used to make internal management decision. This information is called management accounting information. Conversely, external investors and other analysts perform financial statement analysis of an entity to assess the potential return from investment and the risk associated in the investments. The current and the potential investors assess both short-term as well as long-term liquidity position of the entity to ensure that they receive a fair return on their investment. Also, these investors expect that the entity should plough back earnings for future growth and produce a significant long term returns. Thus, through financial statement analysis, investors can predict the expected returns in future.

9.2 Listing of Companies on Stock Exchange and The Importance of Quality Financial Statements

A registered company may be listed on the national or international stock exchange if it wants to raise capital through issue of shares or debt securities to the public. Once the company is listed on the stock exchange, the listed company is subject to stock exchange regulations and Companies Act of the country. This includes a requirement to file with the stock exchange and the company registrar a copy of the annual audited financial statements. The listed companies must also disclose in the income statement the earnings per share (EPS) ratio to assist investors understand the earnings capacity of the company for each equity share. Details of earnings per share is discussed in the accounting ratios.

At this time, student should know that the value of a company is determined by the share price on the stock exchange. For example, if the company has issued 1,000,000 equity shares and these shares are traded at Nu. 12 per share on the stock exchange, the company will be valued at Nu. 12,000,000.

What determines value of shares on the stock exchange? The share price on the stock exchange is determined by the demand and supply of shares. The demand and supply in turn are affected by other factors such as the profitability of the company, free cash flows, management goals, entity's control over source of materials and other supplies etc. Any changes in these factors might induce change in demand and supply for shares on stock exchange and bring changes in share price.

The efficient market hypothesis states that share price fully reflect all available information in the market. This means, the information about company's earnings, for example, of the year gets incorporated in the share price once the news or information on the company's earnings is made available in the market.

9.3 Financial Statement Analysis Tools

There are different methods of financial statement analysis. This chapter will largely focus on analyzing financial statements using accounting ratios. However, learners should be aware that there are other methods employed in the analysis of financial statements. This chapter will briefly touch on trend analysis and common size statement and then explore in more detail into ratio analysis.

9.3.1 Trend analysis

Trend analysis involves analyzing financial statements to understand the performance of business over an extended period of time, say months, quarterly, or yearly. Through studying the financial data over the period, trend analysis can track changes in the amounts of assets, liabilities, income and expenses and their relationship over a period of time that will produce an important information for managerial and investment decisions. BAS1/IAS1 requires entities to present at least two comparative financial statements to assist the users compare the results of the entity for two years. However, trend analysis require the data for more number of periods, weeks, months and years to overcome the unusual occurrence of factors that would distort the results. Given below is a trend analysis of monthly sales for two years.

Month	*2019*	*2018*	*Variance Amount*	*%*
January	65076278	45583652	19492626	43%
February	70382889	56503348	13879541	25%
March	79742917	60458411	19284506	32%
April	76662811	56524736	20138075	36%
May	70981466	59839813	11141653	19%
June	90114514	61777509	28337005	46%
July	87606756	60093718	27513038	46%
August	87769363	64148666	23620697	37%
September	93876281	71125934	22750347	32%
October	86245203	61391274	24853929	40%
November	83262411	64492109	18770302	29%
December	114742511	103108079	11634432	11%
	1006463400	765047250	241416150	32%

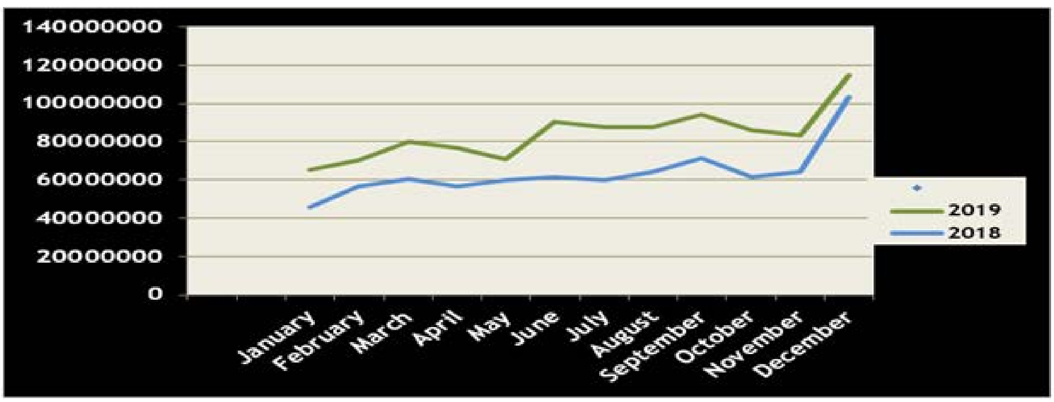


Figure 9.2 Trend analysis

Trend analysis is also used by traders to predict movement of share prices in the stock exchange based on the past events or the observed data.

a) Basic calculation in trend analysis

Trend analysis is normally calculated as percentage change in the items in financial statements over its previous year. That is,

$$\text{Percentage change} = \frac{\text{Current year's amount - Previous year's amount}}{\text{Previous year's amount}} \# 100$$

b) Common size analysis

Common size analysis is useful in evaluating performance of entity over time or comparing performance of entities that are significantly different in size.

Financial statements items are expressed in relative percentages of the total. Generally all items in the statement of income are expressed as percentages of total sales where the total sales is considered as 100%. Similarly, items in the statement of financial position are expressed as percentage of total assets. Let's consider the following case.

The trading company prepared its financial statement as follows. The management wants to understand its financial position, and in particular, the movement of its working capital. The management accountant can perform the common size statement analysis to obtain that information as follow:

Statement of financial position as at 31 December 2019

	2018	2019
Non-current assets:		
Property, plant and equipment	358,000	374,000
Accumulated depreciation	(82,400)	(92,800)
Development cost	3,200	5,100
Investment	3,900	8,250
Total non-current assets	282,700	294,550
Current assets:		
Inventory	18,400	28,480
Trade receivables	26,800	32,620
Cash and cash equivalents	1,100	1,400
Total	**329,000**	**357,050**
Equity and liabilities:		
Equity shares of Nu.1 each	100,000	120,000
6% preference shares of Nu. 1	10,000	10,000
Retained earnings	183,020	196,920
Non-current liabilities:		
8% bank loan	5,000	5,000
Deferred tax	420	540
Current liabilities		
Trade payables	21,800	16,070
Accrued expenses	1,280	940
Tax liabilities	7,480	7,580
Total	**329,000**	**357,050**

Common size statement analysis

	2018		2019	
Non-current assets				
Property, plant and equipment	275,600	83.8%	374,000	78.8%
Development cost	3,200	1.0%	5,100	1.4%
Investment	3,900	1.2%	8,250	2.3%
Current assets				
Inventory	18,400	5.6%	28,480	8.0%
Trade receivables	26,800	8.1%	32,620	9.1%
Cash and cash equivalents	1,100	0.3%	1,400	0.4%
	329,000	**100.0%**	**357,050**	**100.0%**
Equity and liabilities				
Equity shares of Nu.1 each	100,000	30.4%	120,000	33.6%
6% preference shares of Nu. 1	10,000	3.0%	10,000	2.8%
Retained earnings	183,020	55.6%	196,920	55.2%
Non-current liabilities				
8% bank loan	5,000	1.5%	5,000	1.4%
Deferred tax	420	0.1%	540	0.2%
Current liabilities				
Trade payables	21,800	6.6%	16,070	4.5%
Accrued expenses	1,280	0.4%	940	0.3%
Tax liabilities	7,480	2.3%	7,580	2.1%
	329,000	**100.0%**	**357,050**	**100.0%**

Reading the common size statement, both trade receivables as well as inventory have increased from 8.1% and 5.6% to 9.1 % and 8% from 2018 to 2019 indicating that the company has some difficulty in collecting its debt or has taken customers who took a longer credit terms. At the same time, the company's trade payables have decreased from 6.6% to 4.5% showing that company now is taking less credit terms from suppliers and require more cash to pay them. The company is facing a longer working capital cycle, which means it is taking a long time to turn its current assets in to cash.

9.3.2 Ratio analysis

One of the popular methods of financial statement analysis is that of the ratio analysis. As the name suggests, ratio analysis involves constructing financial ratios of the items from various financial statements. Depending on the information need of the user, multiples of financial ratios can be constructed. Ratio analysis is a quantitative method of analyzing financial information contained in the financial statements of an entity. Ratio analysis can be used to assess entity's operating and financial performance over the years or compare entity's performance with other entities in the industry. The method of constructing ratios is presented in the next section.

a) Constructing financial ratios

The oxford dictionary defines ratio as "the quantitative relation between two amounts showing the number of times one value contains or is contained within the other". Financial ratio, also called accounting ratio expresses a similar relationship between amounts of various items of financial statements that helps the users to draw some conclusions from the relationship. Ratios can be calculated either as:

i) Pure ratio (e.g. A and B shares profit in the ratio of 2:1), or

ii) Percentage form (e.g. Company A's profit is 30% higher than company B's profit), or

iii) Times cover (e.g. current assets cover current liabilities two times)

b) Types of accounting ratios

Depending on the information need of the users, numerous accounting ratios can be developed and used to analyse the financial statements. Some of the commonly used accounting ratios have been discussed below:

Let's consider the case where a reporting entity has prepared and subsequently audited its financial statements for 2019. The same financial statements have been issued for public on 31 March 2020 as given below.

Statement of income for the year ended 31 December 2019

Sales revenue	348,000
Cost of sales	(224,000)
Gross profit	124,000
Operating expenses	(78,500)
Operating profit	45,500
Income from dividend	300
Impairment loss	(2,000)
Interest paid	(400)
Profit before tax	43,400
Tax	(8,900)
Profit after tax	34,500

Statement of financial position as at 31 December 2019

	2018	2019
Non-current assets		
Property, plant and equipment	358,000	374,000
Accumulated depreciation	(82,400)	(92,800)
Development cost	3,200	5,100
Investment	3,900	8,250
Total non-current assets	**282,700**	**294,550**
Current assets		
Inventory	18,400	28,480
Trade receivables	26,800	32,620
Cash and cash equivalents	1,100	1,400
	329,000	**357,050**
Equity and liabilities		
Equity shares of Nu.1 each	100,000	120,000
6% preference shares of Nu. 1	10,000	10,000
Retained earnings	183,020	196,920
Non-current liabilities		
8% bank loan	5,000	5,000
Deferred tax	420	540
Current liabilities		
Trade payables	21,800	16,070
Accrued expenses	1,280	940
Tax liabilities	7,480	7,580
	329,000	**357,050**

Further, the entity issued 2,000 equity shares of Nu. 1 each on 1 April 2019. The entity also got listed on the stock exchange on 31 December 2019.

Let's consider the above case and discuss different types of accounting ratios.

i) ***Profitability ratios***

As their name suggests, profitability ratios measure the entity's ability to earn profits. Profit is the primary objective of the business and the basis to give investors the return they require. Profit also provides funds for reinvestment in the business. There are three ratios commonly used to assess profitability of the business.

a. Return on capital employed (ROCE)

$$\text{ROCE} = \frac{\textit{Operating Profit}}{\textit{Noncurrent Liabilities} + \textit{Total Equity}}$$

Return on capital employed (also known as return on investment or ROI) measures the return that is being earned on the capital invested in the business. Every investor needs a return on their investment for the risk they take to invest in the company. The operating profit (profit before interest and tax) represents the profit available to pay interest to debt investors and dividends to shareholders. The capital employed is calculated as the sum of non-current liabilities and the total equity. Generally, the higher the ROCE figure, the better it is for investors. The ROCE calculated should be compared with returns on offer to investors on alternative investments of a similar risk.

Referring to the case:

Operating profit (profit before interest and tax) = 43,800

Capital employed:

Capital employed for the year is the average of the opening and closing balances of capital plus non-current liabilities. That is,

$$\frac{(\text{Opening equity} + \text{Non current liabilities}) + (\text{Closing equity} + \text{non current liabilities})}{2}$$

$$= \frac{(298,440 + 332,460)}{2} = \text{Nu. } 315,450$$

$$\text{ROCE} = \frac{43,800}{315,450} = 13.9\ \%$$

Management use ROCE when making investment and financing decisions. For example, when borrowing money from the banks, it would not make sense to borrow at 15% if the ROCE is 13.9 % since the cost of capital is higher than the return generated by the borrowed capital. Similarly, management might use ROCE in making a decision to acquire or dispose an asset or a project. The return on the new investment project should be always higher than the entity's ROCE.

Lower ROCE would indicate over capitalization, that is, returns are not commensurate with the capital employed.

Return on Equity (ROE)

Sometimes, instead of return on total capital employed, the shareholders or the equity owners of the business might be interested to find out the return on their investment. In such as case, ROE can be used.

$$\text{ROE} = \frac{\text{Profit after tax (after any pre dividend)}}{\text{Average equity + reserves}} \times 100 \text{ or } \frac{\text{Net profit}}{\text{Total Equity}}$$

$$= \frac{43400 - 600 - 8900}{599940 \div 2} \times 100 = 11.30\%$$

ROE provides a return on the capital employed by the owners of the company. That is why, the interest and dividends paid to any preference shares are excluded from the calculation.

Comparison between ROCE and ROE

On comparing ROCE with ROE, ROCE (13.9%) is less than ROE (14.3%). This is because, ROCE considers other capital employed such as preference shares and debt (e.g. loan) which are much cheaper than the equity capital. This low cost capital helps to increase return on equity holders.

b. Return on sales (ROS)

$$ROS = \frac{\textit{Operating profit}}{\textit{Revenue}} \; x \; 100$$

Return on sales (also known as operating margin) looks at operating profit earned as a percentage of revenue. The higher the ratio is better. Low ratio is generally because of prices being too low or costs being too high.

Referring to the case:

$$\text{Return on sales (ROS)} = \frac{\text{Operating profit}}{\text{Sales revenue}} \times 100$$

$$= \frac{45{,}500}{348{,}000} \times 100$$

$$= 13\%$$

Operating profit excludes non-operating income and expenses like dividend received and interest expense since these non-operating income and expenses do not have a meaningful relationship with sales. Operating profit margin of 13% by itself is meaningless unless compared with other companies in the industry or with the industry margin. It would not make any sense if the operating margin of one entity is compared with another entity operating in different industry. The operating profit margin in manufacturing industry generally ranges from 8% to 10% while it is around 3% in retail and wholesale industry, where entities deal in high-volume low-margin products.

c. Gross profit margin

$$\text{Gross profit margin} = \frac{\text{Gross Profit}}{\text{Revenue}} \times 100$$

Gross profit margin on the other hand focuses on the entity's trading (main revenue earning) activities. In simple terms, the higher the ratio the better it is, with poor performance often being explained by prices being too low or costs being too high.

Referring to the case:

$$\text{Gross profit margin} = \frac{124{,}000}{348{,}000} \# \ 100$$

$$= 35.6\%$$

Unlike the operating profit margin, gross profit margin does not reflect the ability of the entity to make profit. It simply indicates how the entity is buying and selling its products and at what price levels, i.e. whether it is selling higher volumes at low price or vice versa. Companies operating in designing and fashion products are known for low-volume high price trading policy to earn higher gross margin as compared to supermarket that deals with high-volume low-price trading policy and making low gross margin. Learner must once again know that gross margin of an entity must be compared with similar entities in the same industry in order to make comparisons more meaningful. The gross margin will also depend on market competition and the ability of the management to control cost of sales within its own operation. For example, entities having a cheaper source of raw materials or supplies of inventory can expect to have higher gross profit margin than the entity acquiring inventory and supplies of goods at much higher price.

ii) ***Liquidity ratios***

Liquidity ratio measures the ability of the entity to meet its short-term financial obligations.

There are two ratios commonly used to assess liquidity position:

a. Current ratio

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

The current ratio measures entity's ability to meet its liabilities which are payable within twelve months out of the assets which can be converted into cash within the same period. Normally or the rule of thumb says current ratio of 2: 1 is satisfactory. However, current ratios vary between industrial sectors, and many companies operate safely at below the 2:1 ratio.

A very high current ratio is also not necessarily good. It could indicate that a company is too liquid. Cash is often described as an 'idle asset because it earns no return, and carrying too much cash is considered wasteful. A high ratio could also indicate that the company is not making sufficient use of cheap short-term finance.

Referring to the case

$$\text{Current ratio} = \frac{62{,}500}{24{,}590}$$

$$= 2.5 \text{ times}$$

Simply saying, current ratio of 2.5 times means that an entity has current assets 2.5 times more than the current liabilities held at the year-end. This gives a sense that the entity can meet its current liabilities even with 50% of its current assets are realized in cash. Conventionally current ratio of 2 or more is considered satisfactory. However, current ratio like other ratios should be interpreted on a case basis. For example, supermarkets normally have a negative current ratio whereas manufacturing or wholesale businesses have higher current ratio. Similarly, fashion and design industry also operates in low current ratio due to fast changing fashion in the market. Likewise, the nature and buying behavior of customers will also determine the current ratio of the business. The low current ratio does not necessarily indicate a problem.

b. Acid test

$$\text{Acid test ratio} = \frac{\textit{Current assets} - \textit{Inventory}}{\textit{Current Liabilities}}$$

The acid test (also known as quick ratio) recognises that inventory often takes a long time to convert into cash. It therefore excludes inventory values from liquid assets. Normally or the thumb rules require an acid test ratio of 1:1 but once again many successful companies operate below this ratio.

In practice a company's current ratio and acid test should be considered alongside the company's operating cash flows. A healthy cash flow will often compensate for weak liquidity ratios.

Refereeing to the case

$$\text{Acid test ratio} = \frac{62{,}500 - 28{,}480}{24{,}590}$$

$$= 1.4 \text{ times}$$

Comparatively, acid test ratio provides a better measure of entity's liquidity position than current ratio since acid test ratio considers only part of the most liquid current assets.

iii) ***Activity ratios***

Activity ratios measure an entity's ability to convert entity's assets into cash or sales. They measure the efficiency of the business in managing its assets. There are four commonly used ratios:

a. Asset turnover

$$\text{Asset turnover} = \frac{\text{Revenue}}{\text{Non current liabilities} + \text{total equity}}$$

This measure the ability of the entity to generate sales from its capital employed. The same ratio can also be calculated as

$$\text{Asset turnover} = \frac{\textit{Revenue}}{\textit{Non current assets}}$$

Generally higher ratio is better. However, high asset turnover ratio would also indicate the problem of overtrading, which means there are few assets or less capital employed in business to generate too much of sales. This can cause sustainability issues of the business.

Referring to the case

$$\text{Asset turnover} = \frac{348{,}000}{332{,}460}$$

$$= 1.1 \text{ times}$$

Asset turnover of 1.1 times indicates that an entity has been able to achieve a sales level of 1.1 times that amount of capital employed. The ratio should be compared with similar entities in the industry to draw any meaningful conclusions. An entity having higher than 1.1 times of asset turnover ratio would generally mean that entity has been able to use its capital more efficiently than this entity. However, as discussed above, higher asset turnover ratio would also indicate 'over trading', means 'doing too much business with too little capital'.

a. Receivables days:

$$\text{Receivables days} = \frac{\textit{Trade receivables}}{\textit{Credit sales}} \# \textit{ 365 days}$$

This measures the ability of the entity to collect its debts in term in of number of days. For liquidity purposes the faster money is collected the better. Also, generally, the longer the credit terms, the higher the level of bad debts. However, too much pressure on customers to pay quickly may damage a company's ability to generate sales.

Referring to the case

$$\text{Receivable days} = \frac{32,620}{348,000} \# 365 \text{ days}$$

$$= 34.21 \text{ days}$$

The ratio of 34.21 days means an entity's sales is held up in receivables for 34.21 days. Once again whether the 34.21 days ratio is good or bad depends on the credit term of the business. Entities in large retail shops with ratio of 34.21 days would be quite reasonable as compared with a smaller retail shops that would need much faster circulation of cash. That way, entities with long term contract purchase and supplies of goods would operate with even higher receivable days.

b. Inventory days

$$\text{Inventory days} = \frac{\textit{Inventory}}{\textit{Credit sales}} \# \textit{365 days} \quad \text{or}$$

$$\text{Inventory days} = \frac{\textit{Inventory}}{\textit{Purchases}} \# \textit{365 days}$$

This measure how long a company carries inventory before it is sold. Again for liquidity purposes the shorter this period the better, as less cash is tied up in inventory. Also long inventory holding periods can result in obsolete inventory and additional storage costs. On the other hand, too little inventory can result in production stoppages and dissatisfied customers.

Referring to the case:

$$\text{Inventory turnover} = \frac{28,480}{234,080} \text{ (Purchases = Cost of sales – Op inventory + Cl inventory)}$$

$$= 44.41 \text{ days}$$

The ratio of 44.41 days means the purchases are held up in inventory for 44.41 days or it takes almost 44. 41 days to convert those inventories into cash. Whether the ratio of 44.41 days is good or bad depends on the nature of business. Entities trading in consumer goods like refrigerators and washing machines would operate with higher inventory days compared to those trading in grocery items or short shelf lives.

c. Payable days

Payable days $= \dfrac{\textit{Trade Payables}}{\textit{Purchases (cost of sales)}} \# \ 365 \ days$

This measures the number of days the entity takes to pay the suppliers. Because the purchases figure is often not available to analysts external to the business, the cost of sales figure is often used to approximate purchases. Long payment periods are good for the customer's liquidity, but can damage relationships with suppliers.

Referring the case:

Payable days $= \dfrac{16,070}{234,080} \# \ 365 \text{ days}$

= 25.06 days

Whether the ratio is satisfactory depends on credit terms. An entity with 30 days of credit terms, 25.06 ratio is satisfactory. As discussed above, increased payable days can indicate failure of the entity to pay suppliers on time which might jeopardize the relationship with customers.

iv) ***Gearing ratios***

This measures an entity's ability to meet its long-term debts. There are two ratios commonly used.

a. Capital gearing

Capital gearing $= \dfrac{\textit{Non current liabilities}}{\textit{Equity capital employed}} \# \ 100$

This is also known as the 'debt to equity' ratio or 'leverage'. Capital gearing measures the risk due to high proportions of borrowed funds (long term debts) in the capital structure of the company. Borrowed funds carry risk as the interest and capital repayment are legal obligations, and an entity must meet this obligation to avoid insolvency. Why should companies borrow funds? Companies depend on borrowed funds to finance their business because the borrowed funds are less costly than equity shares as they are secured. Moreover, the interest paid on borrowed funds are corporate tax deductible.

Capital gearing ratios depend on industries. Entities requiring high investment in property, plant and equipment are generally highly geared. However, in general practice, too high gearing may be considered risky, i.e. when an entity is carrying a large proportion of debt finance that exceeds the equity.

Referring to the case:

$$\text{Capital gearing} = \frac{15,000}{316,920} \# 100$$

= 4.7%

Highly geared company should have ratio of more than 100%.

b. Interest cover

$$\text{Interest cover} = \frac{\textit{Operating profit}}{\textit{Finance costs}}$$

This is also known as income gearing. It measures how many times a company's operating profits exceed its interest payable. The higher the figure, the more likely a company is to be able to meet its interest payments. Anything in excess of four is usually considered to be safe.

$$\text{Interest cover} = \frac{43,400 + 400}{400}$$

=110 times

Interest payments are covered 110 times by its earnings. An entity operating with high proportion of debt finance should have interest cover ratio much lower than what is depicted in the case. Student should read the financial statements of companies to make this assessment more realistically.

c. EPS

Earnings per share measure the ability of an entity to generate profit to each equity share in issue. Entity listed on stock exchange is required to publish earnings per share (EPS) in its income statement to assist investors make estimate of what each equity share in the company is able to earn. Generally higher EPS is better.

Other comprehensive income:			
Re-measurements of post-employment benefit obligations		127,876,209.00	36,466,536.00
Income tax relating to these items		38,362,862.70	10,939,960.80
Total other comprehensive income for the year		**89,513,346.30**	**25,526,575.20**
Comprehensive income for the year		**5,176,483,300.10**	**5,579,499,944.56**
Basic & diluted earnings per share		**164.09**	**181.67**
Significant Accounting Policies & Notes on Accounts	**23**		

Source: DGPC Annual Report 2017

Calculation of EPS

EPS is calculated as the ratio between profit distributable to the equity shareholders and the weighted average number of equity shares issued. It is possible that equity shares may be issued at any time of the year. This requires calculation of the weighted average of the number of shares issued in the year taking in to account of the time proportion of the shares issued.

$$\text{Eps} = \frac{\textit{Profit after tax - Pref dividend}}{\textit{weighted avergae no of equity shares}} \# 100$$

Referring the case

$$\text{Eps} = \frac{34{,}500 - 600}{115{,}000} \# 100$$

= Nu. 29.5

Weighted average no of shares outstanding for the year

100,000 shares x 3/12 = 25,000 shares

120,000 shares x 9/12 = 90,000 shares

Weighted average shares on issue for the year 2019 = 115,000 shares

9.3.3 Cash flow analysis

The statement of cash flows is one of the primary financial statements of an entity and learner should be able to explain the performance of an entity based on all of the financial statements including the cash flows given. To do this, learner should understand cash flows from different activities of an entity and its implications for the business.

One of the first things to note is student should not simply comment on the overall change in the total cash and cash equivalents figure in the year in the statement of cash flows. An increase in this figure does not necessarily mean that the entity has performed well in the year. A situation could arise where an entity is struggling to generate cash and raised a bank loan or issued additional equity capital. This means, an entity's over all cash position increases in the year but is clearly not a sign that the entity has performed well. Similarly, an entity which has differed acquisition of a critical asset to the future for want of cash could mean that the entity has serious cash flow issues but that will have not affected the cash position of the entity for the year since it has postponed its acquisition to the next financial years.

A good analysis will examine the statement of cash flows in detail and look for the reasons behind the changes in cash flows and commenting on the performance of the entity. As discussed in the previous chapter, the statement of cash flows contains cash flows from three activities of business. Each of these cash flows provides useful information about an entity's performance.

a) Operating activities

Cash flows from operating activities show how much cash the business can generate from its core activities (what in previous chapters was referred to as main revenue generating activities) before looking at one-off items such as asset purchases or sales and raising money through debt or equity. In fact, the cash generated from operation is effectively the cash profit from operations. The cash generated from operation should be compared to the profit from operations to show quality of the profit. The closer the cash generated from operations to the operating profit, the better the quality of profit. What if the profit from operations is significantly larger than the cash generated from operations? In that case, the entity is not able to turn that profit into cash which could lead to problems like short term liquidity.

Examine the changes in working capital (a lot of cash flows occur as a result of change in current assets and current liabilities). Large increases in trade receivables and inventories could mean problems for cash flow and should be avoided if possible. This could mean an entity has potential irrecoverable debts, or may be that a large customer has been given an increased payment terms.

What if the entity has increased trade payables? This shows that the entity has taken a long credit terms from the suppliers or delaying payments to them in order to improve its cash flow position at the end of the year.

The cash generated from operation should be positive figure. This is to ensure that the entity has enough cash to fund its day to day operations. The entity's cash from operations should also be enough to pay government tax liabilities and interests on borrowed money without the need to take on extra dent or issuing shares or selling assets.

b) Free cash

The cash flows from operations after deducting the tax and interest is normally called 'free cash'. The entity should carefully plan to use this free cash. An entity may use free cash to pay its dividends or purchase non-current assets, to generate returns in the future, without having to resort to borrowed money.

c) Cash flows from investing activities

The cash flows from investing activities arise from the activities related to non-current assets. For example, an entity may buy or sell its non-current assets which could increase or decrease the overall cash. The investment decision will also affect the operation of the business. Say, an entity buys a new plant and machinery to replace its old plant and machinery. This will help the production and generate cash revenue. However, an entity should not sell assets to finance its operation or pay dividends. This may indicate that management is not able to generate any cash from business and most likely to face financial distress.

d) Cash flows from financing activities

Cash flows from financing is concerned about how the operations and assets are financed in the business. It is always better to have the operations and purchases of new assets financed through cash from operations. This indicates that an entity is generating significant levels of excess cash.

While an entity may use borrowed funds to finance non-current assets, it is also important to assess the future risks. For example, taking out loans will lead to higher interest charges and will increase the level of gearing for the entity. Generally, the banks do not provide loans to borrowers who have already taken high amount of loans from other loan providers. Raising finance through issue of shares may save the business from paying the interest; however, this will lead to increased number of shareholders and future dividend payments.

e) Use of graphical presentations

Learners must explore the use of excel sheets to analyse financial statements and presenting the financial information and the results of financial statement analysis in graphical representations such as pie charts, dotted lines and bar charts to enhance the understandability and quality of information to the users.

Exercises:

1. In groups, identify and discuss the limitations of accounting ratios. The discussion should use prior knowledge related to accounting concepts and practices.

2. ABC Company Limited prepared a summary of its income statement for the year 2019 as follow:

Particulars	Amount
Sales revenue	164,250
Cost of sales	98,550
Gross Profit	65,700
Operating expenses	39,420
Operating profit	26,280

The company also projected an income statement for 2020 as given below:

Particulars	Amount
Sales revenue	216,000
Cost of sales	129,600
Gross Profit	86,400
Operating expenses	50,760
Operating profit	35,640

The company's capital as at 31 December 2019 is Nu.7.5 million. Company directors are proposing to raise additional capital of Nu. 1.5 million by issue of shares and expect that the performance will be same as projected. Assuming that their expectations materialize:

i) Calculate ROCE for 2019 and 2020.

ii) Explain how directors can improve the performance by improving the operating margin and the asset turnover in 2020.

3. Dorji Apparels and Pema Garments both trade in ready-made cloths. Dorji Apparels focuses on more expensive end of the market and Pema Garments at the cheaper end.

The financial statements of the two companies are presented below.

	Dorji Apparels	Pema Garments
Revenue	2,840,000	18,460,000
Cost of sales	1,988,000	16,712,000
Gross profit	852,000	1,748,000
Administrative expenses	429,000	426,000
Distribution cost	184,000	216,000
Operating profit	239,000	1,106,000
Interest	40,000	
Profit before tax	199,000	1,106,000
Tax expense	39,000	220,000
Profit after tax	160,000	886,000

Statement of financial position as at 31 December 2019

	Dorji Apparels	Pema Agrments
Property, plant and equipment	3,200,000	1,840,000
Accumulated depreciation	(648,000)	(484,000)
Current assets		
Inventory	548,000	414,000
Trade receivables	346,000	28,000
Cash and cash equivalents	34,000	12,000
	3,480,000	1,810,000
Equity and liabilities		
Equity shares	2,000,000	900,000
Retained eranings	669,000	354,000
8% bank loan	500,000	
Current liabilities		
Trade payables	266,000	328000
Taxation	45,000	228000
	3,480,000	1,810,000

Required:

Comment on the comparative profitability of the two companies.

4. B-Mart deals in all brands of washing machines. It reports gross profit for the year along with comparative financial statements as follow:

		2019		2018
Sales		884,000		876,000
Inventory (Op)	128,000		116,000	
Purchases	726,000		652,000	
Inventory (Cl)	(164,000)	690,000	(128,000)	640,000
Gross Profit		194,000		236,000

Required:

i) Calculate gross profit ratios.

ii) Explain possible reasons for the change in relations between sales and gross profit.

5. Blue Poppy limited prepared its statement of income for the year ended 31 December 2019 as shown below. The company also presents a summary of its capital employed.

Statement of income for the year ended 31 December 2019	
	Amount (Nu)
Operating profit	945,000
Interest on bank loan	(400,000)
Profit before tax	545,000
Tax	(80,000)
Profit after tax	465,000
Pref Dividend	(180,000)
Retained earnings	285,000

Equity and liabilities	Amount (Nu.)
Equity shares	4,000,000
6% Pref shares	3,000,000
Reserves	500,000
	7,500,000
Non-current liabilities	
8% Loan	5,000,000
	12,500,000

Required:

i) Calculate capital gearing of the company.

ii) Explain how high gearing affects equity shareholders.

Chapter 13
Stores Ledger

Learning Objectives:

- Define cost, cost centre and cost unit
- Describe the terms- bin card, stores and stock
- Explain the term stores ledger
- Assess the importance of preparing stores ledger
- Differentiate periodic and perpetual systems of stock verification,
- Illustrate different methods of stock valuation- FIFO and weighted average method,
- Interpret the treatment of normal and abnormal loss, and transfer of materials, and
- Prepare stores ledger.

13.1 Cost Concepts

According to Council of the Institute of Cost Accountants of India, "Cost is a measurement, in monetary terms, of the amount of resources used for the purpose of production of goods or rendering services". Manufacturing of goods or rendering services involves consumption of resources. For example, material cost is the price of materials consumed for manufacturing a product or for rendering a service.

Broadly, the cost concepts include the following:

a) Cost of Purchase

The cost of purchase means the purchase price including duties and taxes, fright inward and other expenditure directly attributable to the acquisition of goods and services. For the purpose of determining the costs of purchase, trade discount, rebate, duty drawbacks and other similar items are deducted.

b) Cost Centre

According to Council of the Institute of Cost Accountants of India, Cost Centre means "any unit of an entity selected with a view to accumulating all cost under that unit". The unit can be a product, a service, division, department, section, group of plant and machinery, group of employees or combination of several units.

c) Cost Unit

According to Council of the Institute of Cost Accountants of India, "Cost unit is a form of measurement of volume of production or service". It means the cost attributable to unit or quantity of product, service, time or combination of these.

The followings are the examples of cost units:

Products or services	Unit of measurement
Power	Cost per mega-watt per hour or kilo-watt per hour
Books / pen / pencil etc.	Cost per number
Transport	Cost per kilometre per passenger
Petroleum products	Cost per litre
Rice, vegetables etc.	Cost per kilogram

13.1.1 Classification of Cost

For the purpose of controlling cost and other decisions related to production, the cost can be broadly classified into three types:

a) Material Cost

Material Cost is the cost of material of any nature used for the purpose of production of goods and services.

b) Labour Cost

Labour Cost is the remuneration paid to either permanent or temporary workers of an undertaking for their services in the form of wages, commission, bonus, etc.

c) Expenses

Expenses are cost of services other than material or labour cost which are involved in operation of the business.

13.1.2 Components of Cost

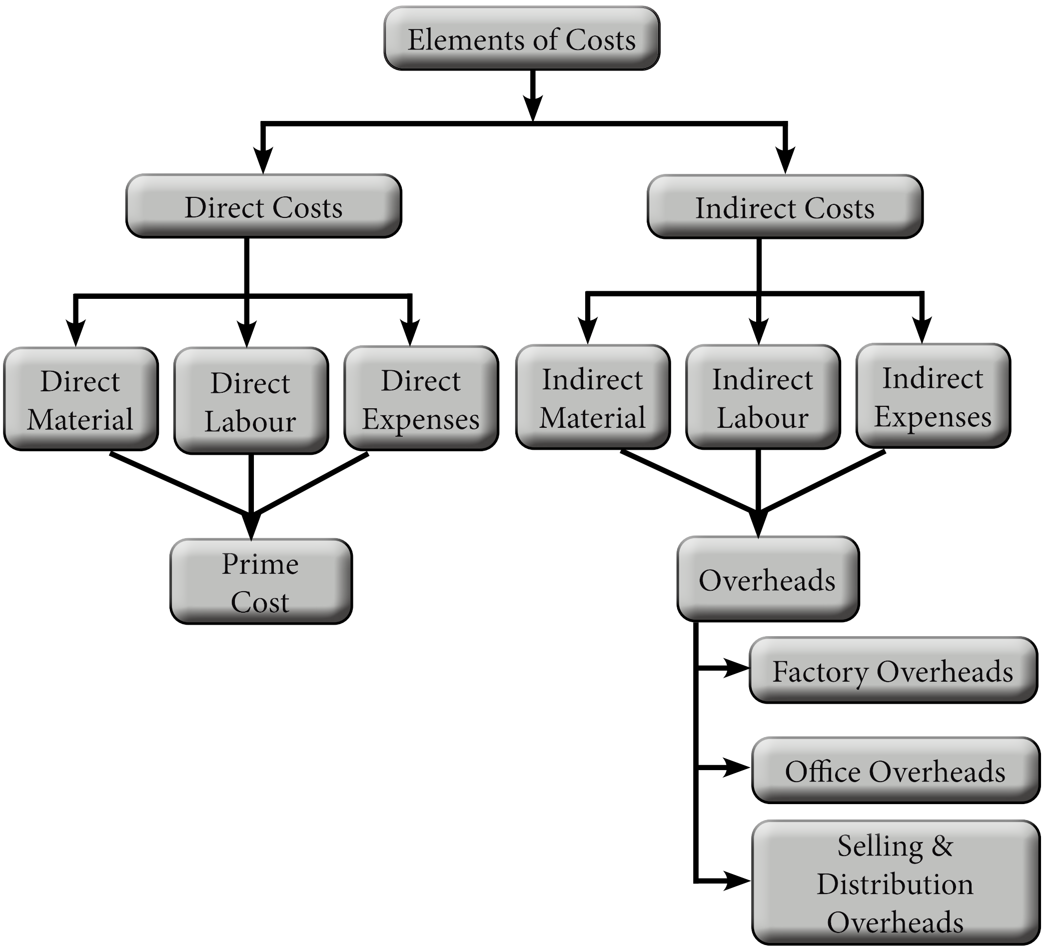


Figure 13.1 Components of cost

a) Prime Cost

Prime cost is the sum total of all the direct materials cost, direct labour cost and direct expenses.

Direct Material Cost + Direct Labour Cost + Direct Expenses = Prime Cost

i. Direct material Cost

Direct material Cost is the cost of material which can be directly identified and can be allocated to cost unit conveniently. For examples, cost of raw materials and insurance, freight inward, taxes and duties which are directly attributable to the acquisition.

ii. Direct Labour Cost

Direct labour cost is the wages paid to the labour who are directly engaged in the production process; altering the composition or condition of raw materials in order to produce a product in a manufacturing concern. For examples, the wages, Provident Fund, gratuity, overtime, incentives, bonus, leave encashment, wages for holidays and idle time etc. for workers.

iii. Direct expenses

A direct expense includes any expenditure other than direct material and direct labour engaged in the production process; altering the composition or condition of raw materials in order to produce a product in a manufacturing concern. Examples; hiring of equipment for a particular job, cost of special layout, design or drawings, fees paid to architects of a building etc.

b) Overhead cost

Overhead cost is the aggregate cost of indirect materials, indirect labour and other expenses which cannot be easily charged to specific cost units. Thus overhead costs are all expenses other than direct expenses. Overheads can be subdivided into:

i. Factory overhead,
ii. Office and administration overhead, and
iii. Selling and distribution overhead.

Each of these overhead cost comprises of indirect materials, indirect labour and indirect expenses.

Indirect Material+ Indirect Labour + Indirect Expenses = Overheads

a) Indirect Material

Materials used in the manufacture of goods which cannot be directly identified in the job or the product. For example, consumable stores, spare parts and lubricants.

b) Indirect labour

Indirect labour is wages which cannot be conveniently identified with or allocated to cost units. Examples of indirect labour are salaries of staff in the administration and accounts department, salaries of security staff etc.

c) Indirect expenses

Indirect expense includes any expenditure other than indirect material and indirect labour which cannot be easily identified and allocated to the cost unit. Examples of indirect expenses are insurance, taxes, duties, etc.

Learning Activity 1

Mr. Dubjur a capenter owns a furniture house and he incurs expenses on the items listed in Table 1. You are required to answer the following questions after studying the cost items in the table.

Sl No	Cost items for Mr. Dubjur
1	Wood
2	Nails
3	Glue
4	Polish
5	The wages paid to the carpenters
6	Wages paid to store-keeper
7	Cost of design of furniture
8	Minors repairs and maintenance of equipment's used for making furniture
9	Ply wood
10	Paint brushes
11	Sandpaper
12	Wages to sweeper
13	Telephone bills
14	Water bills
15	Electricity bills (office)
16	Transportation

Questions:

i) Classify the cost given in Table 1 into direct materials, direct labour, direct expenses, indirect materials, and indirect labour and indirect expenses?

ii) What criteria did you apply to classify?

iii) Why is classification of cost necessary?

13.2 Inventory

Learning Activity 2

Ever Green Central School provides boarding facilities to the students. Mr Kinley is the mess in charge who keeps the records of receipts and issue of ration. The following are the items received by him.

In the beginning of the year, he has in store, 15 bags of red rice which was purchased at Nu. 1,350 each. In the first month of academic year he purchased 30 bags of white rice, each bag costing Nu. 1500. At the end of the first month, the school administration wanted to know value of rice left in the store. On counting physically he found out that there were 12 bags of rice.

i) What is the value of rice remaining in the store?

ii) Which rice do you think the students where served during the first week of the month? Give reasons?

Business may be classified under Trading (merchandising), Manufacturing and Service undertaking. Accounting for inventory is common to all types of business. For a trading business, the goods purchased for resale is the inventory, for a manufacturing concern inventory comprises of raw materials, works in progress and finished goods. For service organisations like cable service, schools and hospitals, inventory consists of the materials and supplies needed to provide the service.

As per Bhutanese Accounting Standard (BAS - 2), inventories are assets:

(a) held for sale in the ordinary course of business;

(b) In the process of production for such sale; or

(c) In the form of materials or supplies to be consumed in the production process or in the rendering of services.

Inventory valuation is normally made at the lower of cost or net realizable value. This valuation is taken from (BAS - 2). This valuation applies the prudence concept and is shown with the help of Figure 13.1

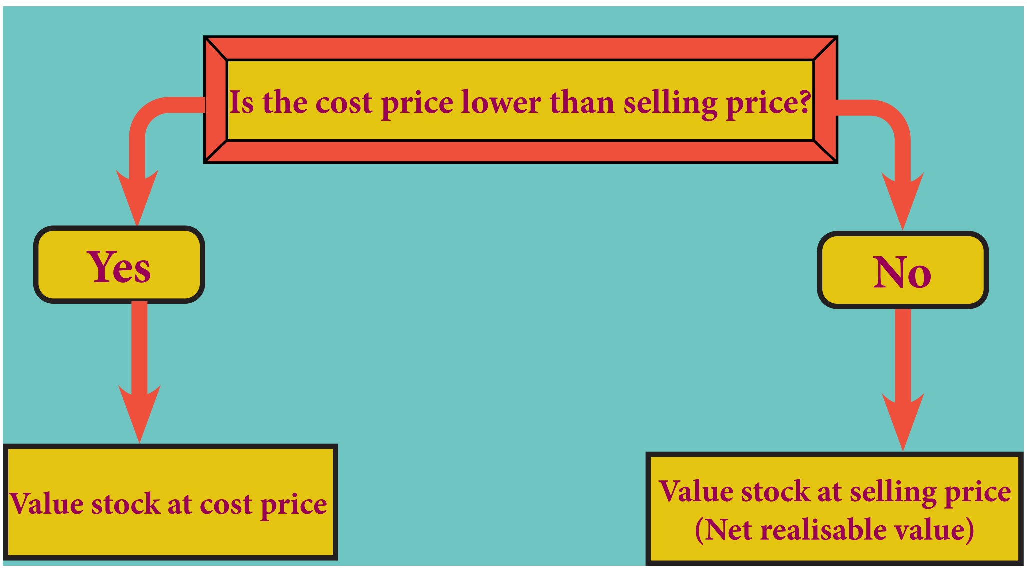


Figure 13.2 principle of stock (inventory) valuation

Illustration 1 (principle of inventory valuation)

Karma Clothing Store at Thimphu bought 30 T-shirts on 1st January with each item costing Nu. 200 each and on 1st July they sold 20 items for Nu. 350 each. Again on 15th August they sold 5 items @ Nu 360 each. At the end of the year the market realizable value is Nu 300 per item. What would be the value of remaining 5 T-shirts?

Solution

Opening Stock + Receipts – Issues = Closing Inventory

<table>
<tr><th>Inventory valued at cost</th><th>Inventory valued at Net realizable value</th></tr>
<tr><td>= 0 + 30- 25 = 5 T-shirts
Value of closing inventory =
5 T-shirts ×200 = Nu 1,000</td><td>= 0 + 30- 25 = 5 T-shirts
Value of closing inventory =
5 T-shirts ×300 = Nu 1,500</td></tr>
<tr><td colspan="2">In this case the value of inventory will be Nu. 1,000 because the cost is less than market value.</td></tr>
</table>

13.2.1 Stores

It includes materials and supplies which will be used in the process of production. It consists of consumable items which will be issued to the production units as and when required. Example: glue and nails in a furniture house.

13.2.2 Bin card

Bin Card consists of two terms, 'Bin' and 'Card'. Bin refers to a place, cupboard or a box where materials are kept. A card is attached to this bin to show the stock position of the bin. This card is known as bin card.

Thus, bin card is a record maintained by the store-keeper to record the stores received, issued and balance in hand at any time which is expressed in terms of quantity only.

13.3 Stores Ledger

Stores Ledger is subsidiary ledger which is maintained by cost department. A separate account is opened for each item of materials in the store to record both the quantity and cost of materials received, issued, returned, and balances in hand.

13.3.1 Documents used in stores procedure

a) Bill of Materials

A document prepared by a particular job dealing in that material and sent to the stores department. It shows the quantity of materials required.

b) Purchase Requisition

This is a document prepared by the stores department and it is sent to the procurement department when it reaches the reorder level. It shows the quantity of materials required by the stores department.

Chartered Institute of Management Accountants (CIMA) defines Purchase Requisition as *"an internal instruction to a buying office to purchase goods or services. It states their quantity and description and elicits a purchase order"*.

c) Purchase Order

This is a document prepared by purchase department which generally shows the name of the item, item code, quantity required etc.

d) Material Inspection Note

After receiving the materials, the Inspection Department thoroughly inspects whether the quality of material is in accordance with the purchase order and the quality of material received and it prepares a note called 'material inspection note'. Copies of the note are sent to the supplier and stores department.

e) Goods Received Note (GRN)

Once the inspection is completed, GRN is prepared by the stores department, and copies of GRN is sent to the purchasing department, costing department, accounts department and production department, which initiated purchase requisition.

A specimen of Store Ledger

Name of material........................... Material Code No........................... Bin Card No..................................													Folio.. Maximum Level........................... Minimum Level........................... Ordering Level............................. Ordering quantity.........................
Date	**Receipts**				**Issues**				**Balance**			**Remark**	
	GRN No	**Qty** (kg)	Rate	Amount	**SR No.**	**Qty** (kg)	Rate	Amount	**Qty** (kg)	Rate	Amount		

13.3.2 Necessities to prepare stores ledger

Store Ledger is prepared mainly because it provides a continuous record of the stores received, issued and discloses the balance in hand at any time, both in quantity and value. It assists in planning since information about stock in hand would be available.

13.4 System of Inventory Verification

Depending on nature and size, a business can choose the system of inventory valuation. The systems are periodic inventory system and perpetual inventory system.

13.4.1 Periodic inventory system

Periodic Inventory System is a method under which verification of the store items is done at the end of the period. Under this method stock verification is done by actual counting, weighing and measuring of items in stock. During the period of stock verification, materials are not issued from the store therefore this method is suitable for small and medium sized business.

13.4.2 Perpetual inventory system

Perpetual Inventory System is a system of recording stores balances after every receipt and issue to facilitate regular checking and to prevent closing down of the operation for stock taking.

Difference between periodic and perpetual systems

Basis of Distinction	Periodic Inventory System	Perpetual Inventory Systems
Basis of Ascertaining Inventory	The value of inventory is determined on the basis of an actual physical count/measure/weight at a given point of time.	Inventory is ascertained on the basis of records maintained on continuous basis.
Calculation of inventory	Inventory is directly calculated by applying the method of valuation of inventories like FIFO or LIFO.	Inventory is calculated as a residual figure as under: Closing Inventory = Opening Inventory + Purchase – Cost of goods sold.

Calculation of cost of goods sold	Cost of materials issued is calculated as a residual figure as under: cost of materials issued = Opening Inventory + Purchases – Closing Inventory.	Cost of Materials issued is directly calculated by applying the method of valuation of inventories.
Continuous Stock Checking	It does not facilitate the continuous stock checking.	It facilitates the continuous stock checking.
Transaction investigations.	Under periodic inventory system it becomes difficult to trace errors as it is done at the end of the reporting period.	Errors can be traced easily because the details regarding the movement of materials are maintained on continuous basis.

13.5 Methods of inventory valuation

As inventory is usually purchased at different rates over an accounting period, there is a need to determine what cost needs to be assigned to inventory. For instance, if a company purchased inventory thrice in a month at Nu. 50, Nu. 60 and Nu.70, what cost must be attributed to inventory at the month end? Inventory cost at the end of an accounting period may be determined in the following ways:

a) First In First Out (FIFO)
b) Weighted Average Method

13.5.1 First In First Out

FIFO is an inventory valuation technique, in which the inventory received first is assumed to have been issued first. Issue takes place in the order of receipts. Closing inventory comprise of the goods which are received most recently.

Illustration 2

Riders Ltd purchased 15 bikes during January and sold 10 bikes, details of which are:

January 1	Purchased 6 bikes @ Nu. 50,000 each
January 5	Sold 2 bikes
January 10	Sold 3 bikes
January 15	Purchased 9 bikes @ Nu. 70,000 each
January 25	Sold 5 bikes

Calculate the value of closing inventory by applying FIFO method of pricing the issues?

Solution: The value of 5 bikes held as inventory at the end of January may be calculated as:

Date	Receipts				Issues				Balance			Remark
	GRN No	Qty (kg)	Rate	Amount	SR No.	Qty (kg)	Rate	Amount	Qty (kg)	Rate	Amount	
Jan 1		6	50,000	300,000		2	50,000	100,000	6	50,000	300,000	
Jan 5						3	50,000	150,000	4	50,000	200,000	
Jan 10									1	50,000	50,000	
Jan 15		9	70000	630,000					1 9	50,000 70,000	50,000 630,000	
Jan 25						1 4	50,000 70,000	50,000 280,000	5	70,000	350,000	

The value of closing inventory:

5 units @70,000 = 350,000

13.5.2 Weighted Average Method

In this method, the rate of issue of materials is computed by dividing the value of materials by units available. Therefore, inventory cost under Weighted Average Price Method will be the average cost of materials available for issue on a particular point of time.

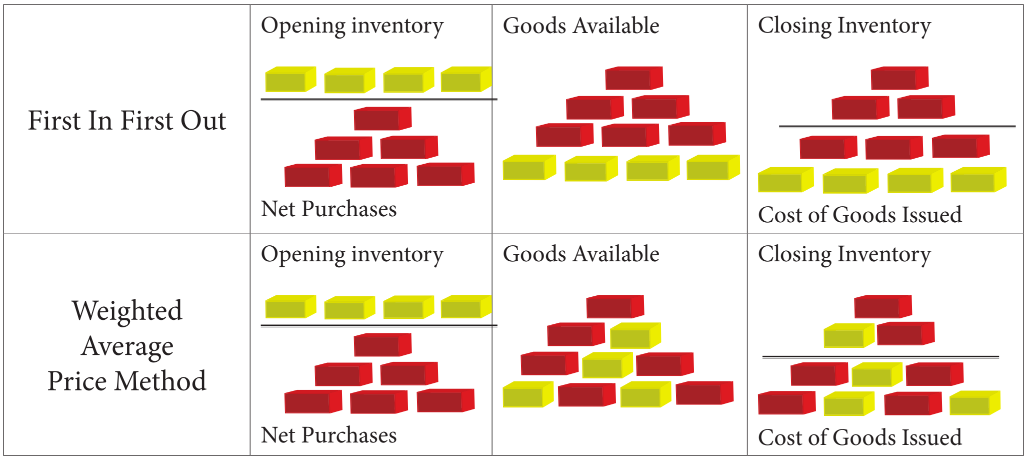


Illustration 3

P.T Kuenzop Pvt. Ltd. uses iron slabs to manufacture Bhukari. The company has the following records for the purchase of iron slabs:

Quantity (Units)	Rate (Nu)
50	60
30	65
40	65
70	70
25	72

Inventory at the end of accounting period shows a balance of 80 units. Assuming that the records of issues are not maintained on a daily basis, compute the value of closing inventory using weighted average price method.

Solution

Quantity (Units)	Rate (Nu)	Amount (Nu)
50	60	3000
30	65	1950
40	65	2600
70	70	4900
25	72	1800
215		14,250

$$\text{Price per unit} = \frac{\text{Tqtal cost of goods available for issue}}{\text{Units available for issue}}$$

$$\text{Price per unit (WAP)} = \frac{14250}{215} = 66.279$$

Value of closing inventory of 80 units will be, 80 units x Nu 66.279 = Nu. 5,302

Important Note:
The illustration is based on the periodic inventory system where the record of date and quantity issued is not maintained on a daily basis.
If the purchase date, and the date and quantity issued are given, then the rate changes after every new receipt.

Illustration 4
Riders Ltd purchased 15bikes during January and sold 10bikes, details of which are-

January 1	Purchased 6 bikes @ Nu. 50,000 each
January 5	Sold 2 bikes
January 10	Sold 3 bikes
January 15	Purchased 9bikes @ Nu. 70,000 each
January 25	Sold 5 bikes

Calculate the value of closing inventory by applying Weighted Average Method of pricing the issues?

If a stores ledger is to be prepared for the transactions in illustration 2 under Weighted Average Method, it would appear as given here.

Date	Receipts				Issues				Balance			Remark
	GRN No	Qty (kg)	Rate	Amount	SR No.	Qty (kg)	Rate	Amount	Qty (kg)	Rate	Amount	
Jan 1		6	50,000	300,000					6	50,000	300,000	
Jan 5						2	50,000	100,000	4	50,000	200,000	
Jan 10						3	50,000	150,000	1	50,000	50,000	
Jan 15		9	70,000	630,000					10	68,000	680,000	
Jan 25						5	68,000	340,000	5	68,000	340,000	

$$\text{Price per unit} = \frac{\text{Tqtal cost of goods available for issue}}{\text{Units available for issue}}$$

$$\frac{50,000 + 630,000}{10} = 68,000$$

Note: Available quantity for issue on 25th Jan consists of:

Balance on 10th Jan	1 unit @ Nu 50,000 =	50,000
Receipts of 15th Jan	9 units @ Nu 70,000 =	630,000
	10 units	**680,000**

Illustration 5

Mr. Dorji is working as a storekeeper in one of the referral hospitals. His daily work is to maintain the record receipts and issue of medicines in order to maintain the required stock of medicine in the store. Due to the outbreak of malaria, the number of patients has increased drastically. Therefore, the management wanted to know the stock of Doxycycline Capsules (100 mg) in the store and he was asked to prepare the store ledger account with the help of the following information applying the First In First Out method of pricing medicine under the Perpetual Inventory and Periodic Inventory Control System.

Date	Particulars	Units (Strips)	Per Unit Cost Nu.
January 1	Opening Stock	2000	7
January 10	Purchases	4000	8
January 12	Issue	3000	-
January 15	Purchase	5000	9
January 19	Issue	3500	-
January 25	Issue	2500	-
January 30	Issue	1500	-

Solution: Calculation of Closing Inventory under FIFO method (Periodic System)

Opening Stock + Purchase – Issues = Closing Inventory

2000 + (4000+5000) - (3000+3500+2500+1500) = 500 Strips

The closing inventory of 500 strips is form the latest purchase (15th Jan) @ Nu. 9 per strip.

Therefore the value of closing inventory is 500 Strips × Nu. 9 = Nu. 4500

Solution:

Store Ledger under FIFO Method (Perpetual System)

Date	Receipts				Issues				Balance			Remark
	GRN No	Qty (kg)	Rate	Amount	S R No.	Qty (kg)	Rate	Amount	Qty (kg)	Rate	Amount	
Jan 1									2,000	7	14,000	Opening Bal.
Jan 10		4,000	8	32,000					2000 4000	7 8	14,000 32,000	
Jan 12						2,000 1,000	7 8	14,000 8,000	3,000	8	24,000	
Jan 15		5,000	9	45,000					3,000 5,000	8 9	24,000 45,000	
Jan 19						3,000 500	8 9	24,000 4,500	4,500	9	40,500	
Jan 25						2,500	9	22,500	2,000	9	18,000	
Jan 30						1,500	9	13,500	500	9	4,500	

Learning Activity 2

You are a newly appointed accountant of YBM Bricks and you presented the following statement to show the value of closing stock of cement on 31st Dec, 2016 to the management.

Date	Quantity received	Rate (Nu.)
21/2/2016	800	320
15/5/2016	900	350
10/7/2016	1,200	355
13/9/2016	1,100	350
24/12/2017	700	365

Closing inventory (on physical count) shows 850 bags.

Value of closing inventory on the basis of FIFO method

700 Bags @ Nu. 365 = 255,500

150 Bags @ Nu. 350 = 52,500

308,000

The management advised you that the business need to prepare final accounts following the principle of consistency and that the business had been following weighted average price method and maintaining continuous records. You are furnished with the following additional information.

24/5/2016	Issued 1100 bags
12/8/2106	Issued 950 bags
14/10/2016	Issued 800 bags
25/12/2016	Issued 900 bags

Find out the value of closing inventory with the help of a stores ledger.

13.11 Treatment of Loss of Materials

Sometimes materials may be lost or destroyed while in the store. This loss of materials can be classified as normal loss or abnormal loss.

a) Normal Loss

Normal loss arises due to unavoidable, inherent and natural causes, such as leakage, drying, evaporation, etc. The business cannot prevent such loss with any effort. Such loss is spread over the remaining quantity by inflating the unit price of inventory to be issued.

b) Abnormal loss

Abnormal loss arises accidentally or out of negligence like theft, fire, etc. and they do not occur frequently. Abnormal loss is excluded from cost and it will be debited in statement of income. It will be shown in issue column of store ledger at the normal issue price.

13.12 Surplus of Material

Any surplus of materials found at the time of physical verification may be treated as a new receipt at the latest purchase price.

Illustration 6

The following is the extract of receipts and issue of Petrol by BOC, Gelephu.

Purchases:

1th January, 2017	1000 ltr. @ Nu.40 per ltr.
3rd January, 2017	500 ltr. @ Nu.42 per ltr.

Issues:

2nd January, 2017	600 ltr.
15th January, 2017	950 ltr.

On 1st January, 2017 the inventory was 500 ltr. @ Nu.40 per ltr. The stock verification on 16th January revealed a shortage of 70 ltr. Show the store ledger by adopting FIFO method, assuming:

i). that the loss was due to evaporation.

ii). that the loss was due to theft.

Solution

i). If the loss is treated as normal

Store Ledger Account

Date	Receipts				Issues				Balance			Remark
	GRN No	**Qty** (kg)	Rate	Amount	**SR No.**	**Qty** (kg)	Rate	Amount	**Qty** (kg)	Rate	Amount	
Jan 1									500	40	20,000	
Jan 1		1,000	40	40,000					500 1,000	40 40	20,000 40,000	
Jan 2						500 100	40 40	20,000 4,000	900	40	36,000	
Jan 3		500	42	63.000					900 500	40 42	36,000 21,000	
Jan 15						900 50	40 42	36,000 2,000	400	42	16,800	
Jan 16					Shortage	70			330	50.91	16,800	Normal loss

Note:

i). The normal loss has been entered only in the quantity column.

ii). The price has been inflated as under:

Nu.16, 800 ÷ 330 = Nu.50.91

Closing inventory =330 Litre × 50.91 = Nu. 16,800 ii). If the loss is treated as abnormal

Store Ledger Account

Date	Receipts				Issues				Balance			Remark
	GRN No	Qty (kg)	Rate	Amount	SR No.	Qty (kg)	Rate	Amount	Qty (kg)	Rate	Amount	
Jan 1									500	40	20,000	
Jan 1		1,000	40	40,000					500 1,000	40 40	20,000 40,000	
Jan 2						500 100	40 40	20,000 4,000	900	40	36,000	
Jan 3		500	42	63.000					900 500	40 42	36,000 21,000	
Jan 15						900 50	40 42	36,000 2,000	400	42	16,800	
Jan 16					Shortage	70	42	2,940	330	42	13,860	Abnormal loss

Note:

The abnormal loss has been entered in the issue column with its original rate.
The price or rate will remain same.
Closing inventory = 330 Litre ×42 = Nu. 13,860

Learning Activity 3

Druk Mentse Central School was established as one of the pilot centre schools in Bhutan. The school management has recently discovered some gaps in its procurement and inventory management which was raised as a matter of concern especially in the context of how poor inventory management would affect service delivery and competitiveness of autonomous school.

All purchases and issues of inventories are carried out by the school administrative officer who has no prior experience in procurement and inventory management. On several occasions she was found losing temper and being reactive when her colleagues questioned about inefficiencies in the school inventory management. Under the supervision of school principal, she maintains a stores ledger to record items of inventories on a daily basis. Although there was no audit observation in the previous financial years, there were traces of unethical issues which required immediate attention.

As a public institution, the school is required to prepare and present the statement of financial position and statement of income and expenditure for its stakeholders. It is first time that Druk Mentse School is valuing inventories for reporting. The administrative officer needs your assistance to value the inventories for the year ended 31 December 2019 to be reported in its financial statements. She provides the following information on procurement and issue of inventories to enable you to perform the task.

Date	Particulars	Unit	Unit cost	Amount
Jan-19	Opening inventories			
	Stationery	560	1000	560,000
	Electric fittings	810	300	243,000
	Vehicle spare parts	125	560	70,000
Feb-19	Purchases			
	Stationery	100	1230	123,000
	Electric fittings	115	400	46,000
Mar-19	Issues			
	Electric fittings	450		

	Vehicle spare parts	100		
Jun-19	Issues			
	Stationery	350		
Sep-19	Inventories written off			
	Stationery because of damage	50		
	Electric fittings because of inferior quality	100		
Oct-19	Purchases			
	Computer accessories	85	2,300	184,000

Required:

i) Calculate the amount of inventories consumed during the financial year 2019.

ii) Calculate the value of inventory to be reported in the financial statements for the year ended 2019.

iii) Suggest how inventory management of the school can be improved.

iv) Suggest the most appropriate method of inventory valuation for the school.

Learning Activity 4

Samten Central School is one of the boarding schools in Bhutan and Mr Karma was the mess in charge for the academic year 2017. As mess in charge his work is to receive the vegetables from the suppliers and issue daily to the head cook. The following is the receipts and issue of vegetables for a period of one month. The school administration wanted to know the closing stock of vegetables.

Therefore, he was asked to prepare Store Ledger using First In First Out [FIFO] and Weighted Average Method of pricing the issues.

December 1st: Balance in hand 1,500 kg @ Nu.3.5 each.

December 4th: Received 3000 kg costing Nu.6, 000

December 24th: Received 4000 kg costing Nu.12,000

December 12th: Issued 3000 kg

December 30th: Issued 4,500 kg

Required:

a) Show the closing inventory of vegetables for the month of December.

b) Compare the inventory under two methods and give reason why the inventory appears to be different between two methods.

c) Suggest which method is best to prepare store ledger for vegetables.

13.13 Return of Materials

Return of materials is broadly divided into return from the issue (departments) and return to the suppliers.

a) Return from the issues / departments / jobs

Return from the issues means return of materials from different departments or jobs to the store. The return from the issues is treated as new purchase of materials or it is treated as new receipts but it is priced at the original price at which it was issued and entered in the Stores Ledger after the last purchase entry.

Illustration 7

Prepare a Stores Ledger Account under the Weighted Average Price Method of pricing the issues of stores, using the following information when the shortage of 20 units is treated as abnormal loss.

2015	Receipts and issues of materials	Units
July 1	Balance in hand @ Nu. 3 per unit	200
July 2	Received @ Nu.3.20 per unit	400
July 10	Issued	200
July 14	Received @ 3.30 per unit	200
July 18	Issued	300
July 23	Returned from issues on 10th January	30
July 28	Wastage	20
July 30	Issued	300

Store Ledger Account

Date	Receipts				Issues				Balance			Remark
	GRN No	Qty (kg)	Rate	Amount	SR No.	Qty (kg)	Rate	Amount	Qty (kg)	Rate	Amount	
July 1									200	3	600	
July 2		400	3.20	1,280					600	3.13	1880	
July 10						200	3.13	626	400	3.13	1252	
July 14		200	3.30	660					600	3.186	1912	
July 18						300	3.186	955.8	300	3.186	955.8	
July 23		30	3.13	93.9	Return from job				330	3.181	1049.7	
July 28					Shortage	20	3.181	63.62	310	3.181	986.11	
July 30						300	3.181	954.3	10	3.181	31.81	

i). Closing Stock = 10 units @ Nu. 3.181 = 31.81

b) Return of materials to the suppliers

Return of materials to the supplier means that the materials returned to the suppliers from the previous purchases.

Illustration 8

From the following information you are required to prepare Stores Ledger Account assuming that the issues are to be priced on the basis of Weighted Average Method for the month of May, 2016.

2016	Receipts and issues of materials	Units
May 1	Received @ Nu.100 per unit	50
May 3	Issued	15
May 10	Received @ Nu.110 per unit	10
May 15	Issued	20
May 20	Returned to suppliers -5 units of the quantity received on 1st May, 2016	5
May 25	Received replacement from suppliers against return dated 20th May, 2016	5
May 28	Stock surplus	6

Solution

Store Ledger Account

Date	Receipts				Issues				Balance		
	GRN No	Qty (kg)	Rate	Amount	SR No.	Qty (kg)	Rate	Amount	Qty (kg)	Rate	Amount
July 1		50	100	5,000					50	100	5,000
July 3						15	100	1,500	35	100	3,500
July 10		10	50	500					45	88.89	4000
July 15						20	88.89	1778	25	88.89	2222
July 20						5	88.89	444	20	88.89	1778
July 25		5	88.89	444					25	88.89	2222
July 28		6	88.89	533.33					31	88.89	2756

Learning Activity 5

Mr. Wangda is the store in charge of Dolma Enterprise which supplies the note books to different schools in Bhutan. He has recorded the following receipts and issue of books.

2017	Receipts and issues of materials	No of Books
July 1	Balance in hand @ Nu. 30 per Book	150
July 2	Received @ Nu.35 per Book	300
July 8	Issued	200
July 12	Received @ Nu. 40 per Book	100
July 16	Issued	200
July 20	Wastage	10
July 24	Issued	110

Required:

1) Show Stores Ledger Account under FIFO Method when the wastage is treated as:
   a) normal loss.
   b) abnormal loss
2) Prepare Stores Ledger Account under Weighted Average Method when the wastage is treated as :
   a) normal loss.
   b) abnormal loss.

Learning Activity 6

The following information has been obtained from the books of accounts of Karma Manufacturing Co. Ltd. pertaining to material A. Prepare Stores Ledger using FIFO method of pricing the issues.

2019	Receipts and issues of materials	Units
January 1	Balance in hand @ 2.5 per unit	150
January 2	Received @ Nu.2 per unit	250
January 12	Issued	200
January 16	Received @ Nu. 2.4 per unit	100
January 18	Returned from the issues on 12th January	10
January 20	Issued	100
January 25	Returned to suppliers received on 16th January, 2019	15

13.14 Treatment of Transfer of Materials

Transfer of excess material from one job to another job or from one department to another department should be avoided as far as possible. This is because record for transfer may not be made and actual material cost of jobs or departments may be inaccurate. However, sometimes the material may be allowed to be transferred to avoid delays and handling charges. The transfer is to be allowed only with preparation of material transfer note so that the cost of material transferred is debited to the job receiving the material and credited to the job transferring the material. Therefore, the transfer of materials from one job / department to another does not appear in the Store Ledger.

Illustration 9

ABC Limited furnishes the following transactions in stores for July, 2015.

2015	Receipts and issues of materials	Units
January 1	Stock in hand @ Nu. 160 per unit	30
January 2	Issued (Requisition No.50)	15
January 12	Receipts@ Nu.161 per unit (G.R.N. No. 15)	50
January 16	Transfer from job 180 to 182	8
January 20	Issued (Requisition No.51)	10
January 25	Transfer from Department A to Department B	2

Prepare Store Ledger Account applying FIFO method.

Solution Stores Ledger Account

Date 2015	Receipts				Issues				Balances		
	GRN No	Qty (kg)	Rate	Amt	S R No.	Qty (kg)	Rate	Amt	Qty (kg)	Rate	Amt
Jan 1									30	160	4,800
Jan 2					50	15	160	2,400	15	160	2,400
Jan 12	15	50	161	8,050					15 50	160 161	2,400 8,050
Jan 20					51	10	160	1,600	5 50	160 161	800 8,050

Note:

i) Transfer of materials from one job to another or from one department to another will be not recorded in the Store Ledger Account.

Closing Inventory = 5 units ×160+ 50 units ×161= Nu. 8,050

Learning Activity 7

Mr. Wangchuk runs a computer supplies business. One of the items stocked is the 'keyboard' of computer. To show how the stores ledger records would appear under FIFO method the following data is used:

2014	Receipts and issues of materials	Units
JMay 1	Opening balance @ Nu 15	25
July 3	Receipts from Karma & Co. @ Nu. 20each	50
July 10	Issued	30
July 22	Transfer job 180 to job 184	10
July 28	Receipts from Dorji& Co. @ Nu. 22 each	10

Exercise

1. Questions for short answer
   1) How bin card and store ledger are similar in nature.
   2) Explain in your own words the following terms:
   a) Purchase Requisition Note
   b) Stores Requisition Note
   c) Goods Received Note
   3) What is a purchase requisition? Give a specimen form of purchase requisition and state the information contained therein.
   4) Distinguish between FIFO and weighted Average Method of stock valuation.
   5) What is purchase order? Give a specimen form. What main points, clauses and instructions must appear on the face of a purchase order?
   6) Distinguish between 'Store Ledger' and 'Bin Card'. Give a specimen of each.
   7) What is the objective behind fixing maximum, minimum, re-order levels?
   8) Discuss in detail 'Perpetual Inventory System.'
   9) What are the objectives of inventory control? How this control is exercised?
   10) What do you understand by 'pricing of issues'? Explain any two methods of pricing of the issues.
   11) What factors should be taken into consideration while fixing a method of pricing of the issues?
   12) Beginning inventory was Nu. 26,000, ending inventory was Nu. 18,000 and inventory issue was for Nu. 94,000. What was the amount of inventory purchased?
   13) On first January 2017 inventory was 37,000. Inventory purchased for

the month of January were Nu. 54,000 and the inventory balance on 31 January was nu. 19,000 what was the value of inventory issued?

2. Essay type questions

1) Explain the following concepts in your own words:
a) Cost of purchase
b) Cost Centre
c) Cost Unit
2) State and explain the advantages of FIFO method over Weighted Average Method of inventory valuation.
3) What is perpetual inventory? Why this method is preferred to periodical Inventory?
4) How finished goods are valued for the purpose of balance sheet?
5) Why inventory is to be valued at cost or market price, whichever is lower?

3) Dechen Bakery supplies 'Birthday Cakes' which are delivered to its customers. The business uses the first in first out (FIFO) method for valuing its inventories. As an accountant, you are required to complete the following Stores Ledger Account for the month of May 2017. The following additional information is given.

a) Issued on 12th May, 2017 = 700 kg
b) Issued on 20th May, 2017 = 1,200 kg

May 2017	**Receipts**			**Issues**			**Balances**			
	Qty (kg)	Rate	Amt	Qty (kg)	Rate	Amt	Qty (kg)	Rate	Amt	Remarks
1							1,000	?	10,000	Opening Balance
8	800	?	9600				1,000 800	? ?	10,000 9,600	
12				700	?	?	? ?	? ?	3,000 ?	
18	300	?	3150				? 800 300	10 ? 10.5	3,000 9,600 ?	
20				300 8,00 ?	10 ? 10.5	? 9,600 5,250	200	?	2,100	

4. The following are the receipts and issue of nails in a furniture house for the month of February, 2017

Date	Particulars
2.2.2017	Received 200 Kg @ Nu. 100
11.2.2017	Received300 Kg @ Nu. 120
17.2.2017	Issued 250 Kg
21.2.2017	Received 250 Kg @ Nu. 130
26.2.2017	Issued 200 Kg

You are required to:

1) Ascertain the value of inventory under FIFO and Weighted Average Price Methods.
2) Comment on the difference in closing inventory under the two methods.

5. Druk Info-Tech supplies spare parts of the computer. Mouse is one of the items stocked. To show how the stores ledger records would appear under FIFO and Weighted Average Method, the following data is used:

Date 2015	Balance, receipts and issues	Units	Cost per unit	Total Cost
July 1	Balance in hand	300	250	75000
July 18	Receipts	200	280	-
July 25	Issues	450	-	-

You are required to complete the table below to show the total issue value and the total inventory value according to FIFO and Weighted Average Method.

Date	Description	FIFO Method (Nu.)	Weighted Average Method (Nu.)
July 25	Total issue value	?	?
July 25	Total closing inventory value	?	?

What will be the effect on the gross profit if other things remain constant?

6. The stock of materials as on 1st July 2017 was 100 kg at Nu.2 each. The following purchases and issues were made. Prepare the Store Ledger Account by adopting Weighted Average Method.

i). If the loss is treated as normal loss

ii). If the loss is treated as abnormal loss

2017

July 5	Purchased 100 kg at Nu.2.20 each.
July10	Purchased 160 kg at Nu.2.40 each
July20	Purchased 180 kg at Nu.2.50 each

July2	Issues	160 kg
July7	Issues	100 kg
July12	Issues	100 kg
July28	Issues	200 kg

On 22nd July, 2017 the stock verification revealed a shortage of 18 kg

7. From the information given prepare Stores Ledger for the month of July 2015 of Mr. Karma Limited using the Weighted Average Method when the shortage is treated as abnormal loss.

Date 2015	Receipts and issues of materials	Units
July 8	Purchased @ Nu.25 per units	550
July 14	Purchased @ Nu.23 per units	700
July 24	Purchased @ Nu. 26 per units	350
July 28	Purchased @ Nu. 28	600
July 4	Issued	500
July 10	Issued	600
July 16	Issued	300
July 26	Issued	200
July 27	Issued	600
July 31	Issued	250

The opening balance on July 1st, 2015 is 1,000 units @Nu. 25 each. A shortage of 25 units was noticed on 9th July, 2015.

8. The following is the record of receipts and issue of a certain materials in a factory.

Date 2015	Receipts and issues of materials	Units (kg)
January 1	Purchase @ Nu.30 per kg	600
January 4	Purchases @ Nu.28 per kg	1,400
January 16	Purchases @ Nu.26 per kg	2,000
January 6	Issued	1,000
January 20	Issued	1,300
January 28	Issued	2,200

The stock on January 1st was 200 kg @ Nu. 32 per kg. On 26th January, stock verification revealed a shortage of 500 kg which is treated as normal loss. Show the Stores Ledger Account by adopting the Weighted Average Price Method.

9. The stock of a material as on 1st July was 200 units at Rs.2 each. The following purchases and issues were made subsequently. Prepare Sores Ledger Account showing how the value of the issues would be recorded under Weighted Average Method when the shortage is treated as abnormal loss.

2016	Receipts and issues of materials	Units
July 6	Purchases @ Nu.2.20 each	100
July 11	Purchases @.2.40 each	150
July 18	Purchases @ Nu. 2.50 each	180
July 2	Issued	150
July 8	Issued	100
July 13	Issued	100
July 28	Issued	200

Physical verification on 21st July revealed a shortage of 10 units and 15 units on 25th July, 2016.

10. From the receipt and issue of materials during the month of July, 2017, prepare Store Ledger Account according to FIFO method.

2017	Receipts and issues of materials	Units
January 1	Stock in hand @ Nu. 10 per unit	50
January 2	Purchased @ Nu.12 per unit	20
January 12	Issued	50
January 16	Purchased @ Nu.13 per unit	100
January 18	Issued	50
January 18	Returned to suppliers received on 12th January, 2017	10

Chapter 11
Budgeting Process and Variance Analysis

Learning Objectives:

- Explain the meaning of budgeting and master budget.
- Prepare operating budget and financial budget.
- Identify ethical issues in budgeting.
- Explain the meaning of standard cost and variance.
- Compute direct material variance, direct labour variance and manufacturing overhead variance.

The success of business depends on its ability to visualize the future specifying the desired goals and determining the amount of resources required for achieving those goals. In the complex and competitive business environment, the survival and success of the business requires proper budgeting. Mangers should be able to predict the factors affecting their business with reasonable precision along with problem solving, organizational and monitoring skills required to meet the challenges business might face with the change in future conditions. Managers should focus on the economy and efficiency of the resources and should keep track on how these resources are used. Moreover, manager should be in a position to fix the accountability of business personnel involved in case of inefficient use of resources. Variance analysis is one such tool which will assist managers in fulfilling the desired goals by controlling the budgeted activities.

In this chapter, first part deals with the budgeting process and preparation of the master budget while second part highlights the importance and application of variance analysis, bringing together, the planning and control functions of management.

11.1 Budgeting

The process of formalizing qualitative plans into quantitative format with proper documentation is called budgeting. The end result of this process is a budget. The organization prepares plan and arranges resources in line with the availability of the budget.

The budget usually is prepared for a set time, most commonly one year with sub-period budgets for each of the quarters or months. The budgeting process ultimately results in preparation of master budget.

11.1.1 Types of budget

a) Master budget

A master budget is a comprehensive budget for a specific period consisting of many interrelated operating and financial budgets. Operating budget involves preparation of sales budget, production budget, direct materials budget, direct labour budget, factory overhead budget and selling and distribution overhead budget. Financial budget includes cash budget, budgeted income statement and statement of financial position. The master budget begins with the preparation of sales budget.

Figure 11.1 shows the process of preparing master budget.

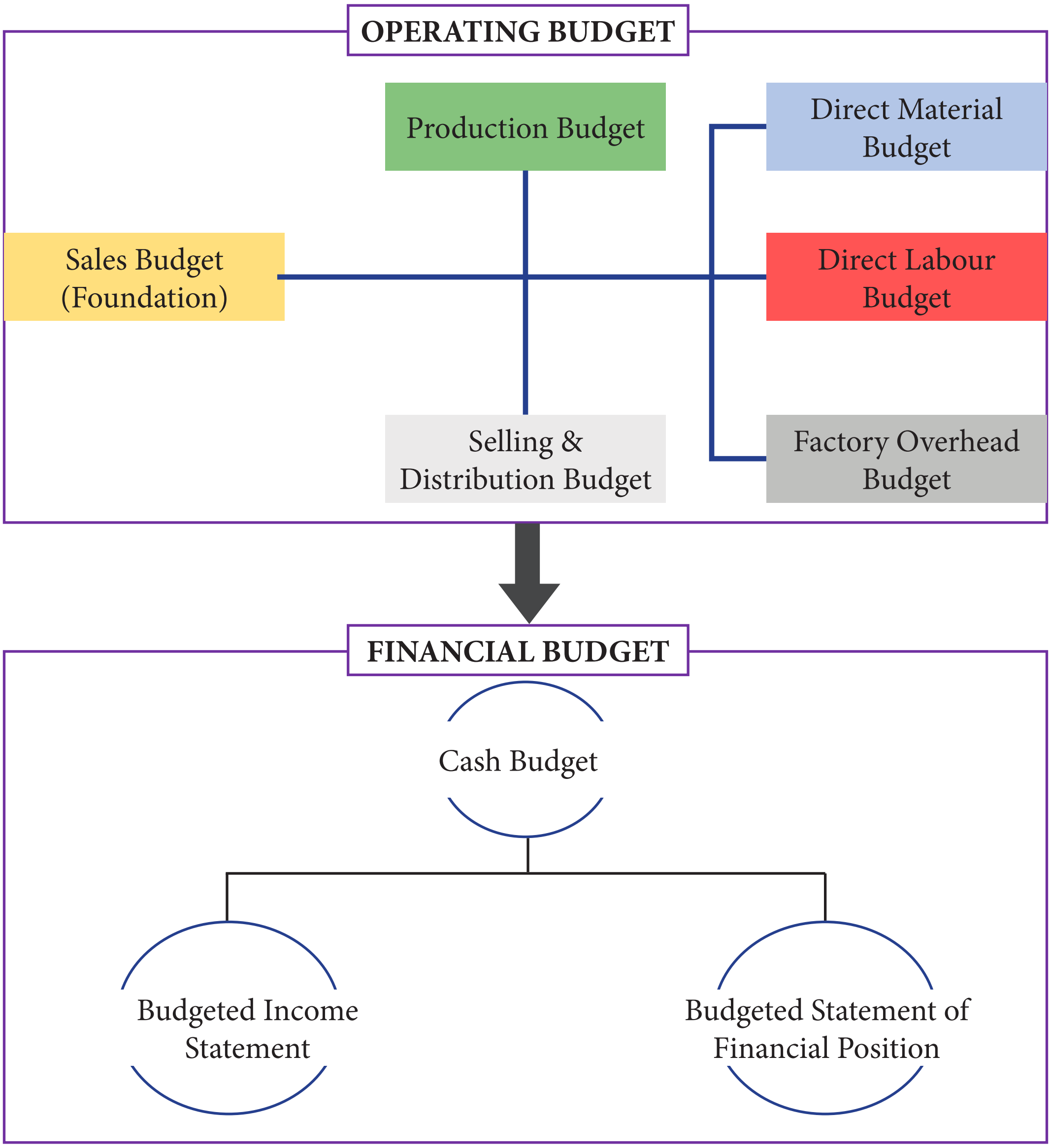


Figure 11.1 Preparation of master budget

b) Sales budget

A sales budget is regarded as the foundation of the entire budget. The starting point in preparing a sales budget is sales forecasts, which requires detail information about the market condition, preference of the consumers, past sales records and competitor's action and operating plans. A sales budget shows expected sales in units at their expected selling prices.

Illustration 1

Jigme Co. is a manufacturer of toys in Bhutan and is preparing budgets for the quarter ending June 30. The following is the budgeted sales for the next five months:

April	20,000 toys
May	50,000 toys
June	30,000 toys
July	25,000 toys
August	15,000 toys

The selling price is Nu.10 per toy.

Solution:

Sales Budget				
	April	**May**	**June**	**Quarter**
Budgeted Sales (Toys)	20,000	50,000	30,000	100,000
Selling Price Per Toy	10	10	10	10
Total Revenue	**200,000**	**500,000**	**300,000**	**1,000,000**

After preparing sales budget, the next step is to calculate the cash receipt budget.

Cash collection budget

It records the cash collected on account of sales. Illustration 2 explains the collection pattern from the sale of toys from customers.

Illustration 2

On March 31, accounts receivable balance amounted to Nu.30,000 which will be collected in full. Jigme Co. follows the following collection pattern for collecting cash on account of sale;

70% collected in the month of sale,
25% collected in the month following sale,
5% is uncollected.

Solution:

Cash Collection Budget				
	April	**May**	**June**	**Quarter**
Total Revenue From Sales Budget	<u>200,000</u>	<u>500,000</u>	<u>300,000</u>	<u>1,000,000</u>
Accounts Receivable Balance	30,000			30,000
<u>April Month Collection</u>				
70% of 200,000	140,000			140,000
25% of 200,000		50,000		50,000
<u>May Month Collection</u>				
70% of 500,000		350,000		350,000
25% of 500,000			125,000	125,000
<u>June Month Collection</u>				
70% of 300,000			210,000	210,000
Total Cash Collection	**170,000**	**400,000**	**335,000**	**905,000**

(**Note:** 5% is uncollected amount and does not require calculation. 25% of June collection will be collected in the month of July)

c) Production budget

A firm prepares a production budget after determining the expected number of units for sale. A production budget is a plan for acquiring the resources needed to carry out the manufacturing operations to satisfy the expected sales, and maintain the desired ending inventory. Production budget forms basis for calculating direct materials budget, direct labour budget and factory overhead budget. Illustration 3 explains the preparation of production budget from budgeted sales in units.

Illustration 3

On March 31, there were 4,000 toys of inventory of finished goods. The management of Jigme Co. wants ending inventory to be equal to 20% of the following month's budgeted sale of toys.

Solution:

20% of May month's sale in Unit

Production Budget				
	April	**May**	**June**	**Quarter**
Sales In Units (Toys)	20,000	50,000	30,000	100,000
Add: Desired Ending Inventory	10,000	6,000	5,000	5,000
Total Required Inventory	30,000	56,000	35,000	105,000
Less: Opening Inventory	4,000	10,000	6,000	4,000
Total Units To Be Produced	**26,000**	**46,000**	**29,000**	**101,000**

Practical Problem:

Jachung Co. is the manufacturer of biscuits located at Thimphu. The following is the budgeted sales of the firm for the year 2018.

First quarter	70,000 units
Second quarter	90,000 units
Third quarter	120,000 units
Fourth quarter	110,200 units

The firm expects each unit to be sold for Nu.6. The management prefers to maintain closing inventory of finished goods equal to 10 percent of next quarter's sales. The closing inventory of finished goods at the end of the fourth quarter is estimated to be 10,000 units. The opening inventory of finished goods of first quarter is 9,000 units.

All sales are on credit. The firm expects to collect 70% of sales in the quarter of sales and the remaining in the quarter following the sale. Accounts receivable at the end of 2017 amounted to Nu.200,000.

Prepare sales, production and cash collection budget.

d) Direct materials budget

The information in the production budget serves as basis for preparing several manufacturing-related budgets. A direct materials budget shows the amount of direct materials required for production and their budgeted cost.

A direct material purchases budget shows the amount of direct materials to be purchased to meet production and ending-inventory of raw materials requirements.

Illustration 4

On March 31, there were 13,000 Kgs. of raw materials. Jigme Co. requires 5 Kgs. of material for a production of one toy. Management of Jigme Co. wants ending inventory of raw materials of each month equal to 10% of the following month's raw materials. There is no opening and closing inventory of work in process. The cost of the raw material is Nu.0.4 per Kg.

Solution:

Direct Materials Budget				
	April	**May**	**June**	**Quarter**
Production In Units (Toys)	26,000	46,000	29,000	101,000
Required Raw Materials Per Toy	5	5	5	5
Total Required Raw Materials	**130,000**	**230,000**	**145,000**	**505,000**
Add: Desired Ending Inventory	23,000	14,500	11,500	11,500
Total Inventory Required	**153,000**	**244,500**	**156,500**	**516,500**
Less: Beginning Inventory	13,000	23,000	14,500	13,000
Raw Materials Required To Be Purchased	**140,000**	**221,500**	**142,000**	**503,500**
Cost of Raw Materials Per Toy	0.4	0.4	0.4	0.4
Cost of Raw Materials to be purchased	**56,000**	**88,600**	**56,800**	**201,400**

July Production	
Sales in units	25,000
Add: Desired Ending Inventory	3,000
Total units required	28,000
Less: Beginning Inventory	5,000
Production Required	**23,000**

June Ending Inventory	
July Production in Units	23,000
Required Raw Materials per toy	5
Total Units Required	115,000
Inventory percentage	10%
June Desired Ending Inventory	**11,500**

Direct material cost per unit = 5 kgs. of materials required per toy × Nu. 0.4 per toy = **Nu.2**

Cash payment budget

It records cash paid on the account of total raw materials required to be purchased. Illustration 5 will briefly discuss on cash payments towards raw materials acquisition.

Illustration 5

Jigme Co.'s accounts payable balance on March 31 is Nu.12,000. The management of Jigme Co. decided to pay half of a month's purchases in the month of purchase and the other half in the following month. The cost of the raw material is Nu.0.4 per Kg.

Solution:

Cash Payment Budget				
	April	May	June	Quarter
Total Cost of Raw Materials	<u>56,000</u>	<u>88,600</u>	<u>56,800</u>	<u>201,400</u>
Accounts Payable Balance	12,000			12,000
<u>**April Month Payment**</u>				
1/2 x 56,000	28,000			28,000
1/2 x 56,000		28,000		28,000
<u>**May Month Payment**</u>				
1/2 x 88,6000		44,300		44,300
1/2 x 88,600			44,300	44,300
<u>**June Month Payment**</u>				
1/2 x 56,800			28,400	28,400
Total Cash Payment	**40,000**	**72,300**	**72,700**	**185,000**

Note: Half of the cash payments for the month of June will be paid in the month of July.

e) Direct labor budget

It records the total direct labour cost incurred in the production of units. Illustration 6 explains the calculation of total direct labour cost incurred in the production of 101,000 toys.

Illustration 6

The management of Jigme Co. calculated that each toy requires 0.1 hours of direct labour. The workers have agreed to a wage rate of Nu.8 per hour.

Solution:

Direct Labour Budget				
	April	**May**	**June**	**Quarter**
No. of Units (Toys) To Be Produced	26,000	46,000	29,000	101,000
Direct Labour Hours Per Unit (Toy)	0.1	0.1	0.1	0.1
Total Direct Labours Required	2,600	4,600	2,900	10,100
Wage Rate Per Hour	8	8	8	8
Total Direct Labour Cost	**20,800**	**36,800**	**23,200**	**80,800**
Direct Labour cost per unit = Direct Labour Hour x Wage Rate per Hour				
= 0.1 x 8 = **Nu. 0.8**				

Practical Problem

Jachung Co. is now preparing the budget for direct materials and direct labor. Each unit of product requires 2 Kgs. of direct materials per unit, and the cost of direct materials is Nu. 1 per Kg. Management prefers to maintain closing inventory of raw materials equal to 30 percent of next quarter's materials needed in production. The closing inventory of raw materials at the end of the fourth quarter is estimated to be 40,000 Kgs. The opening inventory of raw materials of first quarter is 36,000 Kgs.

Moreover, each unit of product requires 0.1 direct labor hours at a cost of Nu.10 per hour. All materials are purchased on credit. The company expects to pay 60% of purchases in the quarter of purchase and remaining in the following quarter. Accounts payable at the end of 2017 amounted to Nu.60,000.

Prepare direct materials, direct labour and cash payment budget.

f) Factory overhead budget

A factory overhead budget often includes all production costs other than direct materials and direct labor. Unlike direct materials and direct labor, manufacturing overhead costs include variable cost as well as fixed cost. The factor overhead expense incurred by Jigme Co. is as follow:

Factory Overhead Budget				
	April	**May**	**June**	**Quarter**
No. of Units (Toys) To Be Produced	26,000	46,000	29,000	101,000
Variable Overhead Costs				
Indirect Materials	6,000	12,000	7,000	25,000
Indirect Labours	7,000	14,000	8,000	29,000
Other Indirect Expense	8,000	17,000	9,000	34,000
A) Total Variable Costs	21,000	43,000	24,000	88,000
Fixed Overhead Costs				
Salaries	20,000	20,000	20,000	60,000
Rent	18,000	18,000	18,000	54,000
B) Total Fixed Costs	38,000	38,000	38,000	114,000
Cash Payments (A + B)	**59,000**	**81,000**	**62,000**	**202,000**
Factory Overhead cost per unit = Total Overhead Expenses / No. of units to be produced				
= 202,000 / 101,000 = **Nu. 2**				

g) Selling and administration expense budget

Selling and general administrative expenses consist of all expenses incurred on selling and distributing finished goods. Illustration 7 shows the calculation of selling and distribution expenses incurred in selling 100,000 toys.

Illustration 7

The management of Jigme Co. has determined selling and distribution expenses @ Nu. 0.5 per toy sold.

Solution:

Selling and Distribution Overhead Budget				
	April	May	June	Quarter
Sales in Units (Toys)	20,000	50,000	30,000	100,000
Selling Price per Unit (Toy)	0.5	0.5	0.5	0.5
Cash Payments	**10,000**	**25,000**	**15,000**	**50,000**

h) Financial budget

Once an operating budget is prepared, the currency values (ngultrum) of operating budget is used in preparing financial budget consisting of cash budget and budgeted income statement.

Practical Problem

The following is the manufacturing overhead expenses and selling and distribution expenses of Jachung Co.

Variable Overhead Cots	
Indirect Materials	Nu. 0.2 per unit
Indirect Labour	Nu. 0.1 per unit
Other Expenses	Nu. 0.3 per unit

Selling & Distribution Expenses	
Advertising	Nu. 20,000
Depreciation	Nu. 15,000

Fixed Overhead Costs of Each Quarter

Salaries	Nu. 30,000
Rent	Nu. 25,000

Note:

- Selling and distribution expenses are fixed for all quarters.
- Depreciation does not result in outflow of cash, hence it is excluded from cash budget.

Prepare manufacturing overhead and selling and distribution overhead budget.

i) Cash budget

It shows all the planned cash inflows and outflows incurred on budgeted activities. Since business cannot survive without cash, it is important to avoid unnecessary idle cash or cash deficiencies. Illustration 8 explains how cash is used in production and sale of toys.

Illustration 8

On April 1, Jigme Co. has a cash balance of Nu.100,000. The management plans to pay dividend of Nu.25,000 in the month of April, and purchase equipment worth Nu.143,700 in the month of May. The management further plans to buy equipment worth Nu.48,300 in the month of June. All payments will be made in cash.

Solution:

Cash Budget				
	April	May	June	Quarter
A) Cash Collection (illustration 2)	170,000	400,000	335,000	905,000
Less: Cash Payments				
Raw Materials (illustration 5)	(40,000)	(72,300)	(72,700)	(185,000)
Direct Labour (illustration 6)	(20,800)	(36,800)	(23,200)	(80,800)
Factory Overhead Expenses Paid	(59,000)	(81,000)	(62,000)	(202,000)
Selling & Distribution Expenses Paid	(10,000)	(25,000)	(15,000)	(50,000)
Equipment Purchased		(143,700)	(48,300)	(192,000)
Dividend Paid	(25,000)			(25,000)
B) Total Cash Payments	**(154,800)**	**(358,800)**	**(221,200)**	**(734,800)**
Cash Balance (A - B)	15,200	41,200	113,800	170,200
Beginning Cash Balance	100,000	115,200	156,400	100,000
Ending Cash Balance	115,200	156,400	270,200	270,200

Note:

- The beginning cash balance in the quarter is equal to April's beginning cash balance since April, May and June constitutes a quarter.
- The ending cash balance of quarter and June month should match.

Cost of goods sold

The final step is to calculate the cost of goods sold which requires per unit of cost of goods sold. Per unit of cost of goods sold can be calculated as follow;

Calculation of Cost of Goods Sold

Particulars	April	May	June	Quarter
Opening Inventory of raw materials (cost of raw materials per toy x opening inventory)	5,200	9,200	5,800	5,200
Add: Purchases (Refer Direct Materials Budget)	56,000	88,600	56,800	201,400
Materials Available for Use	**61,200**	**97,800**	**62,600**	**206,600**
Less: Closing Inventory of raw materials (cost of raw materials per toy x ending inventory)	9,200	5,800	4,600	4,600
Direct Material Used	**52,000**	**92,000**	**58,000**	**202,000**
Add: Direct Labour (Refer Direct Labour Budget)	20,800	36,800	23,200	80,800
Add: Factory Overhead (Refer Factory Overhead Budget)	59,000	81,000	62,000	202,000
Total Manufacturing Cost	**131,800**	**209,800**	**143,200**	**484,800**
Add: Beginning Work in Progress	-	-	-	-
Less: Closing Work in Progress	-	-	-	-
Cost of Goods Manufactured	**131,800**	**209,800**	**143,200**	**484,800**
Add: Opening Inventory of Finished Goods (per unit cost of goods manufactured * opening inventory)	19,200	19,200	19,200	19,200
Cost of Goods Available for Sale	**151,000**	**229,000**	**162,400**	**504,000**
Less: Closing Inventory of Finished Goods (per unit cost of goods manufactured * Closing inventory)	48,000	48,000	48,000	48,000
Cost of Goods Sold	**103,000**	**181,000**	**114,400**	**456,000**

Note:

1. Opening and Closing Inventory of Raw materials figure is taken from Direct Materials Budget, Pg: 279
2. Cost of Raw Materials per Toy is Nu. 0.4 per Kg. (Page: 279)
3. Opening and Closing Inventory of Work in Progress is 0 as mentioned in illustration 4, Pg: 279
4. Opening and Closing Inventory of finished goods units is taken from Production Budget, Pg: 278
5. Per unit cost of goods manufactured = Cost of Goods Manufactured / No. of Goods to be produced = 484,800 / 101,000 = 4.8
6. Opening inventory of finished goods calculation for April month = 4.8 * 4,000 = 19,200

OR

Per Unit Cost of Goods Sold Calculation	
Direct Materials Per Unit Cost (From Direct Material Budget)	Nu. 2
Direct Labour Per Unit Cost (From Direct Labour Budget)	Nu. 0.8
Factory Overhead Per Unit Cost (From Factory Overhead Budget)	Nu. 2
Per Unit Cost of Goods Sold	**Nu. 4.8**

Cost of Goods Manufactured = 4.8*101,000	484,800
Add: Opening Inventory of Finished Goods (4.8 x 4,000)	19,200
Less: Closing Inventory of Finished Goods (4.8 x 10,000)	(48,000)
Cost of Goods Sold	**456,000**

Budgeted income statement

The budgeted income statement estimates the net income from the budgeted operations. Once the budgeted income statement has been approved, it becomes the benchmark against which the performance of the period is evaluated.

Jigme Co.	
Budgeted Income Statement	
For the Three Months Ended June	
Revenue from Sales (100,000 x 10)	1,000,000
Cost of Goods Sold	480,000
Gross Profit	**520,000**
Operating Expenses:	
Selling and Administration Expenses	50,000
Net Profit	**470,000**

Practical Problem

Jachung Co. plans to purchase equipment worth Nu. 50,000 at the end of the fourth quarter. The cash balance on 2017 amounted to Nu.100,000.

Prepare cash budget to determine the ending balance of cash at the end of fourth quarter 2018 and budgeted income statement for the year ending 2018.

Ethical issues in budgeting

The ethical and behavioral factors need to be taken into consideration especially when deciding what is best for individuals and what is best for the business organization. Most often, people tend to believe that it is smarter to guarantee less and deliver more, than to guarantee more and deliver less. In addition, most managers believe that their future budgets will be reduced if they do not use-up all the budget amounts, so they resort to unethical practices to consume the leftover budget by indulging into undesired practices. Conflict of interest is another area which often leads to misallocation of resources such as procurement of inferior goods if the manager has a good relationship with the suppliers. Therefore, it is important for an organization to maintain a proper code of ethics in place to avoid any unethical issues in budgeting. Unethical practices have a negative impact on the organisation.

11.2 Standard Cost and Variance Analysis

The master budget is an example of static budget prepared for only one level of activity (based on sales level as discussed in the first part section of the chapter). This type of budget may be good for planning phase but are not appropriate for controlling phase. Business organisations generally use flexible budget which are based on the actual level of activity. Suppose, if the budgeted sales is Nu.100,000 and the actual sales is Nu.105,000, the flexible budget will be based on the actual sales of Nu.105,000. For this chapter preparation of flexible budget will not be discussed further, however, the concept of standard cost will be discussed.

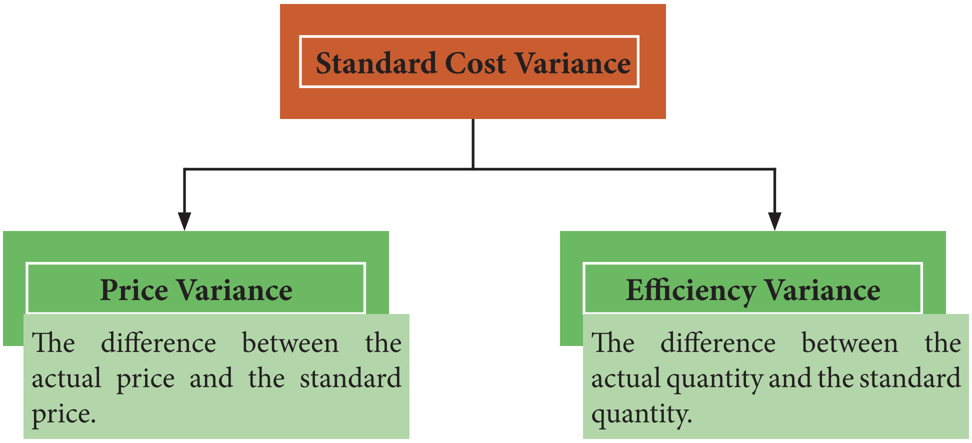
11.2.1 Standard cost

Standard cost is the cost incurred under normal operating conditions. They are usually associated with a manufacturing company's cost of direct material, direct labour and factory overhead. For example, Bank of Bhutan has a standard time to resolve complaints made by clients with regard to ATM.

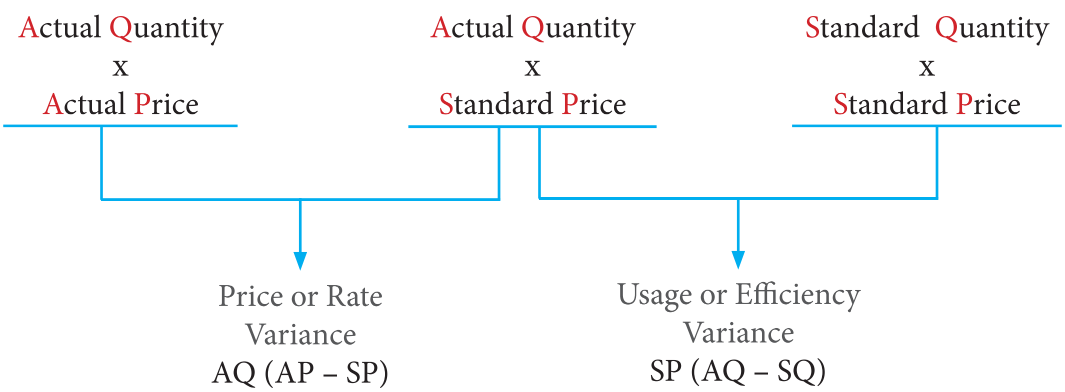
Accounting systems that use standards for product costs are called standard cost systems. Standard cost systems enable management to determine how much a product should cost (standard cost) and how much it does cost (actual cost). The difference between the actual cost and the standard cost are known as standard cost variance.

11.2.2 Standard cost variance

It is the difference between the actual cost and the standard cost. When actual results are better than expected results, the variance is known as favourable variance denoted by the letter 'F'. When actual results are worse than expected results, the variance is known as unfavourable variance denoted by the letter 'U'. The standard cost variance consists of price variance and efficiency variance.



In order to calculate variance, the following general model for variance analysis can be adopted:



Standard price is the amount that should have been paid for the resources acquired. Standard quantity is the quantity allowed for the actual output of good.

The business can adopt various variance analysis techniques to control and evaluate performance of business and employees. Some of the techniques will be discussed further as follow:

a) Direct material variance analysis

It is the difference between the standard cost of materials resulting from production activities and the actual costs incurred. The direct material variance constitutes:

i) **material price variance** – difference between the actual price paid for the material and the standard price of the material allocated, and

ii) **material usage variance** – difference between the actual quantity of material used and the standard quantity of the material allocated.

Illustration 9

Jigme Co. has the following direct material standard to manufacture one block of butter:

1.5 kg per block of butter at Nu.4 per kg.

Last month 1,700 kg of material were purchased and used to make 1,000 blocks of butter. The material cost a total of Nu.6,630.

Standard Quantity = (Actual unit produced x Standard quantity per unit)
Actual Price = (Actual total cost / Actual quantity)

Solution:

Given that;
Actual Price (AP) = Nu. 6,630 / 1,700 kg = 3.9 per Kg
Standard Price (SP) = Nu. 4 per Kg
Actual Quantity (AQ) = 1,700 Kg
Standard Quantity (SQ) = 1,000 x 1.5 = 1,500 Kg.

Material Price Variance = AQ (AP – SP)
= 1,700 (3.9 – 4)
= Nu. 170 (Favourable)

Material Usage Variance = SP (AQ – SQ)
= 4 (1,700 – 1,500)
= Nu. 800 (Unfavourable)

Actual Quantity x Actual Price	Actual Quantity x Standard Price	Standard Quantity x Standard Price
1,700 Kgs. x Nu.3.9 per Kg.	1,700 Kgs. x Nu.4 per Kg.	1,500 Kgs. x Nu.4 per Kg.
Nu.6,630	Nu.6,800	Nu.6,000

Price Variance
Nu. 170 Favourable

Usage Variance
Nu. 800 Favourable

Price variance is favourable since the actual price is less than the standard price indicating that the business has saved Nu.170 in purchasing materials for the production of butter.

Usage variance is unfavourable since the amount of actual materials used is greater than the standard materials. The business has incurred extra cost of Nu.800 by using more amount of materials than expected. This indicates inefficiency of the material usage.

Relationship between material price and usage variance

The purchase of cheaper raw materials in order to obtain a favourable price variance might perhaps lead to unfavourable usage variance since the quality of material is compromised. On the other hand, the purchase of expensive raw materials having longer service life may result in unfavourable price variance but favourable usage variance.

b) Labour variance analysis

It is the difference between the standard cost of labour resulting from production activities and the actual costs incurred. The direct labour variance constitutes:

i) **labour rate variance** – the difference between the actual wage rate paid for the labour and the standard wage rate of the labour allocated, and

ii) **labour efficiency variance** – the difference between the actual hour of labour used and the standard hour of the labour allocated.

Illustration 10

Jigme Co. has the following direct labor standard to manufacture one block of butter:
1.5 standard hours per block at Nu.12 per direct labour hour.
Last month 1,550 direct labour hours were worked at a total labor cost of Nu.18,910 to make 1,000 blocks.

Standard Quantity = (Actual unit produced x Standard hour per unit)

Solution:

Given that;
Actual Rate (AR) = Nu. 18,910 / 1,550 = Nu. 12.2 per hour
Standard Rate (SR) = Nu. 12 per hour
Actual hours (AH) = 1,550 hours
Standard hours (SH) = 1,000 x 1.5 = 1,500 hours.

Labour Rate Variance = AH (AR – SR)
= 1,550 (12.2 – 12)

= Nu. 310 (Unfavourable)

Labour efficiency
Variance = SR (AH – SH)
= 12 (1,550 – 1,500)
= Nu. 600 (Unfavourable)

Actual Hour	Actual Hour	Standard Hour
x	x	x
Actual Rate	Standard Rate	Standard Rate
1,550 hours	1,550 hours	1,500 hours
x	x	x
Nu.12.2 per hr.	Nu.12 per hr.	Nu.12 per hr.
Nu.18,910	**Nu.18,600**	**Nu.18,000**

Rate Variance	Efficiency Variance
Nu. 310	Nu. 600
Unfavourable	Unfavourable

Rate variance is unfavourable since the actual rate is higher than the standard rate indicating that the business have spent excess amount of Nu. 310 in employing labour for the production of butter.

Efficiency variance is unfavourable since the amount of actual hour used is greater than the standard hour. The business has incurred extra cost of Nu.600 by using more direct labour hours than expected. This indicates inefficiency of the labour usage.

Relationship between labour rate and efficiency

If workers in a firm are paid higher rates for experience and skills, the labour rate variance will be unfavourable but since the workers possess experience and skills, the efficiency of the labour will increase resulting into favourable labour efficiency variance. In contrast, favourable labour rate variance might indicate a larger portion of inexperienced workers in the firm, which could result in an unfavourable labour efficiency variance.

c) 2.3 Variable manufacturing overhead variance analysis

The variable manufacturing overhead variance analysis involves two separate variances.

i) **Variable overhead spending variance** – difference between actual costs for variable overhead incurred and standard costs for variable overhead allotted.

ii) **Variable overhead efficiency variance** – difference between the actual direct labour hours worked and standard direct labour work allotted.

Illustration 11

Jigme Co. applies variable factory overhead on the basis of direct labour hours (DLHs) and has the following variable factory overhead standard to manufacture one unit of butter:

1.5 standard DLHs per unit @ a variable overhead rate of Nu.3.00 per DLH.

Last month, 1,550 hours were worked to make 1,000 units of butter, and Nu. 5,115 were spent for variable factory overhead.

Standard Hours = (Actual unit produced x Standard hour per unit)

Actual rate = (Actual total cost / Actual hours)

Solution:

Given that:

Actual Rate (AR) = Nu. 5,115 / 1,550 = Nu. 3.3 per hour

Standard Rate (SR) = Nu. 3 per DLH

Actual hours (AH) = 1,550 hours

Standard hours (SH) = 1,000 x 1.5 = 1,500 hours.

Variable overhead
spending variance = AH (AR – SR)
= 1,550 (3.3 – 3)
= Nu. 465 (Unfavourable)

Variable overhead
efficiency Variance = SR (AH – SH)
= 3 (1,550 – 1,500)
= Nu. 150 (Unfavourable)

Actual Hour	Actual Hour	Standard Hour
x	x	x
Actual Rate	Standard Rate	Standard Rate
1,550 hours	1,550 hours	1,500 hours
x	x	x
Nu.3.3 per hr.	Nu.3 per hr.	Nu.3 per hr.
Nu.5,115	**Nu.4,615**	**Nu.4,500**

Spending Variance
Nu. 465
Unfavourable

Efficiency Variance
Nu. 150
Unfavourable

Rate variance is unfavourable since the actual rate is higher than the standard rate indicating that the business have spent excess amount of Nu. 465 in employing labour for the production of butter.

Efficiency variance is unfavourable since the amount of actual hour used is greater than the standard hour. The business has incurred extra cost of Nu.150 by using more labour hours than expected. This indicates inefficiency of the material usage.

Practical Problem

Lhazon Co. is the manufacturer of chair in Paro. During the year 2017, 1,000 chairs were produced. The following is the information relating to cost standard developed by management and actual expenditure incurred.

<table>
<tr><th>Direct Materials</th><th>Direct Labour</th></tr>
<tr><td>The direct material standard to manufacture one chair is 2 kg per chair at Nu.5 per kg.
1,250 kg of material were purchased incurring a cost of Nu. 5,000</td><td>The direct labour standard to manufacture one chair is 2 hours per chair at Nu.10 per direct labour hour.
1,600 direct labours were worked incurring a cost of Nu. 17,600.</td></tr>
<tr><th colspan="2">Factory Overhead</th></tr>
<tr><td colspan="2">The management calculated variable factory overhead on the basis of direct labour hours. The direct labour hour standard to manufacture one chair is 2.5 hours per chair at a variable overhead rate of Nu.10 per direct labour hour.
2,500 hours were worked incurring a variable factory overhead expense of Nu. 5,000.</td></tr>
</table>

Calculate the direct material, direct labour and factory overhead variance.

Exercises:

Choose the correct answer from the following

1. Karma Co. is the manufacturer of bread product. Each bread requires 3 kg of raw material at the cost of Nu. 2 per kg and 4 direct labour hours at the cost of Nu.7 per hour.
   The production budget for bread for April to June is as follows.

	April	May	June
Production bread (nos.)	7,800	8,400	8,200

On March 31, there was a 3,000 kg of inventory of raw materials. The management of Karma Co. wants ending inventory of raw materials of each month equal to 10% of the following month's raw materials. The ending inventory of raw materials for June is 3,900 kg.

a. Material purchases amount are paid for in the following month purchase. The amount to be included in the cash budget for June in respect of payments for purchases is:
A Nu.25,140
B Nu.52,080
C Nu.50,280
D Nu.26,040

b. Wages are paid 75% in the month of production and 25% in the following month. The amount to be included in the cash budget for May in respect of wages is:
A Nu.222,600
B Nu.231,000
C Nu.233,800
D Nu.235,200

2. Tashi Co. is the manufacturer of mineral water. The management derived the standard direct material to be 2.3 litres at Nu. 2 per litre.
   In the month of May, 1,800 bottles of mineral water was produced and 4,000 litres were used at a cost of Nu. 10,000.

The direct material price and usage variances for May month are:

Material price	Material usage
Nu.2,000 (F)	Nu.280 (F)
Nu.2,000 (U)	Nu.280 (F)
Nu.2,000 (F)	Nu.280 (U)
Nu.2,000 (U)	Nu.800 (U)

3. During the year, 12,000 labour hours were worked at a standard cost of Nu. 6 per hour. The labour efficiency variance was Nu. 9,000 (favourable). How many standard hours were produced?
   A 12,000
   B 16,300
   C 10,500
   D 13,500

4. During the year, 250 labour hours were worked for a total cost of Nu. 3,500. The variable overhead expenditure variance was Nu.125 (Unfavourable). What was the standard rate per labour hour?
   A 12.5
   B 13.5
   C 14.5
   D 15.5

Case Study1

Tshokey Co. produces furniture that are sold throughout Bhutan. The management has a plan to develop direct materials standard to complete production of one unit of furniture. Assuming that you are a production manager, and you receive an incentive for favourable material usage variance. The management has asked your help in developing the standard number of materials required to complete one unit of furniture.

Required:

i) Describe the ethical conflict that you will encounter being a production manager in developing standard number of materials.

ii) What measures can Tshokey Co. adopt in order to avoid this conflict?

Case Study 2

The management of Gongdo Co. has a policy of awarding bonus to the department heads based on the budgetary performance of the firm. The company has a usual trend of giving bonus on any excess profit made above the budgeted profit. Dawa as a sales department head in anticipation of getting more bonus decided to overestimate expenses and underestimate revenue while designing budget plan. At the year end, the actual profit was 150% higher than the budgeted profit.

Required:

i) What ethical issues do you see in the case of Dawa?

ii) How would such behavior of Dawa impact firm?

iii) How would the firm address the unethical practices mentioned in the case?

Case Study 3

Om works as a manager in one of the firms in Gedu. Recently, Om has furnished the following information on material and labour variance analysis for product 'A' and Product 'B'.

	Product 'A'	**Product 'B'**
Material Price Variance	Favourable	Unfavourable
Material Usage Variance	Unfavourable	Favourable
Labour Rate Variance	Favourable	Unfavourable
Labour Efficiency Variance	Unfavourable	Favourable

Required:

What could be some of the possible reasons for favourable and unfavourable variances in case of Product 'A' and Product 'B'?

Chapter 12
Application of Spreadsheet in Accounting

Learning Objectives:

- Apply ms excel in preparation of books of accounts.
- Use functions and formulae to calculate all accounting data.
- Interpret accounting data and generate graphical reports.
- Deliberate on the importance of ms excel in accounting.

There are many accounting software in the market such as Quick Book, Tally, PEMS etc., which can auto-generate financial statements. Similarly, spreadsheet (MS Excel) is known for its vast application in accounting. User can prepare different books of accounts in MS Excel. The chapter deals with preparation of various books of accounts such as trial balance, statement of income, statement of changes in equity, statement of cash flows etc. in a single workbook in MS Excel using its functions and referencing.

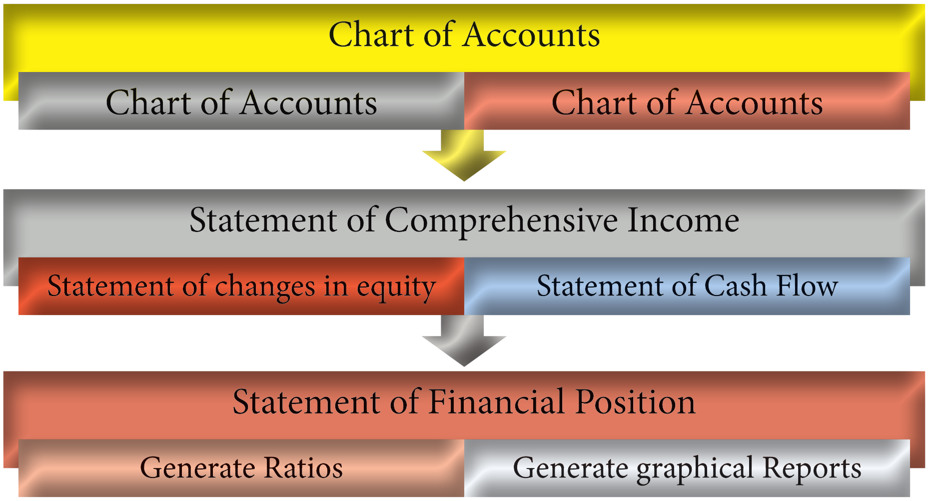


Figure 9.1 Process of preparing books of accounts in MS Excel

12.1 Steps in preparing Books of Accounts using MS Excel

Create a workbook in MS Excel and name it as "Books_Accounts". In this workbook, create multiple work sheets and label them as Chart of Account, Adjusted Trial Balance, Notes, Statement of Comprehensive Income, Statement of Change in Equity, Statement of Cash Flow, Statement of Financial Position and Ratio.

The first sheet, chart of account, contains codes given to every account head. For example, PP&E is coded 100 and any items under the block PP&E must be coded within the range of 100 – 199. Similarly, code 200 will be assigned to equity while 300 is coded as liabilities. This is to ease locating errors and finding required information using account head number or code besides other benefits.

From the given unadjusted trial balance and additional information, prepare adjusted trial balance in the second sheet by using excel functions. Adjusted trial balance prepared should be free of errors as it forms the basis for preparing all other books of accounts.

Account Title	Account No.	Balance
Property, Plant And Equipment	100	Dr
Land And Buildings	100.1	Dr
Machinery And Equipment	100.2	Dr
Vehicles	100.3	Dr
Intangible Assets	101	Dr
Goodwill	101.1	Dr
Financial Assets	102	Dr
Investments And Financial Instruments	102.1	Dr
Inventories	103	Dr
Receivables	104	Dr
Cash And Cash Equivalents	105	Dr
Equity	200	(Cr)
Issued Capital	201	(Cr)
Retained Earnings	202	(Cr)
Profit	202.1	(Cr)
Reserve Fund	202.2	(Cr)
Capital Reserve	202.3	(Cr)
Liabilities	300	(Cr)
Borrowings	301	(Cr)
Provisions	302	(Cr)
Trade And Other Payables	303	(Cr)
Tax Liabilities	304	(Cr)
Revenue	400	(Cr)
Expenses	500	Dr
other incomes	600	Dr

The figures in the financial statements are supported by notes (working) from adjusted trial balance for better understanding. It can be preapred with the use of functions and cell/sheet referencing to the respective financial statements in worksksheet. Statement of Comprehensive Income, Statement of Change in Equity, Statement of Cash Flow, Statement of Financial Position and Ratio is then prepared. Learning Activity 1 will explain the preparation of financial statements using MS Excel functions.

Illustration 1

From the following details, prepare adjusted trial balance, statement of income and statement of financial position.

Code	Particulars	Nu.	Code	Particulars	Nu.
200	Share capital	80,000	601.2	Bank Interest	850
110	Inventory on 1.1. 2019	51,000	602.1	Bad Debts	2500
110.1	Purchases	220,000	100.1	Buildings	95,000
400	Sales	330,000	100.2	Plant and Machinery	98,000

401.2	Returns	3800	602.1	Sundry Debtors	45,000
602	General Expenses	1800	300.2	Creditors	55,500
501.3	Wages	12,000	300.2	Loan	25,000
501.2	Salaries	18,700	112	Cash	1400
602	Traveling expenses	3200	300.4	Reserve Fund	23,000
502.2	Advertisement	1550	602.1	Preliminary Expenses	11,000
600	Rent and taxes	4900	204.1	Profit and Loss Account (Cr.)	55000
601	Discount Received	2200			

Adjustments:

Transfer Nu. 10,000 to Reserve Fund. Provide depreciation on building at 5%. Inventory on 31.12.2017 was valued at Nu. 12,000, Dividend at 15% on share capital is to be provided. Depreciation on Plant and Machinery at 10%.

Solution.

a) Trial balance total error

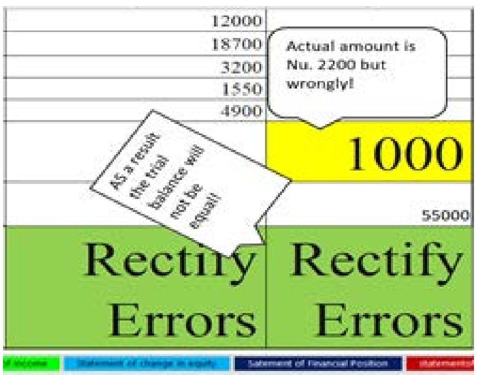


Figure 9.4 wrong Trial balance total

The MS Excel functions can be used to ascertain the arithmetic accuracy of the trail balance. It can be done using the function:

=IF(SUM(Debit)=SUM(credit),SUM(Debit),"Rectify Errors"). This means the total of debit column should be equal to total of credit column. If debit and credit balance disagree, the message "Rectify Errors" will be displayed.

b) Statement of income

The Statement of income presented here is prepared using cell references from the adjusted trial balance. 'Function of expense', one of the two methods of preparing statement of income using MS Excel is shown in fig.9.5.

In financial reports, the sub calculations are shown in notes and only the major items or events are displayed in the financial statements.

Statement of Income			
		For the year ended 31 Dec, 2017	
Particulars	Notes	December 31, 2016	December 31, 2017
Revenue	1	296000	326200
Cost of goods sold	2	256600	271000
Gross profit		39400	55200
Other Income	3	1,000	2200
Distribution cost	4	-2,500	-4,750
Administrative expense	5	-18,000	-23,600
Finance Cost	7	-250	-850
Other expenses	6	-1,000	-4,300
Depreciation and amortisation expense	8	-14,550	-14,550
Profit before tax		4100	9350

Note 1	Revenue	
	sales	return
	330,000	3,800
Revenue	326,200	

c) Preparation of Statement of Financial Position

Statement of Financial Position is cell referenced to adjusted trial balance, notes and statement of income presented in other worksheets.

	Note	2017	2016
Assets			
Non-Current Assets			
Property, Plant & Equipment	8	178,450	185,350
Current Assets			
Inventories		12,000	9,000
Trade Receivables		45,000	36,250
Cash and cash equivalents		1,400	2,000
Preliminary Expenses		11,000	12,000
Total Assets		247,850	59,250

Figure 9.6 Extract of Statement of Position

Note 8	Accumulated depreciation	Dep %	Assets
Plant and machinery	9800	10%	98000
Buildings	4750	5%	95000
Total	14550		
Net PPE value	178450		

d) Generation of Reports

MS Excel allows the user to easily auto generate all types of reports based on the data/figures supplied by different financial statements. It can be customised based on the need of the users.

Practical Problem

Table shows current ratios of Karma & Co. and Tashi & Co. for the past six years. Present the information in the form of a suitable graph using MS Excel and interpret it.

	2013	2014	2015	2016	2017	2018
Karma & Co.	0.75	0.88	0.93	0.97	0.99	1
Tashi & Co.	1.25	1.17	1.35	1.05	1.02	1

Diagrammatic representation of process of preparing financial reports using MS Excel

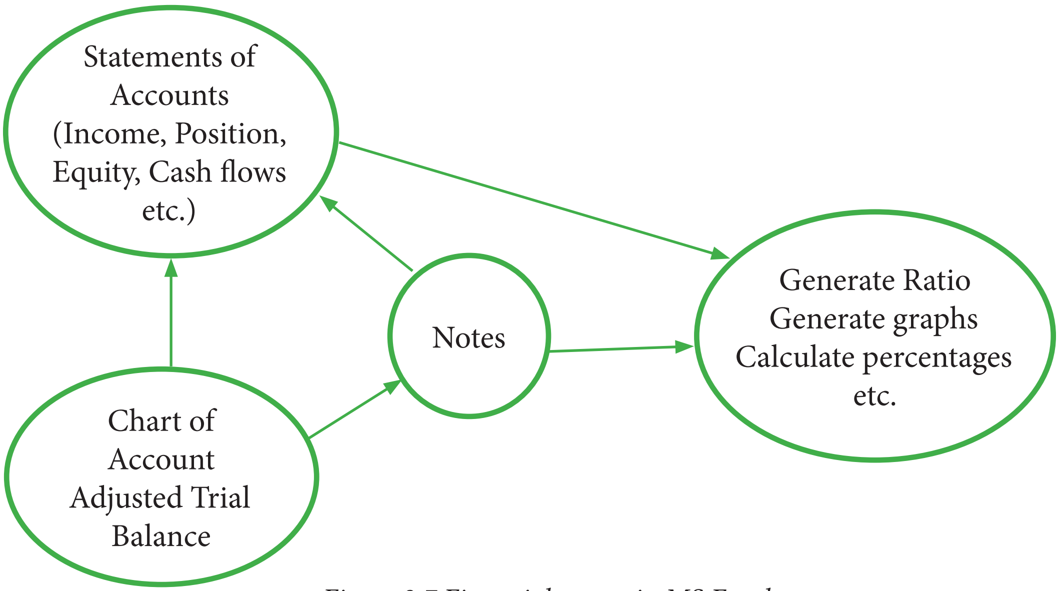


Figure 9.7 Financial report in MS Excel

The advantage of using MS Excel in the preparation of books of accounts is that, all financial statements and reports can be interlinked among different worksheets, such that, if a figure is changed in trial balance, it gets automatically updated in all other statements and reports.

12.2 Payroll

This unit deals with the preparation of payroll using MS Excel by lookup function. A unique identity number is assigned (EID in Figure 9.9) to every employee to generate required information pertaining to him/her.

	A	B	C	D	E	F	G	H
1	EID	Name	Category	Experience	Grade	Profession	Basic Pay	Designation
2	112	Ugyen Dorji	Regular	17	P	Teaching	Nu.30,900	Principal
3	113	Sonam Dema	Regular	9	P	Teaching	Nu.24,400	Vice Principal
4	114	Deki Wangmo	Regular	32	P	Teaching	Nu.31,500	Teacher
5	115	Kencho Choden	Regular	2	P	Teaching	Nu.17,800	Teacher
6	116	Tashi Pelden	Regular	12	S	Non-Teaching	Nu.16,000	Technician
7	117	Tshering Tenzin	Contract	2	S	Non-Teaching	Nu.15,000	Accountant
8	118	Tashi Wangdi	Regular	5	S	Non-Teaching	Nu.12,700	Technician
9	119	Dawa	Contract	14	ESP	Non-Teaching	Nu.7,000	Caretaker
10	120	Gyalpo	Contract	4	GSP	Non-Teaching	Nu.7,000	Caretaker

Figure 9.9 Employee details (Sheet 1)

Figure 9.9 shows a table of employees' details. One need to fill out a simplified payslip form by pulling the information from this table when an employee's ID is selected.
The user will select an employee ID from a data validation list in cell C3 (Fig.9.10). EID is used to extract the employee's name, address, and other information into the payslip from the employee details (sheet 1).

The formulae for the payslip form in Figure 9.10 are shown here:

Name: =LOOKUP(C3,EID,EMPName).
Designation=LOOKUP(C3,EID,Designation)
Experience=LOOKUP(C3,EID,Experience)Category
=LOOKUP(C3,EID,Category)
Basic pay =LOOKUP(C3,EID,Basic_Pay)
Grade =LOOKUP(C3,EID,Grade)
Profession=LOOKUP(C3,EID,Proffession)
Net pay or take home pay=Gross_pay-Grand_Deduction

=LOOKUP(C3,EID,EMPName)

B	C	D	E	F	G
EID	117	Grade	S	EWS	
Name	Tshering Tenzin	Profession	Non-Teaching	YES	
Designation	Accountant			Deductions	
Experience	2			TDS	1,500
Category	Contract	Allowances		HC	150
Basic Pay		TA	0	PF	1,650
15,000		HRA	3,000	GIS	300
		CA	4,500	EWS	150
		Total Allowances	7,500	Total Deductions	3,750
Gross Pay	Nu.22,500.00				
			Net Pay	Nu.18,750.00	

Figure 9.10 Simplified individual pay slip

LOOKUP takes these three arguments:
Lookup value: The value you want to find
Lookup vector: The single column or single row to look in
Results vector: The single column or single row to return from

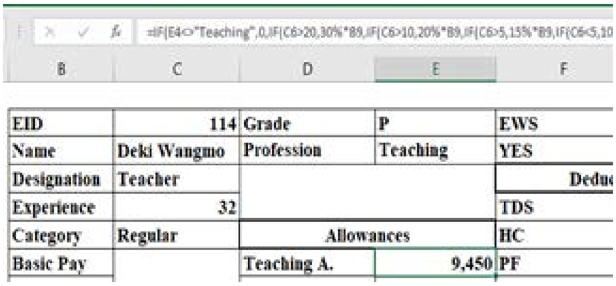


Figure 9.11 Calculation of teaching allowance

There are applications of other formulae. The most used in this sample is IF function.

It is assumed that out of different workers in a school, only teachers are entitled for teaching allowance. Teaching allowance is based on the number of years of experience as shown in Table 9.1.

Table 9.1 Teaching allowance entitlements

Teaching Experience	More than 20 years	10 – 19 years	5-9 years	Less than 5 years
% of Basic Pay	30%	20%	15%	10%

All calculations are based on basic pay. The condition or the logical test, a computer has to consider it to decide if an employee is Teacher or not. If an employee is not teacher, the computer simply has to display '0' amount as teaching allowance. Otherwise, it has to calculate different teaching allowance. The formula is explained here:

Teaching allowance

IF(E4<>"Teaching",0, IF(C6>20,30%*B9,IF(C6>10,20%*B9,IF(C6>5,15%*B9, IF(C6<5,10%*B9,0)))))

E4 is cell where profession is displayed, C6 is cell where years of experience are displayed, B9 is cell where basic pay is displayed.

First logical test is done for profession, because if the profession is not "Teaching", the computer need not do any calculation. Instead, give '0' directly. If profession is "Teaching", then proceed further with more logical test using IF function. Formula indicates that if the teacher is having more than 20 years of experience, multiply 30% with Basic pay and similarly for different numbers of years of experience.

Other Allowances are also calculated using IF function and the conditions of the organization. The Deductions are also calculated using IF function by evaluating the conditions of the organisation.

The Gross pay is sum of all the allowances, and net pay or take-home pay, is calculated by deducting all deduction from the gross pay. Common deduction includes Provident Fund, Tax Deducted at Source and Group Insurance scheme in Bhutan. Other deductions differ from one organisation to another.

The advantage of using MS Excel function is that an organisation can easily determine remuneration payable to employees including gross pay, deductions, net pay, etc. They can also know the type and number of employees in their organisation.

Exercises:

1. Case study

Gang Chu Pvt. Ltd. employs many Bhutanese workers. As a reward, the government has provided a qualified accountant for maintaining their payroll.

The company has 2 managers, 3 supervisors, 4 engineers, 30 regular workers and 20 workers on contract. The basic pay for manager is Nu.48,550, engineer Nu.52,350, supervisor and worker Nu.23,990 each. Contract workers are entitled to contract allowance of 30% of basic pay. Employees occupying company's quarter are not entitled to get house rent allowance but others will get 25% of basic pay. Mangers are not entitled to get 10% of basic pay as risk allowance. Company deposits 11% of gross pay of all the employees except contract employees to Provident Fund Accounts.

The company has also opened a Group Insurance Scheme with RICB to cover up the risk of death during the tenure of the employees in the company. For this, managers contribute Nu.500, Engineers contribute Nu.400 and others Nu. 300 every month as premium deductible from the pay. Company deducts 5% of gross pay as Tax deducted at source. Employee's relationship is very good and everyone works as if they are of the same family. Company decided to open a welfare scheme for themselves and decided to allow accountant to deduct Nu. 500 every month and deposit in bank. This money is to be used only in the event of death of employees, employee's parents, spouse, children and immediate dependents.

Assume yourself as the accountant deputed by the government and prepare comprehensive payroll for the company.
Hint: At least record details of one each from each level or category of employees.

2. The following you are required to prepare Cost Sheet for the period ended on 31st Dec. 2017 in MS excel.

Consumable material:	Nu.
Opening inventory	20,000
Purchases	1, 22,000
Closing inventory	10,000
Direct wages	36,000
Direct Expenses	24,000
Factory overheads	50 % of direct wages
Office and administration overheads	20% of works cost

Selling and distribution expenses Nu.3 per unit sold
Units of finished goods:
In hand at the beginning of the period (Value Nu. 12500) 500 units
Units produced during the period 12,000
In hand at the end of the period 1,500
Find out the selling price per unit if 20% is the profit on selling price. There is no works-in-progress either at the beginning or at the end of the period.

3. Prepare cost sheet from the following information.

Cost Sheet for the period ended on 31st Dec. 2017(output 12000units)		
Number of units produced:		12000
Particulars	Total Cost	Cost/unit
Cost of raw materials consumed	132,000	11
Direct wages	36,000	3
Direct expenses	24,000	2
Prime Cost	**192,000**	**16**
Factory Overheads	18,000	
Works/ factory overheads	**210,000**	**17.5**
Office overheads 20% of work cost	42,000	3.5
Total cost of production	**252,000**	**21**
Add: Opening inventory of finished goods (500 units @25)	12,500	
Cost of goods available for sale (12000+500)	**264,500**	**21.16**
Less: Closing inventory of finished goods @ 21 per unit (1500)	31,500	
Cost of goods sold (12500-1500=11000 units)	**233,000**	**21.18**
Add : Selling & Distribution overheads @ per unit	33,000	3
Cost of Sales	**266,000**	**24.18**
Add Profit 20% on selling price (i.e. 25% of cost of sales)	66,500	6.05
Sales (266000*25/100)	**332,500**	**30.23**

The selling price per unit is Nu. 30.23.

4. From the following information, prepare cost sheet and find cost per unit.
Direct material Nu. 1, 60,000
Direct Labour Nu. 45,000
Direct Expenses Nu. 15,000
Factory overheads Nu. 35,000

Office and administration overheads 20% of works cost
Selling and distribution overheads Nu. 45,000
Opening stock of finished goods Nu. 25,000
Closing stock of finished goods Nu.10, 000
Profit on Sales 10%

5. Case Study

Gangri Pvt. Ltd. has been in the business for few years and they have not prepared any cost sheet until date. You got the job as an accountant in this firm, and manger asked you to prepare cost sheet and report to him on the next day. You got the following details:

The company has leftover raw materials of previous year at Nu.12,500 and procurement officer has purchased new raw material for this year worth Nu.136,000. Labour worth Nu. 54,000 is been hired for the production and incurred another Nu.12,000 as direct expenses. Factory cost is 100% of direct wages. Office and Administration works expenses were 20% of the work cost. The company produced 50,000 units of half-litre bottles of mineral water. They have sold it at Nu.10 per half-litre bottle, which is also an existing market price. They have closing finished goods worth Nu 15,000 this year and they had opening finished goods in the beginning of the year worth Nu. 12,000. The raw material left is Nu.8,500 for current year.

Required: (cost sheet and calculations must be presented in different worksheet)

a. What was the profit per unit at cost until date?
b. How will you make profit of Nu.5 per unit from next production?
c. Which head consumed the major chunk of cash?

Skills to be developed at the end of the chapter;

1. Naming the cell or range of cell
2. Data validation
3. Using IF, And, OR etc. Functions
4. Using Lookup function

Students can explore the use of:

5. ISTEXT function
6. Vlookup function
7. Trim, countif

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Assessment

Accountancy Assessment Matrix

	Continuous Formative Assessment (CFA)			Continuous Summative Assessment (CFA)			Summative Assessment (SA)	
Definition	It is a continuous process of assessing learner's problems and learning needs; provide feedbacks and to identify the needs for the remedial measures to improve learner's learning. It also enables teachers to understand what teaching methods and materials work best.			It is a continuous process of grading learner's performances and achievements. Based on their performance, teachers provide feedbacks for improvement. It also enables teachers to understand what teaching methods and materials work best.			Assesses learner's cumulative performances and achievements at the end of each term.	
Domains	Content knowledge (CK) (Cognitive)	Application of Concepts(AC) (Psychomotor)	Accounting Values and Attitudes (AVA) (Affective)	Content knowledge (CK) (Cognitive)	Application of Concepts(AC) (Psychomotor)	Accounting Values and Attitudes (AVA) (Affective)	CK, AC & AVA	CK, AC & AVA
Techniques	Quiz & debate, self & peer assessment, class presentation, homework, class work, immediate interaction with learner's, concept(mind) mapping.	Immediate interaction with learner's, class work, home work, experiments, exhibition, case studies, observation, use of ICT in problem solving.	Observation of learner's conduct, team work, field trip, excursion, self & peer assessment ,immediate interaction with learners.	Home work – twice in each term, and class test-twice in each term.	Project Work OR case study.	Accountancy Practical	Term exam	Term exam

Assessment Tools	Q&A, rubrics, checklist and anecdotal records.	Checklist and anecdotal records.	Checklist, Q&A, rubrics and anecdotal records.	Rubrics (HW) and Q&A.	Rubrics	Rubrics	Paper pencil test with: MCQ, Fill in the blanks, Matching, True or False, Short answer questions and extended response questions.	Paper pencil test with: MCQ, Fill in the blanks, Matching, True or False, Short answer questions and extended response questions.
Frequency	Check lists and anecdotal records must be maintained for each topic throughout the academic year.			Home Work and class test - twice in each term	Project Work or Case study- once in a year	Accountancy Practical Twice in a Term	Once in a term.	Once in a year.
Weighting %				T1= 2.5 T2= 2.5	T1= 2.5 T2= 2.5	T1= 10 T2= 10	T1=35%	T2=35%
N.B	1. Same mode of assessment will be followed in Mid Term and Trail Examination for class 12. 2. Marks for Project Work and Accountancy Practical will be assessed as part of Internal Assessment. 3. The term examination must be conducted out of 100 marks [Section A: MCQ(20×1), Fill in the blanks (5x1), Matching (5x1), True/False(5×1), ,SAQ(15)], [PART II: EAQ(6×10) answer any 5 questions out of 6 questions]							

16.1 Assessment Tools and Techniques

The following section describes the suggestive techniques and tools that are to be used to assess learner's performance and achievement.

16.1.1 Homework

Assessment Tools: Checklists/Questions/Rubrics

Example 1(Check list):
Topic: Preparation of 'Double Column Cash Book

Tick (√) or (X) whichever is appropriate in the relevant columns.

Key area/ Name of students	Learner knows the exact format	Learner post the entries to the debit and credit side correctly	Amounts are entered without making mistakes	Calculates the total of amount columns correctly	Balancing entries are recorded correctly	Score (by total tick i.e √)
Sonam						
Dorji						

Note: Based on the assessment, the teacher is expected to give feedback only, if formative assessment is conducted.

Example 2 (Check list):
Topic: Posting transactions in the journal using the golden rule.
Tick (√) or (X) whichever is appropriate in the relevant columns.

Key area/ Name of students	Draw the journal format correctly	Applied the rules of journal correctly	Posted accounts correctly	Recorded the transactions in chronological order
Karma Dema				
Pema Yangzom				

Example 3 (Questions):

Asking question is widely used as an assessment tool in the teaching and learning process. Questions may be:

i. verbal,
ii. written,
iii. in the form of interviews, or
iv. in the form of self-assessment questionnaires.

Example 4 (Rubrics)

Roll No.	Class	Timely Submission			
	Key: √- Yes	Always	Usually	Seldom	Never
1	Karma Dema				
2	Pema Yangzom				

Roll No.	Class	Completion			
	Key: √- Yes	Always	Usually	Seldom	Never
1	Karma Dema				
2	Pema Yangzom				

Roll No.	Class	Accuracy			
	Key: √- Yes	Always	Usually	Seldom	Never
1	Karma Dema				
2	Pema Yangzom				

16.1.2 Class Work

Assessment Tools:
Class work will be assessed in the form of question and answer, and through observations of results, findings or behaviour.

a) Question and answer:
Questions are widely used as an assessment tool in the teaching and learning process. It may be verbal, written, in the form of interviews or self-assessment questionnaires.

b) Observation
Observation is also one of the tools to assess the progress of the learner's performance and behaviour. Through classroom activities, teacher can observe the participation of the learners in the class and ascertain his/her performance. Observing learners carefully helps teacher to know them better. The information derived through the observation help teacher to plan, implement, assess and evaluate the teaching and learning process.

As an assessment tool, observation of learners' conduct, is important to:

i. assess learner's level of performance in learning activities,
ii. assess learner's behavioural conduct with teacher, friends and community, and
iii. assess learner's ability to solve problems through problem solving skill.

It is important to give appropriate feedback in order to assess the progressive learning by learners. It is expected that the teachers will give class work regularly to ensure the learners learn progressively.

16.1.3 Experiments

Assessment Tool: Checklist

1. Checklist can be used for assessing the learners' experiments.
Learners can be asked to carry out small research on how well the financial information depicted by the financial statements of the company is used by the various end users.

End Users	Often	Sometimes	Never	Purpose for which such information is used
Government				
Taxation Authority				
Managers				
Financial Institutions				

16.1.4 Class Presentation

Tips for class presentation (Skills)

1. Rehearse your presentation in front of your friends.
2. Speak, don't read.
3. Keep eye contact.
4. Use decent gestures.
5. Ensure that your body do not block the audience from the information you have in charts, etc.
6. Be precise. Stay within the time limit.

Content

1. State the central idea.
2. Explain the main points
3. Support the main point with evidence from other sources.
4. Conclude or restate main points.

Assessment Tips

Class presentation can be assessed based on the following criteria.

1. Effective oral communication (flow of language)
2. Introduction of topic/central idea to the audience.
3. Content (relevance, appropriateness).
4. Supporting materials/ Conclusion
5. Eye contact and other body gestures.
6. Timeliness.

16.1.5 Mind mapping

Meaning

Mind mapping was developed as an effective method for generating ideas about learner's interaction among themselves. The teacher's interaction with learners is an integral part of the teaching and learning process. It is also the most effective, brain friendly way to turn the unorganised, fleeting ideas and thoughts into a structured visual map.

Purpose of Mind Mapping:

1. For introducing ideas/concepts/principles etc. at the initial stage.
2. For generating, visualizing, organising, note taking, problem solving, decision making and revising.
3. For brain storming a topic.
4. Stimulating creative thinking and creative solution to problems.
5. Assess learner's display of integrity, honesty, and attitudes.

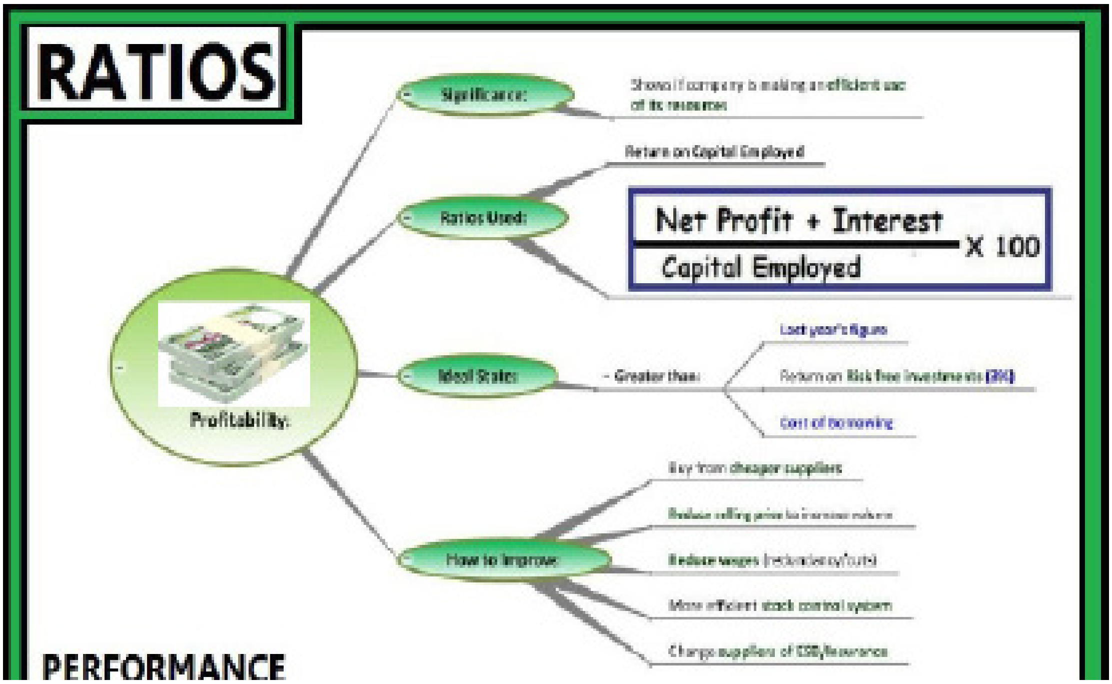
Tips for mind mapping

1. Place the centre theme/ main idea in the centre of the page.
2. Use line, arrows, branches and different colours as ways of showing the connection between the central theme or main ideas.
3. Draw a simple diagram to show the relationship of ideas.
4. Choose different colours to symbolise different things.

Assessment Tips

1. Relevance of the map in terms of audience/context
2. Logical organisation of main and sub-topics/ideas.
3. Use of icons/symbols to add up to the meaning.
4. References cited.
5. Emphasis or the main focus of the map.
6. Prominence or user friendliness.

Example of Mind Map



16.1.6 Class Test

Meaning

As a summative assessment, the role of the class test is to grade learner's learning over a concept, skill, topic or a chapter taught in the class itself. Normally class tests can be either in the form of oral or written test consisting, set of questions answerable within a class time.

Purpose/Objectives

1. To assess what learners have learned after the completion of a lesson.
2. To analyse the result for ascertaining strengths or weaknesses of learners.
3. To revise the lesson taught and check the knowledge.

Sample of a class test blue print

Level of thinking	Number of questions to be asked	Total marks
Creating	1	1
Evaluating	1	1
Analysing	2	2
Applying	2	2

Understanding	2	2
Remembering	2	2

Note: *Class test may be done out of 10 marks.*

16.1.7 Field trip/Educational excursion

Assessment Tool: Check list/rubric

Tick (√) if the learners have the required material and cross (X) if not.

Class ………….. Date……… Contact Nos. of Field Staff:

Sl. No.	Name	Pen/Pencil	Note book	Questionnaire	Camera	Other materials
1	Sonam Tashi					

NOTE: If a field trip covers a long distance travel resulting in night halts, necessary logistics, food and transportation has to be taken care of.

Sample rubric for field trip

Name:………….................……………Class: ……… Section: ………………

Indicators	4	3	2	1
Punctuality/ Timeliness	Arrives before time	Arrives just on time	Arrives late	Arrives very late
Behaviour	Showed exemplary behavior to the group	Behaved well most of the times	Needs several reminders while on trip	Does not follow instructions
Participation	Actively participated (very interactive, takes note, inquisitive)	Participated all times and interacted with members and others but did not make notes.	Participated few times but did not take notes.	Refuses to participate or to take notes. Mere observer.

Report writing	Exemplary field report inclusive of excellent layout, organization of content and reflection.	Field report inclusive of layout and organization of content but without his/ her reflection	Field report inclusive of layout, not well organized content, and without his/ her reflection.	Sketchy Field report without proper organization/ content/ reflection.

Legend: Outstanding = 4; Very Good = 3; Good = 2; Fair = 1

16.1.8 Immediate Interaction with Learners

Assessment Tools: Anecdotal records

Anecdotal record (or anecdote) is like a short story that a teacher uses to record a significant incident observed during teaching and learning process. It is usually written like a journal. Teacher identifies who, what, where, when and how of a particular incident, focusing on the subject's specific conducted. In classroom, teachers use anecdotal records for assessment of skill development of learners. The recorded observations are intended to identify the learner's current skill level, interests and skills to develop next lesson. Anecdotal records should always be objective in recording of the learner's actions and behaviours. These records enable the teacher to make a judgement about the learner's progress and helps teachers to enhance teaching. These tools can be used while preparing the Ledger Account, Bank Reconciliation Statement, Financial Statements, journalising the transactions etc. in accounting.

16.1.9 Observation

Assessment Tool: Anecdotal records/Rubric

A simple rubric illustrated below can be designed to measure the degree of moral standards in terms of ethical and moral values. However, the following rubric is just a sample for reference purpose.

Criteria	Exceeds Expectations	Meets Expectations	Partially Meets Expectations	Never Meets Expectations
Interest	Shows complete interest on any work assigned and always completes work on time.	Shows complete interest on any work assigned and mostly completes work on time.	Does not show much of interest on any work assigned and mostly fails to complete work on time.	Does not show any interest on any work assigned and never completes work on time.
Honesty	Always maintains honesty in work and takes responsibility for his/her action.	Maintains honesty in work most of the time and takes responsibility for his/her action.	Maintains honesty in work most of the time but takes responsibility for his/her action only when told.	Rarely maintains honesty in work and does not take responsibility for his/her action.
Adaptability	Demonstrates adaptability for work assigned and completes multiple tasks without any support.	Demonstrates adaptability for work assigned and completes multiple tasks with little support.	Demonstrates adaptability for the work assigned with difficulties and takes time to complete multiple tasks with support.	Fails to demonstrate adaptability and can never complete multiple tasks even with support.
Due care	Demonstrates sense of belongingness all the time and takes good care of resources provided for learning activity.	Demonstrates sense of belongingness most of the time and takes good care of resources provided for learning activity.	Demonstrates sense of belongingness rarely and takes good care of resources upon reminder only.	Never demonstrates sense of belongingness and never takes good care of resources provided for learning activity.

Assessment Tool

Quiz and debate can be assessed using question and answer, and rubrics.

Quiz and debate can be conducted by dividing the class into groups or amongst the classes.

a) Questions and answer

Asking question is a process through which teacher interacts with learners in the class to assess the content knowledge of the subject. Therefore, questioning is critical to the way teachers manage the class, engage learners in content learning and encourage them to participate in enhancing their understanding. Asking question is widely used as an assessment tool in the teaching and learning process. Questioning may be in the form of:

- verbal questioning,
- written question,
- interviews, and
- self-assessment questionnaires.

b) Rubrics:

Criteria	Excellent	Very Good	Good	Poor
Understanding of topic	Clearly understood the topic in depth and presented information convincingly.	Understood the topic in depth but there was a lapse in convincing the audience.	Seemed to have understood the main points at the surface level.	Unclear about the topic.
Organization	Thoughts were well organized and presented perfectly.	Thoughts were organized but presentation seemed vague.	Flow of thoughts was broken.	Thoughts were jumbled up and disorganized.
Arguments	FIVE or More strong arguments were clearly presented.	FOUR strong arguments were clearly presented.	THREE arguments were presented.	Debate lacked arguments/ arguments were ambiguous/ unclear.

Evidences (facts, examples, statistics etc.)	FIVE or MORE support materials/ evidences cited to prove the arguments.	FOUR support materials/ evidences cited to prove the arguments.	THREE support materials/ evidences cited to prove the arguments.	TWO or LESS than two evidences cited to prove the arguments.
Rebuttal	Offered FOUR or MORE strong evidences to refute opposing points.	Offered THREE strong evidences to refute opposing points.	Offered TWO strong evidences to refute opposing points.	Offered ONE strong evidence to refute opposing points.
Delivery	Used all of the following convincingly and persuasively: - gesture - tone - eye contact - audibility	Used any THREE of the following convincingly and persuasively: - gesture - tone - eye contact - audibility	Used any TWO of the following convincingly and persuasively: - gesture - tone - eye contact - audibility	Used any ONE of the following convincingly and persuasively: - gesture - tone - eye contact - audibility
Team work	Each member of the team presented an argument that was built on from the previous arguments.	Each member of the team presented different argument with no overlapping points.	Each member of the team presented a different argument with at least one overlapping point.	More than one arguments were overlapping, repetitive or contradictory among team mates

16.1.11 Self and Peer Assessment

Assessment Tool

Peer and self-assessment can be assessed using the check list. In teaching Accountancy, teacher can make a listing of Accounting concepts and principles that the learners would have learnt; skills that they would have developed; and Accounting values and attitudes that they should exhibit at the end of every topic.

16.1.12 Reflective Writing

Meaning

Reflective writing is evidence of reflective thinking. In an academic context, reflective thinking usually involves:

1. looking back at something (often an event, i.e. something that happened, but it could also be an idea or object),
2. analysing the event or idea (thinking in depth and from different perspectives, and trying to explain, often with reference to a model or theory from one's discipline/subject area), and
3. Thinking carefully about what the event or idea means and an ongoing progress as a learner.

Stages in Reflective Writing

1. Description –
   a. What happened?
   b. What is being examined?

2. Interpretation-
   a. What is most important / interesting / useful / relevant about the object, event or idea?
   b. How can it be explained e.g. with theory?
   c. How is it similar to and different from others?

3. Outcome
   a. What have I learned from this?
   b. What does this mean for my future?

Assessment Tool

A learner will be required to complete one Reflective Writing in the year. It should be started in term I and the draft will be evaluated out of 2.5 marks and included in Term I result. In term II, the same work should be continued and final work will be evaluated out of 2.5 marks. The following rubric can be used as a reference.

Criteria	4	3	2	1
Description Learner provides a description of the experience, observation, activity, reading, etc. upon which he or she is reflecting.	Clear and focused on the specific aspects that challenge the student.	Situation/Event described but not precise.	Vague description.	Vague and inadequate description.
Interpretation Learner provides a description of their intellectual and emotional response to the experience.	Clear and focused description of the feelings, thoughts, and questions.	Some response but limited to one domain (e.g., only emotional, intellectual).	Learner provides vague description of intellectual and emotional responses.	Very vague description.
Outcome Evidence that the learner has questioned or evaluated their prior perceptions, actions, or beliefs.	Critical reflection – Critical evaluation (questioning, examining more closely) student's personal assumptions, habits, or values and their connection to the opinions or behaviours upon which the student is reflecting in light of other perspectives.	Reflection – Making connection between student's personal assumptions, habits, or values and the opinions or behaviours upon which the student is reflecting.	Minimal reflection – No personal reflection or limited to description of general opinions and behaviours without reflection on underlying assumptions, habits, or values driving those opinions or behaviours.	Inadequate and vague reflection.

Reflective Journal can also be assessed through self and peer assessment in order to:

- identify their strengths and weaknesses and of their peers,
- transcend from passive learning atmosphere to active learning one, and
- enable them to better understand assessment expectations, and work towards improving their own performance.

Peer and self-assessment can be carried out occasionally depending upon the availability of time. Following rubric may be used.

Peer and Self-Assessment

Name...Class………….. Period............Date..................

Indicators	Always	Mostly	Sometimes	Rarely
Shows enthusiasm in work				
Contributes ideas				
Accepts others views/opinion				
Shows willingness to work as a team				

16.1.13 Computer Practical (MS Excel)

Meaning and purpose

As learners learn to use MS Excel in problem solving, the components like format, spelling and accuracy of the data are key factors required to get correct end result. For these reasons, a assessment tool is required to assess learner's ability to solve problem in excel. The performance rubrics chart is preferred tool for assessing the task, which describes degree of proficiency in the use of MS Excel in solving a problem by a learner. The performance chart range from 1 to 4 points. Students can analyse themselves in which level they fall and know the reason for such score. Teachers can use analytic rubrics to assess learner's problem solving skills using MS Excel. Teachers can also use this rubric for differentiated teaching method to focus on particular topic to a identified group of learners.

Assessment Tool

Rubric is used to assess learner's competency over the use of MS Excel for assessing problem solving skill.

Level	4	3	2	1
Formulae	Formulae were used to calculate all numerical values.	ONE value is manually calculated without using formula.	TWO values are calculated without using formulas.	More than TWO values are calculated without using formulas.
Required Data	All data required and shown in the worksheets are accurate.	1-2 data/figures shown in the worksheets are inaccurate/ wrong.	3 or 4 data/ figures shown in the worksheets are inaccurate/ wrong	More than 4 data/figures shown in the worksheets are inaccurate/ wrong.

Graph/ Diagram	The graph/ diagram required for the task is correct in all respect (figures, labelling of axes/columns/ rows, range and numerical values, legend)	The graph/ diagram has any ONE of the following issues: - Wrong figures - Wrong labelling of axes. - Inappropriate range or numerical value. - Legend is missing.	The graph/ diagram has any TWO of the following issues: - Wrong figures - Wrong labelling of axes. - Inappropriate range or numerical value. - Legend is missing.	The graph/ diagram has any THREE OR MORE of the following issues: - Wrong figures - Wrong labelling of axes. - Inappropriate range or numerical value. - Legend is missing.
Critical Analysis	All possible solutions are accurately indicated.	One solution worked out is inaccurate.	Two solutions worked out are inaccurate.	Three or more solutions worked out are inaccurate.

16.1.14 Case Study

Meaning

- It is a written description which provides detailed information about a person, group or thing, and their development for the specific period of time.
- It is an enquiry methodology that is commonly used by learners in examining an in-depth study of a single individual, group or event to explore the causes of underlying principles.
- Case studies are examination of persons, groups, events, decisions, periods, policies, institutions or other systems that are studied holistically by one or more methods.

Purpose

- describe an individual situation (case), e.g. a person, business, organization, or institution, in detail;
- identify the key issues of the case (question or topic should tell you what to focus on);
- analyse the case using relevant data and information;
- suggest solutions for particular case (particularly for problem-solving case studies), and,

- to develop critical thinking skills.

Procedure

- Select the situation/ topic on which to write up the case to be studied.
- Collect as much information as possible about the situation.
- Analyse all of the elements surrounding the situation.
- Determine the final solution implemented.
- Gather information about why the solution worked or did not work.

After gathering the information learner can proceed by:

a) Describing the situation/problem

The reader needs to have a clear understanding of the situation for which a solution is sought. One can explicitly state the problem posed in the study. One can begin by sharing quotes from someone intimate with the situation or one can present a question.

b) Give background

Background is the information one has discovered that describes why there is a problem. This will consist of facts and figures from authoritative sources. Graphs, charts, tables, photos, videos, audio files, and anything that points to the problem is useful here. One might include anecdotal information as well.

c) Describe the solution

This section discusses the solution and the thought processes that lead up to it. It guides the reader through the information to the solution that was implemented. This section may contain the author's opinions and speculations.

d) Evaluate the response to the solution

If the case study is for a recent situation, there may not have been enough time to determine the overall effect of the solution.

e) Telling the whole story

Case study-writing is about telling the story of a problem that has been fixed. The focus is on the evidence for the problem and the approach used to create a solution. The writing style guides the readers through the problem analysis as if they were part of the project. The result is a case study that can be both entertaining and educational.

Assessment Tool: Rubrics

Name : ____________________Class______________Year____________

Standards	**Outstanding (4)**	**Very good (3)**	**Good (2)**	**Satisfactory (1)**
Identification of the issues/ problems	Identifies and understands all of the main issues in the case study.	Identifies and understands most of the main issues in the case study	Identifies and understands some of the issues in the case study.	Identifies and understands few of the issues in the case study.
Analysis of the issues	Insightful and thorough analysis of all the issues.	Analysis of all the issues without thoughtful analysis.	Analysis of two or three issues.	Imperfect and incomplete analysis of the issues.
Comments on effective solutions/ strategies (The solution may be in the case already or proposed by you)	Well documented, reasoned and appropriate comments on solutions, or proposals for solutions, to all issues in the case study.	Appropriate with few thought out comments about solutions, or proposals for solutions, to some issues in the case study.	Artificial and inappropriate solutions to most of the issues in the case study.	Little or no action suggested and in appropriate solutions to all of the issues in the case study.
Research / Reference	Excellent research into issues and clearly documented reasons or arguments.	Good research into issues with some clearly documented links to material read.	Limited research and few documented links to readings.	Incomplete research and links to any readings.
Delivery/flow and enthusiasm	Very clear and concise flow of ideas. Demonstrates passionate interest in the topic.	Clear flow of ideas. Demonstrates interest in the topic.	Most ideas have a flow but focus is lost at times. Limited evidence of interest in the topic.	Hard to follow the flow of ideas. Lack of enthusiasm and interest.
Visuals	Visuals augmentation and extended conception of issues in unique ways.	Use of visuals related to the material.	Limited use of visuals loosely related to the material.	No use of visuals.

16.1.15 Team Work

Assessment Tool: Rubric

The following rubrics can be used as a sample to assess learner's performance in group related works. The focus should be more on the use of soft skills.

Criteria	Exceeds Expectations (excellent = 4)	Meets Expectations (very good = 3)	Partially Meets Expectations (good = 2)	Never Meets Expectations (satisfactory = 1)
Communication Skills	Team members communicate openly, and respect the view of other members.	Members respects the view of others, however there are few members who cannot openly communicate.	Some of the members do not respect the views of others and most of the members do not freely communicate.	Communication is limited, members do not respect views of others and fails to discuss on important topics.
Adaptability	Team members can easily adapt to change in plans and can perform multiple tasks without any support.	Team members can easily adapt to change in plans and can complete multiple tasks with little support.	Team members struggle to adapt to change in plans, and complete multiple tasks with more support.	Team members cannot adapt to change in plans and cannot complete multiple tasks even with strong support.
Time Management	Team members consistently stay focused on activity assigned, and always completes the activities on time.	Most of the time, team members stay focused on activity assigned, and completes activities on time	Team members stay focused on activity assigned some of the time, and takes time to complete activities.	Team members rarely stay focused on activity assigned and always fails to complete activities on time.
Cooperation	Team members always support the idea and efforts of others and can quickly resolve conflicts without the support from outside.	Team members mostly support the idea and efforts of others and can resolve conflicts most of the time on their own.	Team members mostly support the idea and efforts, but requires the help from outside to resolve the conflicts.	Team members are disoriented, and does not support each other and always fails to resolve conflicts.

16.4.16 Project Work

Meaning

Project work is a learning experience which gives an opportunity to learner's for acquiring knowledge from different field of learning and critically and creatively apply it to real life situations. It helps them to enhance their knowledge and skills like collaboration, communication and self-learning, and prepares them to face challenges ahead in life.

Purpose

The purpose of giving project work in Accountancy is to allow learners to enhance their knowledge and enables them to acquire skills like collaboration, communication and independent learning and prepare them for lifelong learning. It enable learners to demonstrate results and findings of their investigations, and make rationale decisions in their life. It will also help them to explore new ideas, learn new techniques and put into practice the concepts learnt in other subjects. The project will further develops competence to read, analyse and interpret the accounting data of the enterprise. Following are the steps to be followed while writing Accountancy project work.

1. Selecting a topic on accountancy project.
2. Literature review.
3. Planning the project.
4. Collecting data and related information.
5. Writing hypothesis based on information gathered.
6. Executing the project.
7. Conclusion.
8. Preparing the project report.

Criteria for the assessment of project work

Name	Criteria					
	Content (4)	Presentation and format (4)	Finding (4)	Research (4)	References (4)	Total (20)
Karma Dorji						
Sonam Rinchen						

Assessment Tool: Rubric

	4	3	2	1	Total
Content	Content is new, relevant.	Content is not new but relevant.	Content is not new and not so relevant.	Content is not new and relevant.	
Presentation and format	Excellent presentation. Correct format is followed and report is free of errors	Only one area of format is not correct. Report has a few errors.	Only two aspect of format is not correct. Report has some errors	Three or more aspect of format is incorrect. Report has many errors.	
Finding	Finding is supported by the facts and figures. Explanation is made on each facts and figures.	Finding is supported by the facts and figures. Insufficient explanation on each facts and figures.	Finding is not supported by enough facts and figures.	Finding is not supported by facts and figures.	
Research	Research done on the topic and all ideas are clear and explained.	Research done on the topic and most ideas are clear and explained.	Research done and a few ideas are clear and explained.	Research not done and ideas are not clear and not explained.	
Reference	Five or more references are cited.	Three or four references are cited.	One or two references are cited.	No references.	

Project Work shall include the following components:

1. Project file.
2. Title of the project work.
3. Acknowledgment.
4. Table of content.
5. Introduction.
6. Content/ theory
7. Case study.
8. Findings.
9. Conclusion.
10. Bibliography/ references.

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