ALLAMA IQBAL OPEN UNIVERSITY

Semester Terminal Exam Autumn 2020

Program /level:	BA/B.Com/Associate Degree Program	Maximum Marks	100
Title /Course Code	Advanced Accounting (444)	Pass marks	40/50

Instructions for Exams:

1. **Attempt All Questions.**
2. **Write answers in your own words and avoid copying from an internet source or any book.**
3. **Be precise, avoid unnecessary details, answer to each question must be between 600-800words.**
4. **Students can attempt paper on any white page. Mention Roll No. , Name & Signature on everypage. Attach undertaking with each course code.**
5. **Students are advised to post their answer sheets to their tutor well in time so the same mustreach on or before 20-06-2021.**
6. **Submissions after due date & time will not be entertained.**

Q. No.	Questions	Marks
1	**Installment trading, hire purchase system, and leasing all are modes of credit sale. Describe the procedure of each and narrate the similarities and differences among Them** **Answer:-** Installment trading, hire purchase system, and leasing are popular methods of financing goods. These methods are different to each other in terms of their option to purchase, a right of termination, and transfer of ownership. Hire purchase is defined as an arrangement between hirer (buyer or User) and seller of an asset whereby the seller allows the hirer to use the asset for a regular payment of installment for the purchase price. The buyer also has the option to purchase the goods on payment of all the installments. Whereas installment purchase is defined as another method of financing the capital goods / assets whereby the goods are purchased by the buyer but the payment is made in smaller installments. Hire purchase (HP) or leasing is a type of asset finance that allows firms or individuals to possess and control an asset during an agreed term, while paying rent or instalments covering depreciation of the asset, and interest to cover capital cost. Assets are defined as anything of monetary value that is owned by a firm or an individual. Assets listed on a firm's balance sheet can include tangible items such as inventories, equipment and real estate, as well as intangible items such as property rights or goodwill.	33

Leases differ from term lending in that the lessee does not have ownership rights to the asset. At the end of the lease contract, the lessee usually has a choice of extending the lease, returning the asset, or introducing a buyer for the asset. Some leasers are entitled to a refund of 95% of the sale proceeds when they introduce a buyer. The refund amount will depend on the contract between the original leaser and lessee.

HP is a financing solution suitable for businesses wishing to purchase assets without paying the full value immediately. The customer pays an initial deposit, with the remainder of the balance and interest paid over a period of time. On completion, ownership of the asset transfers to the customer.

It is important to note that the accounting and tax treatment of leases varies according to the type of lease it is. For example, as a finance lease is accounted for as a loan funding the asset, the tax treatment follows the legal form of the transaction which is the hiring of an asset. More specifically, the treatment of capital allowances differs, and tax treatment should be taken into consideration when deciding how to finance an asset purchase.

Similarities and differences among Installment trading, hire purchase system, and leasing

Hire Purchase/Leasing vs. Installment Purchase

Installment trading, hire purchase system, and leasing purchase may look similar as both are a method of finance and payment in both the cases is made in smaller parts. In that impression, it is interesting to know the differences between the two. Following are the points of differences in these two methods of financing.

Time of Purchase and Ownership

In the case of hire purchase or leasing, the act of purchasing takes place only when whole payment is made to the financing company. It means after making payment of the last hire charges / installment only, the goods are considered purchased or if the buyer or hirer prepays in a lump sum in between the agreed period for purchasing the goods. In the case of installment purchase, the purchase happens as soon as the agreement between the buyer and financing company is entered into. In hire purchase, both ownership and purchase is delayed till the complete payment whereas in installment purchase, purchase and ownership take place before the complete payment.

Option / Right to Terminate

The hirer, in the case of hire purchase agreement or leasing, has an option / right to terminate the agreement and return the goods whereas there is no such right or option available to the buyer in case of installment purchase. This is because the purchase has not taken place in case of hire purchase but it takes place at the beginning only.

Installment/Hire Charges

The monthly or period payment in installment purchase is termed as installment whereas, in hire purchase arrangement, it is called hire charges. Installment derives its value from the length of time, the sale value of an asset, and interest rate whereas the hire charges is a function of two additional factors viz. option of termination and repairs and maintenance. Ideally, the installment should be less than the hire charges for the same asset. Therefore, hire purchase or leasing is an expensive system compared to installment purchase.

2

Ratio analysis is a useful management tool that improves the understanding of financial results and trends over time and provides key indicators of organizational performance. Managers use ratio analysis to pinpoint strengths and weaknesses from which strategies and initiatives can be formed. Keeping in view the above-mentioned benefits of ratio analysis you are required to select the recent annual reports of a y manufacturing company listed at Pakistan Stock Exchange (PSX) from the given link https://financials.psx.com.pk/# and perform the ratio analysis and highlight the strengths and weaknesses of that organization to managers.

33

A sustainable business and mission requires effective planning and financial management. Ratio analysis is a useful management tool that will improve your understanding of financial results and trends over time, and provide key indicators of organizational performance. Managers will use ratio analysis to pinpoint strengths and weaknesses from which strategies and initiatives can be formed. Funders may use ratio analysis to measure your results against other organizations or make judgments concerning management effectiveness and mission impact.

Selected Company from Pakistan Stock Exchange:

Pakistan State Oil (PSO)

FINANCIAL RATIOS

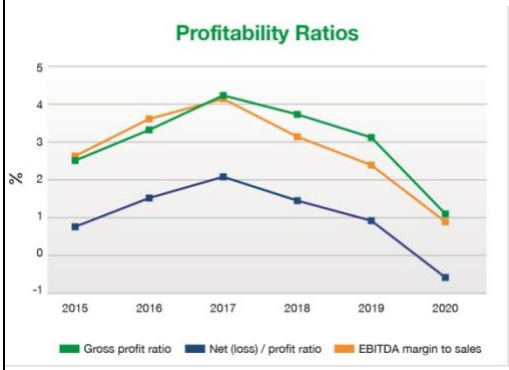
		2020	2019	2018	2017	2016	2015
Profitability Ratios							
Gross profit ratio	%	**1.10**	3.12	3.73	4.23	3.32	2.51

Net (loss) / profit ratio	%	**(0.58)**	0.92	1.45	2.08	1.52	0.76
EBITDA margin to sales	%	**0.89**	2.39	3.14	4.14	3.61	2.63
Return on shareholders' equity	%	**(5.72)**	8.88	14.00	17.72	11.22	8.43
Return on capital employed	%	**(3.19)**	4.97	7.13	8.48	5.39	3.90
Operating leverage ratio	%	**1,725.19**	(211.76)	(40.07)	170.92	(6.54)	198.03

Analysis

The variation in ratios as compared to FY 2019 is because of the following:

- Gross profit ratio has declined primarily due to significant inventory losses during the year on account of decline in international oil prices.
- Net loss ratio vs. net profit ratio in FY19 due to significant inventory losses during the year on account of decline in international oil prices and increase in finance cost on account of higher average policy rate of SBP in FY20.
- EBITDA margins has decreased primarily due to net loss in FY20 on account of reasons mentioned above vs profit in FY19.
- Negative return on shareholders' equity and capital employed is mainly due to net loss during the year on account of reasons mentioned above.
- Increase in operating leverage is due to decline of 68.7% in EBIT against a decrease of 4.0% in net sales.



	2020	2019	2018	2017	2016	2015
Capital Structure Ratios						

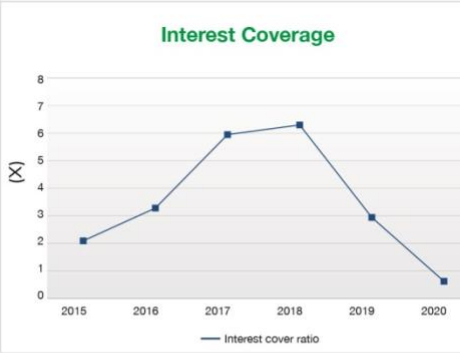
Interest cover ratio	(x)	**0.62**	2.94	6.30	5.95	3.28	2.09
Financial leverage ratio	(x)	**59.00**	90.00	81.00	127.00	115.00	124.00
Weighted average cost of debt	%	**15.49**	8.58	4.10	4.66	5.02	9.68
Economic value addition	Rs. In Mn	**(31,955)**	(14,962)	(8,075)	(4,570)	(9,903)	(11,571)

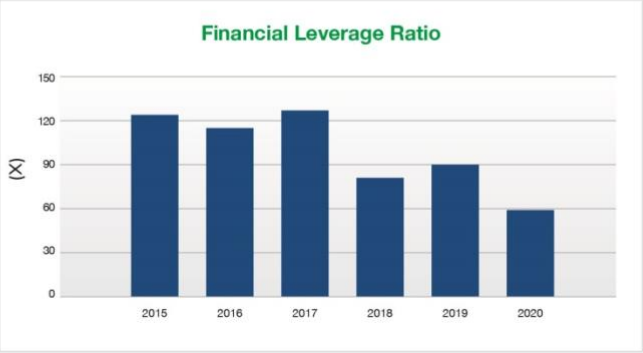
Note: D/E ratio has not been calculated as the Company has no long term debt.

Analysis

The variation in ratios as compared to FY 2019 is because of the following:

- Interest cover has decreased primarily due to decline in profitability.
- Financial leverage has decreased during the year on account of decline of short-term borrowings by Rs. 40.5 bn.
- Weighted average cost of debt has increased mainly due to increase in policy rate by SBP.





		2020	2019	2018	2017	2016	2015
Liquidity Ratios							
Cash to current liabilities	(x)	**(0.004)**	(0.06)	(0.03)	(0.15)	(0.12)	(0.16)
Cash flow from operations to sales	(x)	**0.04**	(0.01)	0.002	(0.03)	(0.001)	(0.03)
Current ratio	(x)	**1.35**	1.32	1.32	1.31	1.12	1.10
Quick ratio	(x)	**1.09**	1.01	1.03	1.07	0.91	0.87
Free cash flows to the firm	Rs. In Mn.	**61,860**	(3,130)	8,063	(18,742)	6,594	(15,171)
Free cash flows to the equity holders	Rs. In Mn.	**29,035**	386	(2,464)	(6,191)	12,091	(41,668)

Analysis

The variation in ratios as compared to FY 2019 is because of the following:

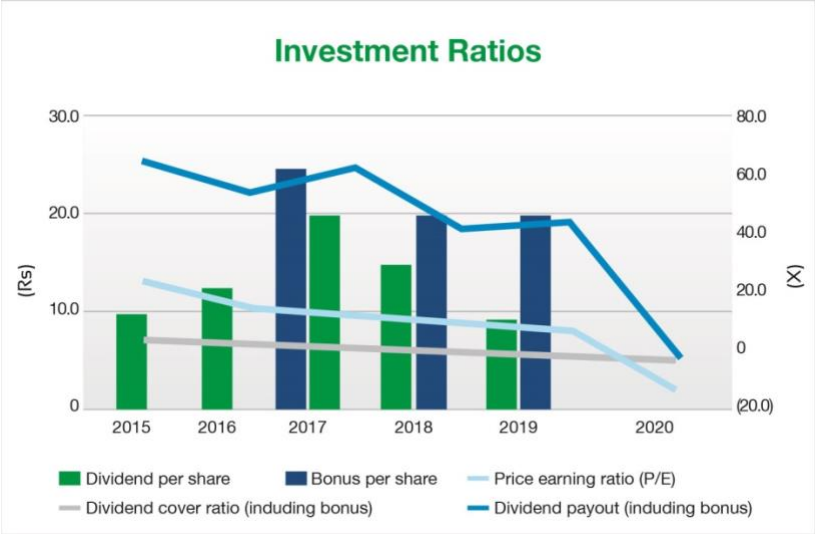
- Cash flow to current liabilities has improved due to improvement in cash and cash equivalents and decline in trade and other payables.
- Cash flow from operations to sales has increased due to higher positive cashflow from operations during the year.
- Current ratio has improved slightly due to greater percentage decline in current liabilities than current assets.
- Quick ratio has improved primarily due to decline in stock-in-trade.
- Increase in cash flows to the firm and equity holders are primarily due to positive working capital on account of decline in trade receivables and other receivables.

		2020	2019	2018
Investment Ratios				
(Loss) / earning per share (basic & diluted)	Rs.	**(13.7)**	22.5	32.9
Market value per share (year end)	Rs.	**158.2**	169.6	318.3
Highest price	Rs.	**216.9**	352.1	466.6
Lowest price	Rs.	**114.0**	151.6	265.2
Break-up value	Rs.	**240.8**	253.9	235.3
Price earning ratio (P/E)	(x)	**(11.5)**	7.5	9.7
Price to book Ratio	(x)	**0.7**	0.7	1.4
Dividend per share	Rs.	-	10.0	15.0
Bonus share	%	-	20.0	20.0

Dividend payout (including bonus)	%	-	44.3	45.5	64.4	57.1
Dividend yield (including bonus)	%	-	7.1	5.3	7.0	3.3
Dividend cover ratio (including bonus)	(x)	-	2.3	2.8	2.5	3.0

		2020	2019	2018	2017	2016	2015
Activity/Turnover Ratios							
Inventory turnover ratio	(x)	**14.93**	13.06	13.84	14.36	11.99	12.30
No. of days in inventory	No.	**25.00**	28.00	26.00	25.00	30.00	30.00
Debtor turnover ratio	(x)	**6.25**	5.77	5.73	5.61	5.05	6.26
No. of days in receivables	No.	**59.00**	63.00	64.00	65.00	72.00	58.00
Creditor turnover ratio	(x)	**12.51**	10.15	10.75	11.64	8.50	8.20
No. of days in creditors	No.	**30.00**	36.00	34.00	31.00	43.00	45.00
Total asset turnover ratio	(x)	**3.43**	3.27	3.30	2.98	2.65	3.12
Fixed asset turnover ratio	(x)	**142.18**	172.07	183.24	160.93	138.97	181.35

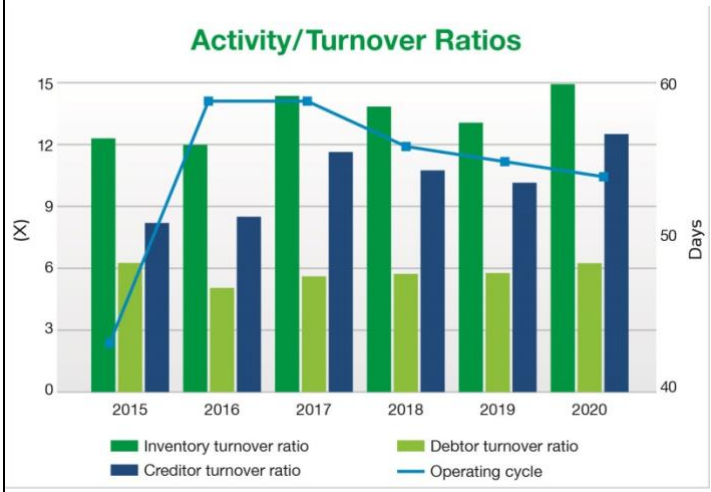
Operating cycle	No.	**54.00**	55.00	56.00	59.00	59.00	43.00



Analysis

The variation in ratios as compared to FY 2019 is because of the following:

- Negative P/E ratio is primarily due to the loss during the year.
- Price to book ratio has remained same due to almost similar decline in market and book price.
- Breakup value of the company decreased primarily due to the loss during the year.
- Divident payout and dividend yield is nil this year due to non declaration of the dividend in FY20 on account of net loss.



Analysis

The variation in ratios as compared to FY 2019 is because of the following:

- Inventory turnover has improved primarily due to decline in inventory by 36.2% mainly due to fluctuations in international oil prices.
- Debtors turnover has increased primarily due to decrease in trade debts by 10.4% on account of recoveries from power sector.
- Creditors turnover has improved primarily due to prompt payments made to suppliers for purchases on credit.

- Operating cycle has improved due to decrease in inventory and receivable days.
- Total assets turnover has improved due to decrease in total assets mainly on accounts of reduction in receivables and stock-in-trade.

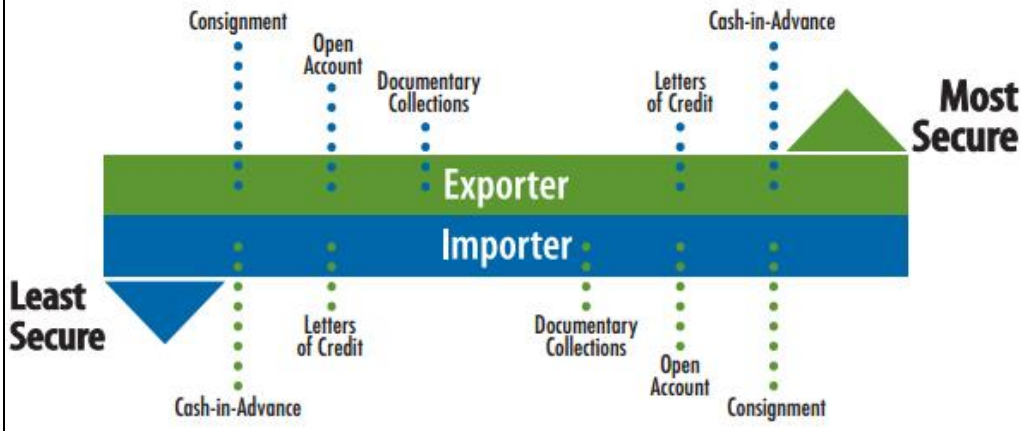
3 **To enhance the sales of goods at national or international markets, a manufacturer/producer can pen the branches in different areas nationwide or can send goods on consignment basis. What do you think that which method is most suitable in Pakistan for selling goods at national or international markets between them? Give your answer in detail keeping in view the advantages and**

Disadvantages of both methods. **34**

Every organization needs proper sale marketing to have detailed knowledge about the area of supply. Every organization has to enter different modes to generate leads for sale.

To succeed in today's global marketplace and win sales against foreign competitors, exporters must offer their customers attractive sales terms supported by the appropriate payment methods. Because getting paid in full and on time is the ultimate goal for each export sale, an appropriate payment method must be chosen carefully to minimize the payment risk while also accommodating the needs of the buyer. As shown in figure 1, there are five primary methods of payment for international transactions that can be carried out in Pakistan. During or before contract negotiations, you should consider which method in the figure is mutually desirable for you and your customer.

Figure 1: Payment Risk Diagram



In Pakistan International trade presents a spectrum of risk, which causes uncertainty over the timing of payments between the exporter (seller) and importer (foreign buyer)

For exporters, any sale is a gift until payment is received.

Therefore, exporters want to receive payment as soon as possible, preferably as soon as an order is placed or before the goods are sent to the importer.

For importers, any payment is a donation until the goods are received.

Therefore, importers want to receive the goods as soon as possible but to delay payment as long as possible, preferably until after the goods are resold to generate enough income to pay the exporter.

Cash-in-Advance

With cash-in-advance payment terms, an exporter can avoid credit risk because payment is received before the ownership of the goods is transferred. For international sales, wire transfers and credit cards are the most commonly used cash-in-advance options available to exporters. With the advancement of the Internet, escrow services are becoming another cash-in-advance option for small export transactions. However, requiring payment in advance is the least attractive option for the buyer, because it creates unfavorable cash flow. Foreign buyers are also concerned that the goods may not be sent if payment is made in advance. Thus, exporters who insist on this payment method as their sole manner of doing business may lose to competitors who offer more attractive payment terms.

Letters of Credit

Letters of credit (LCs) are one of the most secure instruments available to international traders. An LC is a commitment by a bank on behalf of the buyer that payment will be made to the exporter, provided that the terms and conditions stated in the LC have been met, as verified through the presentation of all required documents. The buyer establishes credit and pays his or her bank to render this service. An LC is useful when reliable credit information about a foreign buyer is difficult to obtain, but the exporter is satisfied with the creditworthiness of the buyer's foreign bank. An LC also protects the buyer since no payment obligation arises until the goods have been shipped as promised. Learn more about Letters of Credit.

Documentary Collections

A documentary collection (D/C) is a transaction whereby the exporter entrusts the collection of the payment for a sale to its bank (remitting bank), which sends the documents that its buyer needs to the importer's bank (collecting bank), with instructions to release the documents to the buyer for payment. Funds are received from the importer and remitted to the exporter through the banks involved in the collection in exchange for those documents. D/Cs involve using a draft that requires the importer to pay the face amount either at sight (document against payment) or on a specified date (document against acceptance). The collection letter gives instructions that specify the documents required for the transfer of title to the goods. Although banks do act as facilitators for their clients, D/Cs offer no verification process and limited recourse in the event of non-payment. D/Cs are generally less expensive than LCs.

Open Account

An open account transaction is a sale where the goods are shipped and delivered before payment is due, which in international sales is typically in 30, 60 or 90 days. Obviously, this is one of the most advantageous options to the importer in terms of cash flow and cost, but it is consequently one of the highest risk options for an exporter. Because of intense competition in export markets, foreign buyers often press exporters for open account terms since the extension of credit by the seller to the buyer is more common abroad. Therefore, exporters who are reluctant to extend credit may lose a sale to their competitors. Exporters can offer competitive open account terms while substantially mitigating the risk of non-payment by using one or more of the appropriate trade finance techniques covered later in this Guide. When offering open account terms, the exporter can seek extra protection using export credit insurance.

	Consignment Consignment in international trade is a variation of open account in which payment is sent to the exporter only after the goods have been sold by the foreign distributor to the end customer. An international consignment transaction is based on a contractual arrangement in which the foreign distributor receives, manages, and sells the goods for the exporter who retains title to the goods until they are sold. Clearly, exporting on consignment is very risky as the exporter is not guaranteed any payment and its goods are in a foreign country in the hands of an independent distributor or agent. Consignment helps exporters become more competitive on the basis of better availability and faster delivery of goods. Selling on consignment can also help exporters reduce the direct costs of storing and managing inventory. The key to success in exporting on consignment is to partner with a reputable and trustworthy foreign distributor or a third-party logistics provider. Appropriate insurance should be in place to cover consigned goods in transit or in possession of a foreign distributor as well as to mitigate the risk of non-payment.	