
SELECTED **O**PINIONS

Volume IX

COMPILED BY

TECHNICAL SERVICES DIRECTORATE

of

**THE INSTITUTE OF CHARTERED
ACCOUNTANTS OF PAKISTAN**

INTRODUCTION

This report is the ninth compilation of Selected Opinions issued by the Technical Advisory Committee on inquiries raised by the members and other stake-holders during the period from July 2003 to June 2004 for the general guidance of the members of the Institute. All volumes of selected opinion issued earlier (Volume I to VIII) are available on ICAP's Website.

The opinions contained in this compilation are of the competent Committees constituted by the Council of the Institute and are of operational nature and not on issues on which relevant laws and rules are not explicit. These "Selected Opinions" are not a compendium of "legal advice".

The opinions issued by the Committees to the members' / other stake-holders' queries are dated. Since an opinion is arrived at on the basis of the facts and circumstances of each individual query, it may change if the facts and the circumstances change. An opinion may also change due to subsequent developments in law, pronouncements made by the Institute and other relevant changes. The Institute and the Committees will have no liability in connection with such opinion.

In every case the members / other stake-holders have to take their own decisions in the light of facts and circumstances in accordance with related laws and rules etc., applicable to the issue under decision at that point in time.

Syed Sajid Ali
Director Technical Services

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1. ACCOUNTING

1.1 ACCOUNTING OF SPREAD TRANSACTIONS

Inquiry

While appreciating the deliberations put in by the Committee in reaching the conclusion as given in Selected Opinion No. 1.2 Volume VIII we noted that for determining the nature of a transaction to be considered as a derivative transaction the Committee had relied upon the following elements of the transaction:

- That the transaction has no cost at inception and does not qualify to be recognized as either an asset or a liability but is a commitment.
- That the future sale has been undertaken to protect against the price risk from fluctuation in market price, and
- That the sale transaction can be independently completed through settlement of differentials in price on the settlement date of the transaction without actual delivery of underlying security.

Firstly, we would like to clarify that the so-called “Future transactions” carried out at the KSE are a misnomer. These are in fact forward delivery contracts and have no relevance to Future contracts traded on the international markets.

We analysed the spread transactions carried by us and noted that in case of spread transactions, these have the following characteristics:

- That at the time of purchase full amount is paid to the counter party against delivery of shares in CDC account of the respective Fund and it is not simply a commitment.
- That the future sales (forward date settlement contract) are undertaken simultaneously to book the spread and not to protect against price risk from fluctuation in market price.
- That the sale transaction is settled on future settlement date by delivery of shares against receipt of sale proceeds.

We feel that these transactions should be viewed in their substance i.e. one part of the transaction is to acquire certain shares for ready delivery against payment and the second part of the transaction (entered into simultaneously) is to sell the same shares for delivery at a future date (forward settlement date) against payment may have a credit risk (relating to settlement at the exchange) rather than price risk from fluctuations in the market.

Under such circumstances, we understand that the view formed by the Committee for derivative transactions and the accounting treatment proposed by para 153 of IAS 39 for hedge transactions should not apply to these transactions.

Kindly confirm our understanding at your earliest in view of the close of the financial year on 30 June 2003.

Opinion:

The Committee has considered your observations on its earlier letter and the nature of transactions explained by you. The Committee stands by its initial opinion.

However, the Committee finds it pertinent to add that if the conditions stipulated in para 142 of IAS 39 are not met, alternatively, gains and losses on remeasurement to fair value may be accounted for under para 103(a) of IAS 39 which is reproduced below:

- “ 103. A recognised gain or loss arising from a change in the fair value of a financial asset or financial liability that is not part of a hedging relationship (see paragraphs 121-165) should be reported as follows:
- (a) a gain or loss on a financial asset or liability held for trading should be included in net profit or loss for the period in which it arises (in this regard, a derivative should always be considered to be held for trading unless it is a designated hedging instrument – see paragraph 122); “

We hope you would appreciate that the communication from the Technical Directorate of the Institute is for the assistance of members of the Institute and is not and should not be taken to be a directive of the Council. Hence, while the Committee stands by its above opinion, the members are free to obtain appropriate advice from their consultants or advisors.

(August 9, 2003)

1.2 **APPLICABILITY OF INTERNATIONAL ACCOUNTING STANDARDS ON NON-LISTED COMPANIES**

Inquiry: Through the Companies (Amendment) Ordinance, 2002, section 234(3)(l) of the Companies Ordinance, 1984 (CO84) has been modified. The amended section 234 (3) (l) now stipulates that such International Accounting Standards and other standards shall be followed by all Companies in the preparation of accounts, balance-sheet and profit and loss account as are notified for the purpose in the official Gazette by the Commission.

However, in accordance with the statutory notifications (SROs) issued by the Securities and Exchange Commission of Pakistan (SECP), the International Accounting Standards (IASs) are mandatory for “listed” companies only. Therefore it may be construed that IAS’s are not mandatorily applicable on non-listed companies. We request you to kindly advise whether the IAS’s notified by SECP are to be followed mandatorily by our Company (being a non-listed Public Limited Company).

2. **Accounting Treatment of Deferred Tax Asset under IAS-12**

- 2.1 In case compliance of IAS’s is compulsory for non-listed Public Companies, we seek your approval in respect of an accounting treatment relating to un-recognized net deferred tax asset balance. The details of the subject matter and the proposed accounting treatment is set forth in the following paragraphs.
- 2.2 ABC Limited is a non-listed public company. The operations of the Company were governed by the Gas Well-head Price Agreement dated 1 July 1982 (the GPA), executed between Government of Pakistan and ABC up till 30 June 2001. The Company was prevented through the requirements of the GPA from accounting for deferred taxation with effect from January 1, 1981 and the deferred tax liability of Rs.9.523 million as at December 31, 1982 was being carried forward in the accounts of the company since then. The Company had not recognized deferred tax liabilities and assets due to the requirements of clause (vi)(c) of Article I of the GPA, which states as follows:

“With effect from January 1, 1982 ABC shall make no provision for deferred tax in the audited accounts”.

However, the Company continued to disclose the amounts of the unrecognized deferred tax liabilities and assets in its accounts. Note 3.9.3 to the accounts of the Company for the year ended June 30, 2001 is reproduced below:

“Deferred taxation

Provision in respect of deferred taxation is not being made with effect from January 1, 1982 in the accounts of the Company and the deferred tax liability as at December 31, 1981 amounting to Rs.9.523 million is being carried forward. Had the Company provided for deferred taxation, under the liability method, there would have been a liability of Rs.386.832 million as at June 30, 2001 (2000: Rs.451.027 million).

In addition, a deferred tax asset aggregating Rs.1,788.083 million (2000:Rs. 1,600.052 million) is available for writing off the exploration, appraisal and development drilling expenditure to the profit and loss account when such expenditure is allowable for tax purposes”.

The GPA was dismantled effective July 1, 2001 and following its dismantling the Company started accounting for deferred taxation with effect from July 1, 2001 using the balance sheet liability method. However, the Company did not recognize the net deferred tax asset aggregating Rs.1,273.226 million as of June 30, 2002 in its accounts for the year ended June 30, 2002 on grounds of prudence. The deferred tax liability of Rs.9.523 million as stated in the balance sheet of the company as at December 31, 1981 which was being carried forward up to June 30, 2001 due to the requirements of the GPA, as stated above, was reversed in the accounts for the year ended June 30, 2002. These matters were disclosed in note 3.11 to the accounts of the Company for the year ended June 30, 2002, which is reproduced below:

“3.11 Deferred taxation

Pursuant to the requirements of the Agreement, the Company did not account for deferred taxation with effect from January 1, 1982 and the deferred tax liability of Rs.9.523 million as stated in the balance sheet of the Company as at December 31, 1981 was being carried forward up to June 30, 2001. However, consequent to the dismantling of the Agreement, the Company now accounts for deferred taxation with effect from July 1, 2001 using the balance sheet liability method, providing for temporary taxable and deductible differences between the carrying amounts of assets and liabilities for financial reporting purposes and amounts used for taxation purposes. However, as a matter of prudence, the Company does not recognize net deferred tax debit balance in its accounts, which aggregates Rs.1,273.226 million as at June 30, 2002 (2001: Rs.1,410.774 million). Accordingly, the aforementioned deferred tax liability of Rs.9.523 million as at June 30, 2001 has been reversed in these accounts.”

- 2.3 According to clause (a) (ii) of Article II of the GPA the Company adopted a policy to charge off the exploration expenditure in the year in which such expenditure was incurred. However, according to the provisions of the Income Tax Ordinance, 1979 (now repealed) such expenditure relating to those exploration areas covered under the Fifth Schedule to the Income Tax Ordinance, 1979 was not allowed by the tax assessing authorities as an allowable deduction. Accordingly the current tax charge of the Company was higher in the years up to June 30, 2001 due to the aforementioned disallowance but the Company could

not account for the deferred tax credit arising thereon because of the requirements of GPA referred to in paragraph 2 above. Due to this reason deferred tax asset, arising upon disallowance of exploration expenditure, continued to accumulate and as of June 30, 2002 it aggregated Rs.1,637.046 million.

The deferred tax asset of Rs.1,637.046 million as of June 30, 2002 represents exploration expenditure incurred by the Company up to that date which has been charged off in the accounts of the Company and has not been allowed by the income tax authorities. This amount will be realized in future years either when the Company declares a 'dry hole' or surrenders the Licensed area and claims the related exploration expenditure as 'abortive cost' or when a commercial discovery is made and the exploration expenditure incurred is allowed over the post commercial discovery period according to the requirements of the Income Tax Ordinance, 2001. The requirements of the Income Tax Ordinance, 2001 and the Income Tax Rules, 2002 in this respect have been set forth in paragraph 2.4 below.

2.4 According to Rule 2 of Part 1 of the Fifth Schedule to the Income Tax Ordinance, 2001 any expenditure, under the agreement entered into by an undertaking with GOP for exploration or production of petroleum in Pakistan, on searching for or on discovering and testing a petroleum deposit or winning access thereto, but the search, exploration or enquiry upon which the expenditure is incurred is given up before the commencement of commercial production, the expenditure allocable to a surrendered area or to the drilling of a dry-hole shall be deemed to be lost at the time of surrender of the area or the completion of the dry-hole, as the case may be allowed against any income of such undertaking in either of the following two ways, as may be provided for in the agreement, namely;

- (a) the said loss in any year shall be set off against the income of that year chargeable under the head "Income from Business" or any income (other than income from dividends) chargeable under any other head and where the loss cannot be wholly set off in this manner, the portion not so set off shall be carried forward to the following year and set off in the same manner and so on but no loss shall be carried forward for more than six years; or
- (b) the said loss in any year shall be set off against the income of such undertaking of the income year in which commercial production has commenced and where the loss cannot be wholly set off against the income of such undertaking of that year, the portion not so set off against the income, if any, of such undertaking of that year, and if it cannot be wholly so set off the amount of loss not so set off shall be carried forward to the following year, and so on, but no loss shall be carried forward for more than ten years.

Further, sub-rule 4 of the said rule states that after the commencement of commercial production, all expenditure incurred prior thereto and not deemed to be lost expenditure and not represented by physical assets in use at time of the commercial production shall be allowed as a deduction, so, however, that the portion of such deduction to be so allowed in any year shall be such amount not exceeding ten percent of the aggregate amount deductible in respect of inshore areas.

3. APPROVAL REQUESTED

3.1 The Company intends to comply with the requirements of all the IASs (if IASs are applicable to it) and account for the temporary taxable or

deductible differences between the carrying amounts of assets and their respective tax base, arising subsequent to June 30, 2002. However, as the net deferred tax asset of Rs.1,273.226 million as of that date (i.e. June 30, 2002) represents the cumulative effect of the temporary differences that have arisen over a long period of time during which the Company was not allowed to recognize deferred tax, the Company intends to freeze that balance as of that date.

- 3.2 The recognition of this net deferred tax asset amount as of June 30, 2002 in the accounts of the Company for the year ended June 30, 2003 would not be appropriate as this amount has been accumulated over a number of years due to operation of GPA. The fact that the net deferred tax asset as of June 30, 2002 has not been recognized in the accounts shall continue to be disclosed in the accounts of the Company for the year ended June 30, 2003 and thereafter until the entire amount is reversed through actual tax credits in respective years.
- 3.3 However, the deferred tax assets or liabilities arising after July 1, 2002 due to originating taxable and temporary differences after that date shall be accounted for in the accounts of the Company for the year ended June 30, 2003 and thereafter in accordance with the requirements of IAS-12.

In view of the matters set out in paragraphs 2 and 3 above, we request your kind approval for the Company's proposed accounting treatment for not recognizing the net deferred tax asset of Rs.1,273.226 million as of June 30, 2002 in its financial statements (Paragraph 3.1 to 3.3 above).

Opinion: The Institute of Chartered Accountant of Pakistan has already recommended to the SECP to notify certain International Accounting Standards including IAS 12 under Section 234(3) of the Companies Ordinance, 1984 for application to non-listed companies. However, for the application of IAS 12 we have recommended that a three year transitory period should be allowed in which the non-listed companies be required to provide for deferred taxation equally each year. If that recommendation is approved by the SECP then you may provide for deferred tax assets accordingly.

This Institute would not like to agree with your suggestions in paragraph 3 of your letter under reference. The Company should comply with all the requirements of IAS 12 as may be notified by SECP including three years transitory period if agreed to by them.

(August 9, 2003)

1.3 APPLICATION OF INTERNATIONAL ACCOUNTING STANDARD 17 ON MODARABAS

Inquiry: This has reference to the Securities and Exchange Commission of Pakistan (SECP), Specialized Companies Division Circular No. 16/2003 dated July 18, 2003 and S.R.O. 471 (1)/2003 dated June 04, 2003, regarding amendments in the Modaraba Companies and Modaraba Rules, 1981.

We would like to bring to your notice the following amendment in the Rules, which may have a significant impact upon the operations, accounting, disclosures and audit reports of the leasing Modarabas:-

First Schedule – Form XI {Rule 9(3)}: The form of Auditors' Report applicable to Modarabas has been brought in line with the existing Form 35-A, applicable to companies under the Companies Ordinance, 1984. The aforesaid notification has also

amended Rule 9(2) of the Rules, which requires Modaraba Companies to prepare the annual financial statements of Modarabas in conformity with International Accounting Standards (IAS) and other Standards as notified by SECP from time to time under section 234(3) of the Companies Ordinance, 1984. As you are aware, in terms of the Modaraba Companies and Modaraba (Floatation and Control) Ordinance, 1980, Modaraba Companies and Modaraba Rules, 1981 and Prudential Regulations for Modarabas all leases executed by the leasing Modarabas are classified as "Operating Lease". The agreements/documentation for lease transactions as approved by the Religious Board also comply with Shariah requirements. Hence, since inception the Lease (Ijarah) transactions of leasing Modarabas are classified, treated and disclosed as "Operating Leases" which has always been acknowledged and accepted by the external auditors also. However, the amendments brought in the Modaraba Rules, 1981 vide the aforementioned S.R.O has created an ambiguity as to the applicability of IAS-17 on the leasing Modarabas vis-à-vis the classification, treatment and disclosure of Lease (Ijarah) transactions.

As per IAS-17, a lease is classified as a "Finance Lease" if it meets any of the criteria mentioned in Paragraph 8 of the Standard. The said IAS defines "Operating Lease" as a lease other than a finance lease. In terms of IAS-17, any lease meeting the finance lease criteria as set out therein cannot be classified as an operating lease. However, we understand that in the context of Islamic Banking, Lease (Ijarah) refers to an arrangement whereby the owner of an asset other than consumables transfers its usufruct to another person for an agreed period and against an agreed consideration. The substance of the transaction is that the leased assets remain in the ownership of the Muj'ir (lessor) and its usufruct is transferred to the Musta'jir (lessee). Thus anything which cannot be used without consuming cannot be leased out. Further since the corpus of the leased assets remains in the ownership of the Mu'jir (lessor), liabilities or for that matter risks and rewards emerging from the ownership shall be borne by or vest in the lessor. The Musta'jir accordingly pays rentals in consideration of the use of such leased assets determined at the time of contract for the whole period of Ijarah. The substance of Ijarah is virtually the same as that of operating lease. This is accompanied with the fact that all laws and regulations applicable on Modarabas only refer to operating lease. On this basis and in accordance with the Shariah principles the Lease (Ijarah) transactions undertaken by the Modarabas are "Operating Leases" and the same also conforms to the treatment of operating leases as specified by IAS-17.

We also draw your attention to the exposure draft of Islamic Financial Accounting Standard (IFAS) – 2 issued by the Institute of Chartered Accountants of Pakistan. It does not make any reference to finance lease nor to the criteria for finance lease classification and disclosure requirements as specified by the IAS-17. Paragraphs 8, 9 and 12 of the said exposure draft state that:-

- a. Muj'ir (lessor) should present assets subject to Ijarah (Lease) in his balance sheet according to the nature of the asset.
- b. Ijarah (Lease) income from Ijarah (Lease) should be recognized in income on a straight-line basis over the Ijarah (Lease) term, unless another systematic basis is more representative of the time pattern in which use benefit derived from the leased asset is diminished.
- c. The depreciation of leased assets should be on a basis consistent with the Mu'jir (Lessor's) normal depreciation policy for similar assets and depreciation charge should be calculated on the basis set out in IAS-16.

Hence keeping the above issues into consideration, we are of the view that the application of IAS-17 on Ijarah (Lease) transactions undertaken by the Leasing Modarabas should be limited to the treatment specified by the said IAS in respect of Operating Leases.

You are requested to kindly confirm our afore-mentioned understanding and take the necessary steps to remove this ambiguity. Your early action will be highly appreciated in view of the fact that most Modarabas are currently finalizing their financial statements for the year ended June 30, 2003.

Opinion: The Committee has noted that though the Modaraba Companies and Modaraba (Floatation and Control) Ordinance was promulgated in 1980 which, in its section 10, had laid down: -

- 10 **Business of Modarabas.** – No Modaraba shall be a business which is opposed to the Injunctions of Islam and the Registrar shall not permit the floatation of a Modaraba unless the Religious Board has certified in writing that the Modaraba is not a business opposed to the Injunctions of Islam.

but so far no accounting standards for Islamic Modes of Financing and Investments , except that relating to Murabaha recently finalized by this Institute, have been issued in this country.

The lead in this respect has been taken by the Accounting and Auditing Organization for Islamic Financial Institutions of Bahrain (AAOIFI) which has so far issued 18 standards. On referring to Financial Accounting Standard (FAS) No. 8 issued by AAOIFI it is noted that there are some inconsistencies between IAS 17 and this Standard. For example in paragraph 3/2/1/2 of this Standard which is titled “Ijarah Muntahia Bittamleek through sale for a token consideration or other amount as specified in the lease” such Ijarah should be accounted for as operating Ijarah under paragraph 3/1/1/1(a) which is reproduced hereunder:

“3. Accounting treatment of Ijarah

3/1 Operating Ijarah

3/1/1 Operating Ijarah in the financial statements of the Islamic bank as a lessor

3/1/1/1 Assets acquired for Ijarah

- a) Assets acquired for Ijarah shall be recognized upon acquisition at historical cost. Historical cost of assets acquired for Ijarah includes net purchasing price plus all expenditures necessary to bring the asset to its intended use, such as custom duties, taxes, freight, insurance, installation, testing, etc. (para 5)

However, paragraph 8 (a) and (b) of IAS 17 require the same transaction to be accounted for as a finance lease.

The core financial reporting framework adopted by the regulators for Modarabas is International Accounting Standards (IAS). The AAOIFI has issued 18 Financial Accounting Standards (FAS) that have not been adopted as the financial reporting framework in Pakistan for Islamic financial institutions.

As IAS 17 forms an integral part of the financial reporting framework as adopted in Pakistan, the Committee is not in favour of deferring / making non-applicable or / replacing IAS 17 with FAS 8 of AAOIFI. Furthermore, replacing the applicability of IAS 17 with FAS 8 of AAOIFI may not give the true and fair view of the state of affairs of the Modarabas as partially adopting two different accounting frameworks may lead to

inconsistencies. Hence, an accounting framework should be used for financial reporting in their entirety.

It should be noted as a point of concern that, as a result of applying IAS 17 to Modarabas, there is a likelihood that auditors' reports of the Modarabas may be qualified due to many Modarabas recording certain leases as operating leases which are required to be classified as finance leases under IAS 17 paragraph 8. However, that qualification would be a mere technicality for financial reporting purposes.

The Committee is, therefore, of the opinion that there is no justification to limit the application of IAS 17 on leasing modarabas in any way.

(October 4, 2003)

1.4 COMPUTATION OF DEFERRED TAX LIABILITY

Inquiry: Kindly refer to the SECP Circular No. 16 dated September 9, 1999 on the subject.

Pursuant to the requirement of the above circular, our Company has been providing the deferred tax liability at the applicable tax rate. At 31st December 2002, the total provision made for deferred tax liability amounted to Rs.12.085 million.

It is submitted that the IAS 12 (revised) does not specifically deal with the issues confronted by a leasing company nor does it provide sample calculations directly applicable to a leasing business. However for working out deferred tax liability in a leasing company, methods of computations have been devised by experts by drawing inferences there from. In this connection the two approaches of computation given in an article published in Leasing Association of Pakistan yearbook 1999 are precisely as under: -

A Profit & Loss Approach

Deferred tax liability for the year = Tax rate x (Tax depreciation – Principal portion of lease rentals for the period)

B Balance Sheet Approach

Accumulated Deferred tax liability = Tax rate x (Net Investment in Lease – Tax Written Down Value of Assets at year end)

It has been proved in the article referred to above that the two approaches give the same result. While theoretically, the aforesaid conclusion may be correct, the deferred tax liability worked out separately under the two approaches on the basis of actual data of our Company is grossly divergent with each other. The analysis made to ascertain reasons for variances has led to the conclusion that the results under two approaches can agree only when all rentals are fully realized as has been assumed in the Article. Since this cannot hold true in the long run, the balance sheet approach gets adversely affected and the results of two approaches do not remain in harmony with each other. The reasons stated in detail, are as under: -

- i) The amount of rentals for profit and loss approach are the total lease rentals irrespective of whether these are actually paid or payable by the lessee. But the "Net Investment in Leases" (NIL) taken in the Balance Sheet approach is worked

out on the basis of actual rentals realized by the leasing company. The necessity of taking into account unrealized rentals along with realized rentals for current taxation / profit & loss approach for deferred taxation is covered by the tax law which requires to include total rentals (both paid or payable) as revenue for the purpose of tax computations. Obviously if different amounts of rentals are taken into account in the two approaches, the figures of deferred tax liability determined under each approach is bound to differ.

- ii) When rentals are in default, less amount is adjusted against net investment in leases (NIL). The result is that NIL remains higher than it would have been if the rentals had not been in default. This in turn, leads to higher difference between NIL and TAX WDV, which results in extra amount of deferred tax liability. This extra liability could have been avoided if there had been no rentals in default. The principal portion of rentals in default in our case as at 31st December 2002 amounted to Rs.27.260 million and their non-adjustment against NIL has increased our deferred tax liability by Rs.9.54 million.
- iii) Apart from non-adjustment of principal portion of rentals in default, as discussed at (ii) above, residual value of leased assets (RVs) against the defaulting lessees remain unadjusted. This also makes the "NIL" to remain higher than the figures, which would have emerged if the RVs had been adjusted. The figures of such RVs in our case as of 31st December 2002 amounted to Rs.3.9 million and their non-adjustment against NIL has increased our deferred tax liability by Rs.1.36 million.

In nutshell, while Tax WDV of assets in leasing business is identical to Tax Base" referred to in IAS-12 (revised), the "NIL" is not exactly comparable to carrying cost of assets in the other businesses for the reasons stated above. Thus the difference between the two (NIL and Tax WDV) is not representative of temporary differences envisaged under the IAS. The balance sheet approach of working out deferred tax liability, in leasing companies in which defaults are high, is bound to bloat deferred tax liability unjustifiably.

We have also compared our up to date current plus deferred tax provisions with similar calculations of a few other leasing companies. It transpires that our total tax provisions as percentage of pretax profits are quite close to these companies on the basis of their published data.

In view of above it is requested that the whole position may kindly be examined in the light of the points raised above and we may be given necessary guidelines for working out appropriately the deferred tax liability in consultation with other leasing companies, if considered necessary.

Opinion: The appropriate Committee of the Institute has examined the issue of arriving at different figures of deferred tax liabilities following the profit and loss approach and the balance sheet approach, and would like to draw your attention to Introduction to IAS-12 revised which states that "the original IAS 12 required an enterprise to account for deferred tax using either the deferral method or a liability method which is sometimes known as the income statement liability method. IAS 12 (revised) prohibits the deferral method and requires another liability method, which is sometimes known as the balance sheet liability method.

The income statement liability method focuses on timing differences, whereas the balance sheet liability method focuses on temporary differences. Timing differences are differences between taxable profit and accounting profit that originate in one period and reverse in one or more subsequent periods. Temporary differences are differences between the tax base of an asset or liability and its carrying amount in the balance sheet.

The tax base of an asset or liability is the amount attributed to that asset or liability for tax purposes.

Furthermore, there are some temporary differences, which are not timing differences, for example those temporary differences that arise when: -

- (c) the carrying amount of an asset or liability on initial recognition differs from its initial tax base".

Unquote---

The temporary differences in case of a leasing company fall under (c) above.

The Committee is, therefore, of the opinion that leasing companies should follow balance sheet method for calculating their deferred tax liability.

(August 9, 2003)

1.5 CONSOLIDATION OF INTERIM FINANCIAL STATEMENTS

Inquiry: I request the kind advice/opinion of the Technical Committee on "whether the interim financial statements require consolidated statements". I hereby give briefly some facts/extracts that may be helpful for the Technical Committee in forming the opinion.

Section 237(1) of the Companies Ordinance, 1984 states:

There shall be **attached** to the financial statements of a holding company having a subsidiary or subsidiaries, **at the end of the financial year** at which the holding company's financial statement are made out, consolidated financial statements of the group presented as those of a single enterprise and such consolidated financial statements shall comply with the disclosure requirement of the Fourth Schedule and International Accounting Standards notified under sub-section (3) of section 234.

Section 245(1)(a) of the Companies Ordinance, 1984 states:

Every listed company shall within one month of the close of the first, second and third quarter of its year of account, prepare and transmit to the members and the stock exchange in which the shares of the company are listed a profit and loss account for, and balance sheet as at the end of, that quarter whether audited or otherwise;

Section 234(3) of the Companies Ordinance, 1984 states:

Subject to the provisions of this Ordinance –

- (i) Such International Accounting Standards and other Standards shall be followed in regard to the accounts and preparation of the balance sheet and profit and loss account as are notified for the purpose in the official Gazette by the Commission.

Paragraph 14 of the International Accounting Standard – 34 (Interim Financial Reporting) states:

An interim financial report is prepared on a consolidated basis **if the enterprise's most recent financial annual financial statements were consolidated statements**. The parent's separate financial statements are not consistent or comparable with the consolidated statements in the most recent annual financial report. **If an enterprise's annual financial report included the parent's separate financial statements in addition to consolidated financial statements**, this Standard neither requires nor

prohibits the inclusion of the parent's separate statements in the enterprise's interim financial report.

Limited Scope Review of Consolidated Financial Statements by the Statutory Auditors

Clause (xxi) of the Code of Corporate Governance requires that all listed companies shall ensure that half-yearly financial statements are subjected to a limited scope review by the statutory auditors.

Discussion:

- As per the Companies Ordinance, 1984 consolidated financial statements are required to be prepared and attached to the entity's separate financial statements on yearly basis.
- As per the Companies Ordinance, 1984 the quarterly financial statements do not require attachment of consolidated financial statements.
- As per IAS-34, interim financial statements are required to be consolidated if the recent financial statements are consolidated.
- Recent financial statements of all the listed companies are consolidated and attached to the individual / separate financial statements of those companies only to comply with the requirement of Section 237 of the Companies Ordinance, 1984.
- IAS-34 refers to the countries in which only consolidated financial statements are prepared and separate financial statements may not be required to be attached separately. However, in Pakistan separate financial statements are prepared and consolidated financial statements are attached which is a statutory requirement.
- Statutory auditors are not required to review the yearly accounts

In the light of above discussion, it is very clear that the consolidated accounts are required under IAS-34 only and especially for those entities whose recent financial statements are consolidated and separate financial statements are attached. However, in Pakistan the separate financial statements are a requirement along with the Consolidated Statements on yearly basis to be attached. Therefore, the quarterly consolidated accounts should not be mandatory.

Further, I would also like to draw your kind attention to the fact that the opinion states "the consolidated interim financial report is required to be issued to comply with the Companies Ordinance, 1984 (Ordinance)" which is not the case as the Ordinance requires consolidated financial statements to be attached with annual financial statements and regarding the quarterly report the Ordinance is silent.

Therefore, I once again request the Technical Committee to review and form an opinion on the basis of national regulatory requirements and reporting environment.

To take this opportunity, I would also like to mention, which is in your knowledge as well, that all reporting to the Securities and Exchange Commission of Pakistan, Central Board of Review, credit rating agency, banks and financial institutions is made on the separate account basis and not the consolidated basis. Therefore, publishing of consolidated account only for the sake of compliance to the IAS-34 does not serve any purpose as well as it results in cost to the stakeholders and consume effective time of the senior management.

Opinion: The Committee appreciates your concern and would like to inform you that once an accounting standard is notified by SECP, its compliance is as mandatory as any of the provisions of Companies Ordinance and therefore there is no way out to do away with the requirements of IAS-34.

The Committee would also like to draw your attention to its following opinion given at No.2.3 of Selected Opinions Volume VIII: -

The appropriate Committee of the Institute has examined your above points raised in connection with the preparation, review and circulation of half-yearly financial statements and would like to point out that the whole spectrum of corporate laws governing the functioning of corporate sector comprises of the Companies Ordinance, 1984, Rules framed there-under, circulars and notifications issued by the SECP from time to time and the Listing Regulations of the three Stock Exchanges. All these laws and regulations supplement each other and cannot be taken in isolation.

In the light of the above the Committee is of the view that its opinion (Selected Opinion No. 1.14 of Volume V) is appropriate and does not need any amendment.

(January 3, 2004)

1.6 **CONSOLIDATION OF FINANCIAL STATEMENTS**

Inquiry: **Purpose**

The Securities and Exchange Commission of Pakistan (SECP) has directed us to seek advice from the Institute regarding consolidation of financial statements. Please find enclosed the letter received from SECP.

BRIEF BACKGROUND

ABC Fund Limited (the Fund) is a venture fund. The Fund was incorporated on July 16, 2003 and is managed by XYZ Ventures Limited (The Venturers).

VENTURE CAPITAL INVESTMENT – AN OVERVIEW

The main idea of venture capital as by definition - investment in risky projects with the anticipation of getting higher returns. These funds are invested in industries, which are unable to access the funds through the conventional sources such as banks and financial institutions. Such risky enterprises generally do not have any major collateral to offer as security, hence banks and financial institutions are averse to funding them. Venture capital funding may be by way of investment in the equity of the new enterprise or a combination of debt and equity, though equity is the most preferred route.

Most of the ventures financed through this route are especially in the "industries" like infotech, electronics, biotechnology, and communication or in short can be said to be ICE industries. Venture capitalists apart from offering money take active participation in management of the company. They evaluate and monitor the project on a continuous basis. The returns on the investment by the venture capitalist generally come in the form of selling the stocks when they get listed on the stock exchange or by a timely sale of his stake in the company. Venture capitalists assess several projects and invest only in a handful after careful scrutiny of the management and marketability of the project. Exit is preferably process of

getting out of the venture through a public issue and listing on stock exchanges.

OUR STRUCTURE

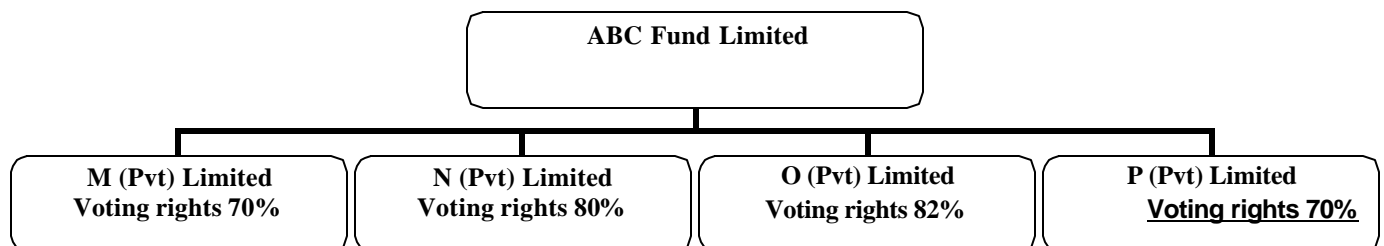
Rule 25(1) (d) of the Non-Banking Finance Companies (Establishment and Regulation) Rules 2003 (NBFC Rules) requires every venture fund to enter into a contract, in writing, with a NBFC duly licensed by the SECP to operate as a venture capital company for managing its entire business. The Fund has entered into a management contract with the Venturers for managing its entire business. Following are the key powers delegated to the Venturers under this management contract:

- i. to make investments of funds available with the Fund in venture projects as contemplated and defined by the Rules from time to time;
- ii. to pay for acquisition of shares, securities or such properties, rights and privileges as are or may be acquired for monetary consideration either wholly or partly in cash or in shares or by way of exchange or other securities of the Fund;
- iii. to secure fulfillment of any and all contracts or agreements entered into by the Fund in respect of any venture projects, shares, securities or of any property, whether movable or immovable, and in force and realize all claims or demands of the Fund;
- iv. to appoint advisers, managers, contractors, officers, clerks, agents and servants for permanent, temporary or special services as the Management Company may from time to time think fit and to determine their powers and duties and fix their salaries, emoluments or remuneration and to require security in such instance and of any amount as may be thought fit and to remove, suspend or terminate contracts with them;
- v. to appoint any person or persons, whether incorporated or not to accept and to hold on trust or under any specific arrangements for the Fund any property belonging to the Fund or in which it is interested or for any other purpose and to execute and do all such acts and deeds and to provide for the remuneration of such Trustee or Trustees and to revoke such trust or arrangements;
- vi. to institute, commence, conduct, defend, compound or abandon any legal proceedings by or against the Fund or its officer or officers or otherwise concerning the affair or affairs of the Fund and also to compound and allow time for payment or satisfaction of any claim or demand by or against the Fund and to sign, swear and verify pleadings, give evidence, pay court fees and legal costs and to appoint advocates for any or all for the said purposes, and to revoke their powers or appoint other advocates in their place, as also appoint chartered accountants, income tax practitioners or lawyers, in general;
- vii. to refer any claim or demand by or against the Fund to arbitration and observe and perform the awards;

- viii. to make, give receipts, releases and such other discharges for money payable to and received and for the claims and demand of the Fund;
- ix. to determine who shall be entitled to sign on behalf of the Fund, bills, notes, receipts, acceptance, endorsement, cheques, releases, contracts and documents in the name of the Fund and deal with the funds and assets of the Fund;
- x. to provide for the management of the affairs of the Fund, in or outside Karachi and in particular to appoint any person to be attorneys, brokers, commercial or other agents of the Fund with such powers, including powers to sub-delegate and upon such terms as the Management Company may think fit;
- xi. to invest and deal with any money of the Fund not immediately required for the purposes thereof, in such manner and upon such securities as may be thought fit from time to time and to vary or release such investments;
- xii. to open and operate bank accounts in the name of the Fund with any bank, to sign and execute all and several documents, instruments and instructions pertaining to all and every such account, including cheques;
- xiii. to enter into all such negotiations, contracts and to rescind and vary all such acts, deeds and things in the name and on behalf of the Fund as the Management Company may consider expedient for or in relation to the matters aforesaid or otherwise for the purpose of the Fund;

The Venturers had invested in equity of four venture projects on behalf of the Fund where the Fund holds majority of the voting rights (see picture 1). Section 237 of the Companies Ordinance, 1984 requires the holding companies to attach consolidated financial statements of the group presented as those of a single enterprise with the financial statements of the company.

Picture 1



QUERY

Whether the Fund's consolidated financial statements present a meaningful picture to its investors if definition of subsidiary given in Section 3 of the Company Ordinance is kept set-aside.

We believe that following are the reasons for preparing single company financial statements instead of consolidated financial statements:

1. Voting rights

Power over the voting rights in these venture projects are delegated to the Venturers being the management company of the Fund. Thus, the Fund is not able to participate in the affairs of the venture projects.

2. Representation on the board of directors

Under NBFC Rule 25 (2), the board of the venture capital fund should not have a director, who is on the board of any venture project being financed by the Fund. Therefore, the Fund is not directly or indirectly involved or participating in the financial and operating policies of these venture projects.

The Venturers by virtue of their management contracts have the power to nominate directors on the board and manage the affairs of these venture projects. This indicates that the ability to control the financial and operating policies of these venture projects is not there.

3. Fair presentation

A typical venture project burns its entire capital before it generates any cash flows and for investors it will be a long time before they actually receive any cash flow from these venture projects. The real cash flow which the Fund investors are looking for will come through capital gains arising from strategic sale or public offer of these venture projects. Therefore, from an investor point of view the real value lies in valuation of these investments on portfolio basis. Consolidation of these venture projects would give a misleading picture because the nature and dynamic of every venture project is different.

4. Intention to sale

Similar to any other venture capital fund in the world, the Fund intends to obtain benefit from venture projects through strategic sale i.e. to earn capital gain. Therefore, the consolidated results of these venture projects will not have any real investor value.

5. By-pass vehicle:

The Fund is used as a by-pass vehicle where the sponsors of the Fund have pooled the financial resources, which are being managed by ABC Ventures. In such cases, consolidation is performed at the level where the ultimate control resides (Please refer SIC 8).

From the above it is clear that the Fund is a passive investment vehicle with no decision making power with respect to these venture projects. Therefore, the question of control does not arise which is the basic requirement for consolidation of financial statements under International Accounting Standard 27 paragraph 12. The only reason why the fund has to consolidate its financial statements with venture projects is due to the definition of subsidiary as given in Section 3 of the Companies Ordinance 1984. If the definition given in Section 3 of the Companies Ordinance, 1984 were in line with definition given in IAS 27 then in our opinion the requirement of consolidation would not have arisen.

Opinion: First of all your attention is drawn to the following sections of the Companies Ordinance, 1984 :-

- 3. Meaning of “subsidiary” and “holding company”. – (1)** For purposes of this Ordinance, a company or body corporate shall be deemed to be a subsidiary of another if-
- (a) that other company or body corporate directly or indirectly controls, beneficially owns or holds more than fifty percent of its voting securities or otherwise has power to elect and appoint more than fifty percent of its directors; or
 - (b) the first mentioned company or body corporate is a subsidiary of any company or body corporate, which is that other’s subsidiary

237. Consolidated financial statements

- (1) There shall be attached to the financial statements of a holding company having a subsidiary or subsidiaries, at the end of the financial year at which the holding company’s financial statements are made out, consolidated financial statements of the group presented as those of a single enterprise and such consolidated financial statements shall comply with the disclosure requirement of the Fourth Schedule and International Accounting Standards notified under sub-section (3) of section 234.

In view of the above the Committee is of the opinion that as the law stands today your Fund has to consolidate all the companies in which it is holding more than 50% of voting rights whether the control of Fund over its subsidiary is there or not and there is no exception to it.

The Committee also appreciates your above-mentioned concerns and justification for not preparing the consolidated financial statements of your Fund but as you are well aware that on the basis of unwritten law that local legal requirements would have precedence over the provisions of IAS, you are therefore required to consolidate irrespective of any control if holding is more than fifty percent.

(March 6, 2004)

1.7 DISCLOSURE AND AUDIT REPORT ON UNTAXED FUNDS DECLARED AND CREDITED IN PROFIT & LOSS ACCOUNT

Inquiry:

Under the Tax Amnesty Schemes from time to time or foreign remittance exemption provided under section 111(4) of the Income Tax Ordinance, 2001, individuals and companies declare the untaxed funds and credit the same in profit and loss account. Examples are FEBCs, US \$ Bonds, Tax Amnesty 2000, foreign remittance through proper banking channels etc. taken into account.

We will appreciate if you provide technical guidance as to disclosure of such events in the accounts of the clients and audit reports thereon. The following points need guidance:

- 1. Where these amounts should be shown i) in Profit and Loss Account as other income ii) in Profit and Loss Appropriation Account or iii) taken to Balance Sheet as Capital Reserve.
- 2. **Accounts – disclosure –** whether the following disclosure is in order if not what should be the proposed disclosure.

Quote

Note _____ Foreign Remittance

The company has brought foreign remittance of US \$ _____ equivalent to Rs. _____ for investment.

Unquote

3. **Audit Report** – highlight

In the third para, last line, after the words “after due verification”, “ ‘ and without commenting on Note _____ ’ we report _____ ”

Whether the above highlight / reference is enough if not what should be the proposed reporting.

We will appreciate an early reply in this respect.

Opinion:

With reference to the queries raised by you, the appropriate Committee of the Institute would like to draw your attention towards the following paragraphs of IAS-8, *Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies* which provide complete guidance in this respect: -

Fundamental Errors

31. Errors in the preparation of the financial statements of one or more prior periods may be discovered in the current period. Errors may occur as a result of mathematical mistakes, mistakes in applying accounting policies, misinterpretation of facts, fraud or oversights. The correction of these errors is normally included in the determination of net profit or loss for the current period.

Benchmark Treatment

- 34. *The amount of the correction of a fundamental error that relates to prior periods should be reported by adjusting the opening balance of retained earnings. Comparative information should be restated, unless it is impracticable to do so.***

Allowed Alternative Treatment

- 38. *The amount of the correction of a fundamental error should be included in the determination of net profit or loss for the current period. Comparative information should be presented as reported in the financial statements of the prior period. Additional pro-forma information, prepared in accordance with paragraph 34, should be presented unless it is impracticable to do so.***

With regard to point No. 3 of your above enquiry, your attention is drawn to the following paragraph of ISA-700, *The Auditor's Report on Financial Statements*: -

Matters That Do Affect the Auditor's Opinion

36. An auditor may not be able to express an unqualified opinion when either of the following circumstances exists and, in the auditor's judgment, the effect of the matter is or may be material to the financial statements:
- (a) there is a limitation on the scope of the auditor's work; or

- (b) there is a disagreement with management regarding the acceptability of the accounting policies selected, the method of their application or the adequacy of financial statement disclosures.

The circumstances described in (a) could lead to a qualified opinion or a disclaimer of opinion. The circumstances described in (b) could lead to a qualified opinion or an adverse opinion. These circumstances are discussed more fully in paragraphs 41–46.

As such for further guidance you are advised to refer to paragraphs 37-46 of ISA –700.

(May 8, 2004)

1.8 IMPLEMENTATION OF IAS-12 INCOME TAXES

Inquiry:

1. The International Accounting Standard No. 12 (Revised-2000) in respect of income tax has been made effective in Pakistan with effect from 1st January, 2002.
2. The standard provides that:

“A deferred tax asset should be recognized for the carry forward of unused tax losses and unused tax credits to the extent that it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilized”. (IAS 12.34)

3. It is obvious that the creation of a Deferred Tax Asset is based on a **probability** that future tax profits will be available for adjustment against unused tax losses.
4. The application of new standard has brought substantial deceptive variation in the declared results of some of the listed companies. We can understand the distortion being created by a Tax Asset with reference to just one example. The ABC Cement Company Ltd has created a Tax Asset of Rs. 379 Million in its accounts for the year ended on 30th June, 2003. **The company had incurred a loss of Rs. 331 Million during the year but the creation of Tax Asset has converted its loss of Rs. 331 Million to a profit after tax of Rs. 47 Million** as can be seen by the following figures:

Net Loss Before Tax		Rs.	332 Million
Tax Asset		Rs.	379 Million

Net Profit after Tax		Rs.	47 Million
			=====

5. The tax asset, which is a hypothetical asset, based on probable tax credit in future has converted a loss of Rs. 332 Million to a profit of Rs. 47 Million. A potential investor in stock market usually looks at earning per share after tax of a script. We can see from the following calculations the extent of distortion introduced by the creation of Tax Asset in the case of above example.

Loss Per Share Before Tax	(-)	Rs.	(11.92) Per Share
Earning Per Share After Tax	+	Rs.	1.69 Per Share

Increased	+	Rs.	13.38 Per Share
			=====

6. **It is obvious that this EPS of Rs. 13.38 is not based on any tangible receipt of income to company nor does it represent the operating performance of the company. It is based on PROBABLE expectations in undetermined future years.**

7. I am not aware of the number of companies, which might have created a Tax Asset. I am enclosing a statement showing the particulars of 27 listed companies, who have created Tax Assets during the year ended on 30th June, 2003 and 30th September, 2003 and whose accounts have come to my notice. The statement shows the profit before tax, the amount of tax asset created, and the amount of profit after tax. The statement also shows the earning per share before tax representing the actual operating results of the company and earning per share after tax arrived at by creating a deferred tax.
8. An ordinary investor normally looks at the figures of after tax profit. He can never think of a positive provision for taxation increasing the profit by Millions.
9. The International Accounting Standard however has taken a number of precautions to guard the interests of investors by giving some warnings. For example, it warns the corporate bodies that they have to be very careful in creating an asset based on the expectation of future profits because if you have an history of losses, the chances of profits arising in future years are negligible. Para-35 of the IAS-12 says:

“The existence of unused tax losses is strong evidence that future taxable profit may not be available”.

10. Para-36(b) of IAS-12 again raises a very important question and it is for the management of the company and its auditors to answer it:

“Whether it is probable that the enterprise will have taxable profits before the unused tax losses or unused tax credits expire?”
11. This is very important. The management of the company and the auditors have to find out the reasons for the losses suffered by the company in the past and should have a strong reason to assume that the reasons causing losses in the past will not be repeated in coming years.
12. Para-36 (c) again introduces an element of caution:

Whether the unused tax losses result from identifiable causes, which are unlikely to recur; ?

It warns that:-

To the extent that it is not probable that taxable profit will be available against which the unused tax losses or unused tax credits can be utilized the deferred tax asset is not recognized.

Para-35 discusses the issue in detail:

Therefore, when an enterprise has a history of recent losses, the enterprise recognizes a deferred tax asset arising from unused tax losses or tax credits only to the extent that the enterprise has sufficient taxable temporary differences or there is convincing other evidence that sufficient taxable profit will be available against which the unused tax losses or unused tax credits can be utilized by the enterprise. In such circumstances, paragraph 82 requires disclosure of the amount of the deferred tax asset and the nature of the evidence supporting its recognition.

13. The requirement of this paragraph has to be noted because it requires that the enterprise, which has a history of recent losses, must have a CONVINCING

EVIDENCE supporting the management's expectation about future profitability. The disclosure required by this para is missing from the annual reports of the companies shown in the annexed statement. **The standard requires disclosure of "nature of the evidence" supporting the recognition of the Asset** but none of the companies has made any disclosure about evidence, which has been relied upon as the basis for creation of the Tax Asset.

14. The disclosure requirements have been specifically dealt with by para-82 of the IAS-12, which says:

An enterprise should disclose the amount of a deferred tax asset and the nature of the evidence supporting its recognition, when;

- (a) the utilization of the deferred tax asset is dependent on future taxable profits in excess of the profits arising from the reversal of existing taxable temporary differences, and
- (b) the enterprise has suffered a loss in either the current or preceding period in the tax jurisdiction to which the deferred tax asset relates.**

15. I sincerely feel that distortion in the published accounts being introduced by IAS-12 will be deceptive for many small investors who use the figure of earning per share published in various newspapers as criteria for their investment decisions. They will be misled to make investment in companies, which are not profitable at least presently. Ultimately, it may result in some sort of scandal in Pakistan's Stock market.

16. Pakistan has very low level of education and the disclosure practices being adopted by our listed companies are not still adequate. The adoption of IAS-12 in Pakistan at this stage is likely to have negative impact for the investment climate in Pakistan and may open the doors for deception of small investors.

17. **The Tax Asset being created by listed companies under IAS-12 is directly credited to the income statement and the consequent profit becomes part of general reserves. By tradition, a general reserve is considered as a free reserve available for distribution as dividend.** However, the portion of the general reserve, which consists of a Tax Asset, is not backed by any tangible Asset and the company does not have the means to distribute it among the shareholders. **It is difficult for an ordinary investor to realize and appreciate this fact.** He is bound to be misled by the figure of the general reserve especially in the following year in which the Tax Asset was created.

18. I earnestly request the Securities & Exchange Commission of Pakistan to kindly suspend the Adoption of IAS-12 with immediate effect and direct all the companies which have created Tax Assets to reverse the entry.

19. In case, the SECP does not find it appropriate to suspend the operation of IAS-12, it may introduce some variation in the methodology of accounting for the credit of Tax Asset. I suggest **that instead of crediting the value of Tax Assets to income statement,** the amount should be credited to an account which can be named as 'TAX RESERVE' or whatever other nomenclature the SECP may like to adopt. I personally feel that it's a very important matter **and need immediate action by SECP and the professional accounting bodies of the country.**

Opinion:

First of all the appropriate Committees of the Institute would like to draw your attention towards the following paragraphs of IAS 12 (revised 2000):

35. The criteria for recognizing deferred tax assets arising from the carry forward of unused tax losses and tax credits are the same as the criteria for recognizing deferred tax assets arising from deductible temporary differences. However, the existence of unused tax losses is strong evidence that future taxable profit may not be available. Therefore, when an enterprise has a history of recent losses, the enterprise recognizes a deferred tax asset arising from unused tax losses or tax credits only to the extent that the enterprise has sufficient taxable temporary differences or there is convincing other evidence that sufficient taxable profit will be available against which the unused tax losses or unused tax credits can be utilized by the enterprise. In such circumstances, paragraph 82 requires disclosure of the amount of the deferred tax asset and the nature of the evidence supporting its recognition.
36. An enterprise considers the following criteria in assessing the probability that taxable profit will be available against which the unused tax losses or unused tax credits can be utilized:
- (a) whether the enterprise has sufficient taxable temporary differences relating to the same taxation authority and the same taxable entity, which will result in taxable amounts against which the unused tax losses or unused tax credits can be utilized before they expire;
 - (b) whether it is probable that the enterprise will have taxable profits before the unused tax losses or unused tax credits expire;
 - (c) whether the unused tax losses result from identifiable causes which are unlikely or recur; and
 - (d) whether tax-planning opportunities (see paragraph 30) are available to the enterprise that will create taxable profit in the period in which the unused tax losses or unused tax credits can be utilized.

To the extent that it is not probable that taxable profit will be available against which the unused tax losses or unused tax credits can be utilized the deferred tax asset is not recognized.

82. An enterprise should disclose the amount of a deferred tax asset and the nature of the evidence supporting its recognition, when:
- (a) the utilization of the deferred tax asset is dependent on future taxable profits in excess of the profits arising from the reversal of existing taxable temporary differences; and
 - (b) the enterprise has suffered a loss in either the current or preceding period in the tax jurisdiction to which the deferred tax asset relates.

Keeping in view the above provisions of IAS-12, the Committee is of the opinion that the revised Standard has not left the recognition of deferred tax assets open-ended, instead it has prescribed a number of precautions to guard the interests of investors by setting out various criteria which are to be met religiously before the recognition of deferred tax assets. On the other hand since in the preparation of financial statements the compliance with IAS is mandatory, the Committee is of the firm view that deferred tax asset be recognized as required by IAS 12.

Further the Institute has also issued a Circular No. 03/2004 dated March 25, 2004 in which the members of the Institute have been advised to pay special attention and exercise extra care that the deferred tax assets are measured, recognized and disclosed in accordance with the requirement of IAS-12.

(February 14, 2004)

**1.9 MATTER PERTAINING TO ENTRIES IN THE BOOKS OF ACCOUNT-
CLARIFICATION REGARDING – REQUEST FOR**

Inquiry: The facts about the matter are briefly narrated as under:-

1. The assessee, an A.O.P, carrying on steel manufacturing business filed its return for the assessment year 2000-01 (year ending 30-6-2000). The trading/manufacturing account enclosed with the return is reproduced hereunder:-

Opening stock	1,315,000	Sales	153,447,103
Purchases	134,356,834	Closing stock	61,300,000
Electricity	60,046,617		
Wages	2,695,000		
Stores	6,500,000		
Gross profit	9,833,652		
	<u>214,747,103</u>		<u>214,747,103</u>
	=====		=====

2. The assessee also filed a Declaration under the Tax Amnesty Scheme 2000 (TAS). In Part-I of the declaration, undisclosed income was shown at Rs.35,000,000 which was balanced against stock-in-trade (up to 30-6-99) of an equal amount i.e. Rs.35,000,000 shown in Part-II of the same declaration.
3. Wealth statements of the owners for the year ending 30-6-2000 reflect credit taken on account of undisclosed income declared as per Tax Amnesty Scheme 2000 (TAS).
4. Since stock-in-trade worth Rs.35,000,000 was not visible in the trading account for the year ending 30-6-2000, a show cause notice was issued to the assessee.
5. The assessee filed a revised trading account without disturbing the gross profit declared in the original trading account. The revised trading account is reproduced below:

	Rupees
Sales – Net (Excluding Sales Tax including income declared Under TAS)	188,447,103
Cost of Sale	
Opening Stock	36,315,000
Purchases excluding sales tax	134,356,834
Electricity excluding sales tax	60,046,617
Wages	2,695,000
Consumption of store items	6,500,000
	<u>239,913,451</u>

Less: Closing stock including declared under TAS	(61,300,000)	
	<hr/>	178,613,451
	G.P	<hr/> <u>9,833,652</u>

From the above narration of facts the queries which come to my mind are:-

- (a) What entries (debit & credit) are required to be made in the books of account for the year ending 30-6-2000 with reference to undisclosed income and stock-in-trade declared under Tax Amnesty Scheme (TAS).
- (b) Whether stock declared under Tax Amnesty Scheme (TAS) is to be debited to the trading account before it is shown as part of closing stock or sales for the same year.

You are humbly requested to kindly spare your precious time to look into the matter and send reply at an early date.

Thank you for your kind cooperation.

Opinion: First of all your attention is drawn towards paragraph 31 of IAS – 8 which says:-

FUNDAMENTAL ERRORS

31. Errors in the preparation of the financial statements of one or more prior periods may be discovered in the current period. Errors may occur as a result of mathematical mistakes, mistakes in applying accounting policies, misinterpretation of facts, fraud or oversights. The correction of these errors is normally included in the determination of net profit or loss for the current period.

In the light of above the amount of undisclosed income referred to in your letter falls under the category of fundamental errors. Now the question arises what is the treatment of fundamental errors.

According to IAS 8 there are two ways of treating the fundamental error and they are as follows:

(A) Benchmark

- 34 The amount of the correction of fundamental error that relates to prior periods should be reported by adjusting the opening balance of retained earnings. Comparative information should be restated, unless it is impracticable to do so.

In the case of benchmark treatment the accounting entry would be:

Opening stock	Debit	
	Retained earning (opening)	Credit

(B) Allowed Alternative Treatment

38 The amount of the fundamental error should be included in the determination of net profit or loss for the current period. Comparative information should be presented as reported in the financial statements of the prior period. Additional pro forma information, prepared in accordance with paragraph 34, should be presented unless it is impracticable to do so.

In this case the suggested accounting entry would be:-

Opening stock	Debit	
	Current year Profit and Loss	Credit

Further your enquiry (b) is also taken care of in the above discussion.

(January 3, 2004)

1.10 PROFESSIONAL OPINION ON MARKUP PREVIOUSLY CAPITALIZED

Inquiry:

We are in the process of finalization of audit of a client (public company) for the year ended September 30, 2003. In this respect we seek your opinion on certain issues given below:

Facts of the Case

In the year ended September 30, 1999, on reaching a restructuring agreement with lender bank, whereby outstanding mark up on loan, which was not recognized by the company, was converted into demand finance. The company capitalized current and prior year's mark up on long term loans from the lender bank aggregating to Rs. 140 million towards the cost of plant and machinery. In accordance with generally accepted accounting principles, this should have been charged to profit and loss account as it represented accrued mark-up on long-term loan, which was not recognized previously by the enterprise. We, as the auditors of the company qualified the capitalization of mark-up in all financial statements issued subsequent to the restructuring transaction of 1999, pointing out that the capitalization of accrued mark up was not in line with generally accepted accounting principles. Board of directors' report, gave an explanation for qualification that "the mark up of Rs.140 million was due against the loan which was obtained for the acquisition of plant and machinery. Keeping in view the capacity and useful life of the assets vis-à-vis financial restructuring package approved by the bank, the management of the company decided to capitalize the mark up".

ISSUE I

During the year ended September 30, 2003, the company again entered into a new settlement agreement with the same lender bank on August 25, 2003 under BPD circular No. 29 dated October 15, 2002. The loan was restructured on the basis of forced sales value determined by valuer of the lender bank whereby the company would have to make payments of Rs.155 million as full and final settlement of total outstanding of Rs.327 million. The new liability would be retired through a down payment of Rs.15 million and twelve equal half yearly instalment due from November 23, 2003.

The above settlement agreement resulted into recognition of waiver of loan liability of Rupees 171.9 million by the company in the accounting year 2003.

The company has now also decided to reverse its earlier treatment of capitalization of mark up amounting to Rs.140 million.

Option I

The capitalized mark up in the year 1999 is to be charged to profit and loss account after netting off the waiver of long-term loan received during the year 2003. Following is the manner in which the effect can be disclosed:

**PROFIT AND LOSS ACCOUNT
FOR THE YEAR ENDED SEPTEMBER 30, 2003**

	2003	2002
	Rs. in	Rs. in
	million	million
Profit/(loss) for the year before tax	(55.0)	(5.0)
Taxation	<u>(2.0)</u>	<u>(3.5)</u>
Profit after Taxation	(57.0)	(8.5)
Extra Ordinary Items	Note 1 <u>57.7</u>	
Profit after Tax and Extra Ordinary Items	<u>0.7</u>	<u>(8.5)</u>

**EXTRACTS FROM NOTES
TO THE ACCOUNTS**

Note 1:

Extra Ordinary Items
(Netting Off of Waiver of Loan with Previously Capitalized Mark-up)

Waiver of Loan	171.8	-
Correction of Previously capitalized Mark-up	<u>(114.1)</u>	<u>-</u>
Extra Ordinary Item-	<u>57.7</u>	<u>-</u>

Option II

The capitalized mark up on long-term loan pertained to earlier years and to be adjusted against opening balance of retained earnings. Waiver of long term loan to be treated as separate line item being extraordinary item. Following is the manner in which the effect will be disclosed:

**PROFIT AND LOSS ACCOUNT
FOR THE YEAR ENDED SEPTEMBER 30, 2003**

	2003	2002
	Rs. in	Rs. in
	million	million
	(Restated)	
Profit for the year before tax	(55.0)	1.0
Taxation	<u>(2.0)</u>	<u>(3.5)</u>
Extra Ordinary Item	171.8	-
Profit after Tax and Extra Ordinary Item	114.8	(2.5)
Accumulated Profit/Losses Brought Forward	Note 2 <u>(276.8)</u>	<u>(283.7)</u>
Accumulated Losses Carried Forward	<u>(162.1)</u>	<u>(286.2)</u>
	2003	2002
	Rs. in	Rs. in

million million

**NOTE 2:
ACCUMULATED LOSSES**

Opening accumulated losses as previously stated	(162.7)	(163.6)
Previously capitalized mark up now charged to income	<u>(114.1)</u>	<u>(120.1)</u>
Opening accumulated losses as restated	(276.8)	(283.7)
Net Profit / (Loss)	<u>114.8</u>	<u>(2.5)</u>
Closing accumulated losses	<u><u>(162.0)</u></u>	<u><u>(286.2)</u></u>

Comments

It should be noted that under option I the EPS is more realistic as compared to option II in which the EPS is inflated artificially. Thus misleading the end user.

ISSUE II

Facts of the case

The settlement agreement under BPD circular 29, carries an important fact that the agreement was based on the valuation by lender bank's valuer who valued the assets on market value and afterward calculated forced sale value to determine the amount to be recovered from borrower-client.

Issue involved

This valuation is significantly less than the carrying amount of the fixed assets. However management is of the opinion that the valuation has been carried out only for the purpose of restructuring therefore could not be used as a basis for recognition of impairment of assets. Its projections for the next five years show that value in use/depreciation based on original cost of the asset is fully recoverable. In such case do we have to provide for any impairment loss on the basis of forced sale value as determined under BPD circular 29.

We would like to have ICAP views on the above issues. Please note that we are in the process of finalization of accounts and would appreciate an early reply.

Opinion: The appropriate Committee of the Institute has considered your above-mentioned queries and before expressing its opinion would like to draw your attention to the following paragraph of IAS 8, which states that:

FUNDAMENTAL ERRORS

31. Errors in the preparation of the financial statements of one or more prior periods may be discovered in the current period. Errors may occur as a result of mathematical mistakes, mistakes in applying accounting policies, misinterpretation of facts, fraud or oversights. The correction of these errors is normally included in the determination of net profit or loss for the current period.

According to IAS 8 there are two ways of treating the fundamental error and they are as follows:

(A) Benchmark

34 The amount of the correction of fundamental error that relates to prior periods should be reported by adjusting the opening balance of retained earnings. Comparative information should be restated, unless it is impracticable to do so.

(B) Allowed Alternative Treatment

38 The amount of the correction of a fundamental error should be included in the determination of net profit or loss for the current period. Comparative information should be presented as reported in the financial statements of the prior period. Additional pro forma information, prepared in accordance with paragraph 34, should be presented unless it is impracticable to do so.

After considering the above the Committee is of the opinion that: -

Issue I: Treatment mentioned in option II appears to be appropriate being in accordance with the benchmark treatment as prescribed in IAS 8 on “Net Profit and Loss for the Period, Fundamental Errors and Changes in Accounting Policies”.

However, the Committee feels that the following observations need to be taken care of:

- The amount of waiver of loan should not be treated as an extraordinary item, rather it is a derecognition of a financial liability that should be treated as per paragraph 63 of IAS 39 which requires that:

“The difference between the carrying amount of a liability (or part of a liability) extinguished or transferred to another party, including related unamortised costs, and the amount paid for it should be included in net profit or loss for the period” (IAS 39.63)

Therefore, considering the size, nature, and incidence of the item (IAS 8.16) this should be shown as a separate line item on the face of profit and loss account as “income from derecognition of financial liability”

- In the balance sheet notes, the difference of amount of loan capitalised and carrying value thereof should be disclosed. The reversal of accumulated depreciation should also be highlighted for better presentation.
- In line number 2 of Note 2 of accumulated losses of Options II the word ‘income’ should be replaced with ‘retained earnings’

Issue II: The Committee would like to draw your attention towards IAS 16 “Property, Plant and Equipment” which defines impairment loss as:

“An impairment loss is the amount by which the carrying amount of an asset exceeds its recoverable amount.” (IAS 16.6)

While “**recoverable amount** is the higher of an asset’s net selling price and its value in use.” (IAS 36.5)

In order to clearly understand the meaning of recoverable amount, we would like to quote definitions of the terms “net selling price” and “value in use” as defined in IAS 36 – Impairment:

“Net selling price is the amount obtainable from the sale of an asset in an arm’s length transaction between knowledgeable, willing parties, less the costs of disposal.” (IAS 36.5)

“Value in use is the present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life.” (IAS 36.5)

From the above it is clear that the term forced sale value is not defined/referred to in the IAS 36. Therefore, the Committee is of the view that if an impairment loss does exist, it should be measured and recognized as per the guidance available in the relevant IAS.

Moreover, the Committee would also like to emphasize that BPD Circular 29 of State Bank of Pakistan will not be applicable to the company to which you are referring to, as the Committee assumes that the said company is not a bank while the concept of Forced Sale Value as mentioned in the said Circular is only applicable to banks particularly when a bank is determining the amount to be recovered from the borrower in case of default by the borrower.

(April 3, 2004)

1.11 PAYMENT OF DIVIDENDS FROM INCREMENTAL DEPRECIATION

Inquiry:

I am associate member of the Institute of Chartered Accountants of Pakistan. I require opinion/ clarification of the Institute on whether incremental depreciation on revalued assets, as transferred to unappropriated profit and loss account through statement of changes in equity can be considered for distribution of profits in the form of dividends by any company

Following scenario fully explains the issue and the importance of decision arrived at in this respect.

SCENARIO

A company declared interim cash dividend to its shareholders (Rs.10 million) on the basis of profitability in its quarterly accounts. Subsequently annual accounts of the company disclosed that the company has earned net profit after tax of only Rs. 2 million for the year. Accounts do not show any reserve whereas losses had accumulated to Rs. 50 million. Statement of changes in equity shows that the company has transferred incremental depreciation on revalued assets relating to prior years Rs. 15 million and for current year Rs. 10 million as per notification No SRO 45(I)/2003 of the Commission.

Resultantly, profits of the company do not cover the amount of dividend and in the absence of any reserve, this tantamount to **violation of Section 249** of the Companies Ordinance, 1984 which prohibits distribution of dividends, otherwise than out of profits of the Company.

Following table shows position of statement of changes in equity keeping in view the above information

STATEMENT OF CHANGES IN EQUITY	
	Rs. in millions
Share Capital	20.000
Accumulated losses at the beginning	50.000

Loss for the year	2.000
Dividend	10.000
Incremental depreciation	
Prior years	(15.000)
Current year	(10.000)
Balance of accumulated loss at the end	37.000

Following should be kept forth before forming opinion in this respect:

- Para (2) & (3) of SRO 45(I)/ 2003 of Commission states that
 - (2) *An amount equal to incremental depreciation for the period shall be transferred from "Surplus on Revaluation of Fixed Assets Account" to un-appropriated profit / accumulated loss through Statement of Changes in Equity to record realization of surplus to the extent of the incremental depreciation charge for the period;"*
 - (3) *an amount equal to incremental depreciation charged in previous years may be transferred from "Surplus on Revaluation of Fixed Assets Account" to un-appropriated profit / accumulated loss through Statement of Changes in Equity; and*
- **Sub-Section (2) of Section 235 of the Ordinance strictly disallows utilization of surplus on revaluation for distribution of profits by way of dividends. It states**
 - (2) *Except and to the extent actually realized on disposal of the assets which are revalued, the surplus on revaluation of fixed assets shall not be applied to set-off or reduce any deficit or loss, whether past, current or future, or in any manner applied, adjusted or treated so as to add to the income, profit or surplus of the company, **or utilized directly or indirectly by way of dividend or bonus***

Provided that the surplus on revaluation of fixed assets may be applied by the company in setting-off or in diminution of any deficit arising from the revaluation of any other fixed assets of the company:

[Provided further that incremental depreciation arising out of revaluation of fixed assets may be charged to Surplus on Revaluation of Fixed Assets Account.]

In view of the above information following points require clarification:

- (1) **Can dividend be paid out of incremental depreciation (both relating to current and prior periods) transferred to accumulated profit/ accumulated losses through statement of changes in equity in the light of Section 235, Section 249 and aforementioned notification; and**
- (2) **Would the decision be same, where any company does not have any reserves and accounts show huge accumulated losses, as in above-mentioned example.**

Any decision taken in this respect will be detrimental for the companies. I would appreciate early response in this respect.

Opinion: To deal with the queries raised by you, the appropriate Committees of the Institute would like to draw your attention towards clauses (2) and (3) of SRO No. 45(I)/2003 dated January 13, 2003.

- (2) an amount equal to incremental depreciation for the period shall be transferred from "Surplus on Revaluation of Fixed Assets Account" to un-appropriated profit /

accumulated loss through Statement of Changes in Equity to record realization of surplus to the extent of the incremental depreciation charge for the period;

- (3) an amount equal to incremental depreciation charged in previous years may be transferred from "Surplus on Revaluation of Fixed Assets Account" to un-appropriated profit / accumulated loss through Statement of Changes in Equity.

In the light of above clauses, the Committee is of the opinion that any dividend paid out of incremental depreciation whether relating to current year or previous years which does not fully offset the accumulated loss would appear to be paid out of capital.

(April 3, 2004)

1.12 SURPLUS ON REVALUATION OF FIXED ASSETS

Inquiry:

In accordance with the recent revaluation report from an independent valuer it has transpired that our fixed assets value, which was estimated at higher amount previously, has now gone down due to various reasons.

In view of this, we request you to please clarify the following questions emanating from the above situation:

1. Can the company bring down surplus on revaluation of fixed assets, recorded earlier under section 235 of the Companies Ordinance, 1984?
2. If the answer to the above is in affirmative, then there may be two different approaches to deal with the matter in accordance with IAS 16.
 - i) directly reverse the surplus on revaluation of fixed assets account and credit to book value of fixed assets, or
 - ii) release incremental depreciation amount to un-appropriated profit/accumulated losses account through statement of changes in equity relating to the surplus on revaluation of fixed assets charged earlier and also follow the entry as suggested in paragraph (I) above.

We request you to advise us on the matter in the light of SRO 45(1)/2003 dated January 13, 2003.

An early reply shall be highly appreciated.

Opinion:

1. The appropriate Committee of the Institute would like to draw your attention to the following first Proviso to Sub-section (2) of section 235 of the Companies Ordinance, 1984 read with paragraph 38 of IAS-16:-

Sub-section (2) of section 235

Provided that the surplus on revaluation of fixed assets may be applied by the company in setting off or in diminution of any deficit arising from the revaluation of any other fixed asset of the company.

Paragraph 38 of IAS-16

When an asset's carrying amount is decreased as a result of a revaluation, the decrease should be recognized as an expense. However, a revaluation decrease should be charged directly against any related revaluation surplus to the extent that the decrease does not

exceed the amount held in the revaluation surplus in respect of that same asset.

2. (i) please refer to paragraph 38 of IAS-16 as quoted above.
- (ii) Please refer to the following paragraph 3 of SRO No. 45(I)/2003 dated January 13, 2003.
- (3) an amount equal to incremental depreciation charged in previous years may be transferred from "Surplus on Revaluation of Fixed Assets Account" to un-appropriated profit / accumulated loss through Statement of Changes in Equity;

Please be guided by the above.

(September 13, 2003)

1.13 SURPLUS ON REVALUATION OF FIXED ASSETS WHETHER OR NOT A PART OF EQUITY

Inquiry:

We have received an enquiry from one of our clients, seeking our opinion on whether or not surplus on revaluation of fixed assets is to be considered as part of the equity in the light of the relevant provisions of the Companies Ordinance, 1984 and the applicable International Accounting Standard-16 which is understood by a rating company as not being a part of equity owing to its reflection in the financial statement after capital and reserves as per the requirement of Section 235(2) of the Companies Ordinance, 1984. The rating agency also considers that clause 2 of section 235 has the effect of overriding para 37 of IAS-16.

We shall hence appreciate your comments on the matter referred to in (a) below in the light of definition of equity given in IASC framework for the preparation and presentation of financial statements and the notification in SRO 777(1)/86 dated August 6, 1986 relating to IAS-16:

- (a) Whether or not section 235(2) of the Companies Ordinance, 1984 overrides paragraph 37 of IAS-16 and as such restricts the treatment of revaluation surplus as a part of equity.

It is pertinent to draw your attention to SRO 777(1)/86 dated August 06, 1986 directing listed companies to follow IAS-16 in regard to their accounts and preparation of the balance sheet and profit and loss account followed simultaneously by insertion of clause 7A in the Fourth Schedule. Prior to the notification "surplus on revaluation of fixed assets" appeared after share premium account in the sub-heading of RESERVES in the Fourth Schedule.

Trusting to receive an early reply in the matter, we remain.

Opinion:

To deal with the query raised by you, the appropriate Committee of the Institute would like to discuss IAS 16.37, section 235 and other pertinent provisions of IAS and Companies Ordinance, 1984: -

IAS 16.37 When an asset's carrying amount is increased as a result of a revaluation, the increase should be credited directly to equity under the heading of revaluation surplus. However, a revaluation increase should

be recognized as income to the extent that it reverses a revaluation decrease of the same asset previously recognized as an expense.

However, the word equity as used in IAS 16.37 should be read in the context of paragraph 65 of the International Accounting Standards Board's Framework for the Preparation and Presentation of Financial Statements as reproduced below: -

65. Although equity is defined in paragraph 49 as a residual, it may be sub-classified in the balance sheet. For example, in a corporate enterprise, funds contributed by shareholders, retained earnings, reserves representing appropriations of retained earnings and reserves representing capital maintenance adjustments may be shown separately. Such classifications can be relevant to the decision-making needs of the users of financial statements when they indicate legal or other restrictions on the ability of the enterprise to distribute or otherwise apply its equity. They may also reflect the fact that parties with ownership interests in an enterprise have differing rights in relation to the receipt of dividends or the repayment of capital.

Section 235 of the Companies Ordinance, 1984

235. Treatment of surplus arising out of revaluation of fixed assets. - (1) Where a company revalues its fixed assets, the increase in, or sums added by writing up of, the value of such assets as appearing in the books of accounts of the company shall be transferred to an account to be called "Surplus on Revaluation of Fixed Assets Account" and shown in the balance-sheet of the company after Capital and Reserves.

(2) Except and to the extent actually realized on disposal of the assets which are revalued, the surplus on revaluation of fixed assets shall not be applied to set-off or reduce any deficit or loss, whether past, current or future, or in any manner applied, adjusted or treated so as to add to the income, profit or surplus of the company, or utilized directly or indirectly by way of dividend or bonus:

Provided that the surplus on revaluation of fixed assets may be applied by the company in setting-off or in diminution of any deficit arising from the revaluation of any other fixed assets of the company:

Provided further that incremental depreciation arising out of revaluation of fixed assets may be charged to Surplus on Revaluation of Fixed Assets Account.

Thus the appropriate Committee of the Institute is of the opinion that the provisions of IAS 16 are over-ridden by the provisions of section 235 of the Companies Ordinance, 1984 on the basis of unwritten law that local legal requirements would have precedence over the provision of IAS.

To further elaborate the matter we reproduce below an extract from Selected Opinion No. 1.15 of Selected Opinions Volume IV issued by this Committee in 1996-97: -

Opinion:

1. Revaluation of Fixed Assets

Section 235(1) of the Companies Ordinance, 1984, provides that "surplus on revaluation of fixed assets account" should be shown in the balance sheet of the company after capital and reserves. Sub-section (2) further prescribes that such surplus shall not be applied to set off or reduce any deficit or loss. The revaluation surplus cannot therefore be shown and boxed with Capital and Reserves.

(June 5, 2004)

2. AUDITING

2.1 AUDITOR'S REPORT IN CASE OF AUDITS OF PROPRIETORS AND PARTNERSHIP FIRMS

Inquiry: Thank you for your response vide letter # CA/DTS/TAC-2003 dated November 21, 2003 in connection with above.

In the letter you have recommended two International Auditing Standard ISA-700 and ISA-800, but these standards provide general guidance regarding such audit reports. The inquiry raised in our previous letter was for specific format for auditor report for sole proprietors and partnership firms.

It is worth mentioning that the ICAP has issued a format of Audit report for NGO'S and charitable Institutions vide ATR -17 but no attempt has yet been made for proprietorship concerns and partnership firms, which constitute a major portion of our industry.

You are requested to please consider this matter so that the practice of issuance of different nature audit reports in the absence of exact format may be stopped.

Opinion: We appreciate your concern regarding a standardized format of audit report for the sole proprietors and partnership firms. However, we would like to clarify that the nature and scope of audits of sole proprietors and partnership firms largely varies on a case-to-case basis.

As you are aware that limited companies are run by the board of directors while trusts and NGOs are run by the board of trustees. In both cases, public money is invested/utilized for running the entity and there arises a need for an independent auditor to step in and report on the smooth operations of the business. While the entities like sole proprietors and firms are owned by one or more persons with limited or no interest of the general public thus there does not exist a liability to report to the stakeholders of the company or to the trustees at large. Also, there is no legal binding on such entities to get their audits done on a regular basis; rather such entities normally opt for an audit (mostly agreed upon procedures) as per their individual needs.

Therefore, keeping in view the above, the Institute does not find it appropriate to issue a standardized format of audit report where in most of the cases such format would not suffice the need of the audit. The Institute would also like to reiterate that the guidance provided in ISA 700 and ISA 800 is adequate for an auditor to exercise judgement and tailor the audit report as per the specific needs of the audit of such entities.

(January 3, 2004)

2.2 AUTHENTICITY OF AUDITED FINANCIAL STATEMENTS

Inquiry: This is with reference to ICAP's Circular No. 4/99 dated June 17, 1999 wherein ICAP has advised its members not to stamp or sign financial statements of an enterprise, which have been audited by them. Accordingly, we have been forwarded a copy of ICAP's letter reference no. CA/DTS/TAC-2003 dated May 17, 2003, (Selected Opinions Volume VIII Opinion NO. 2.9) wherein ICAP has reiterated its above stance, even though such a practice creates practical difficulties in establishing the authenticity of the audited financial statements, especially when they are not in printed/published form- as in the case of non-listed companies.

We appreciate ICAP's concerns regarding the legal obligations and professional responsibilities of its members in practice. However, in our view, it is not only essential for

protection of interests of all users of financial statements but also logical that there should be some necessary identification mark on the financial statements by auditors regarding which they are issuing an audit report and which are not being presented in published form. Such identification can either be in form of initials of the firm concerned on the financial statements or the financial statements may be printed on the continuation sheets bearing logo of the audit firm.

We would like to request ICAP to re-examine this issue and come up with a solution, which- without affecting the liability of auditors prejudicially – ensures that interests of all stakeholders are safeguarded.

We shall appreciate your early response in this regard.

Opinion: The appropriate Committee of the Institute has thoroughly re-examined its views as stated at Opinion No. 2.9 of Selected Opinions Vol. VIII and particularly in the light of comments in your letter under reference and come to the conclusion that its views as expressed therein do not need any revision.

(October 4, 2003)

2.3 CLARIFICATION REGARDING SIGNING OF AUDITORS' REPORT AND OTHER DOCUMENTS ON CHANGE OF STATUS OF THE FIRM

Inquiry: Kindly favour us with your opinion on the following issue.

We have been appointed as the statutory auditors of our clients in their respective annual general meetings held during last year under the capacity of a sole proprietor firm. However, now the status of our firm has changed from a sole proprietorship firm to a partnership firm w.e.f. July 12, 2003 by the introduction of a partner. We have submitted the information regarding the introduction of partner as required by Section 252 of the Companies Ordinance, 1984 to all our clients and accordingly they have intimated the said change to the Registrar Joint Stock Companies by filing Form 29 as required by that section.

You are requested to kindly advise us whether the auditors' report and other documents purported to be signed or authenticated by the auditors, may be signed or authenticated by any partner in the firm name or only by the person appointed in the respective annual general meetings in the capacity of sole proprietor of the firm.

An early response shall be highly appreciated as the finalization of our audits is around the corner.

Opinion: The appropriate Committee of the Institute is of the opinion that your sole-proprietor firm has ceased to exist in practice from the day you formed into a partnership firm and your sole-proprietor firm can, accordingly, no longer continue to be the auditors. A casual vacancy has therefore been created.

This new firm of partnership can, however, be appointed to fill in the casual vacancy under section 252 (4) read with section 252(5) and 252(6) of the Companies Ordinance, 1984 created by the closure of the sole-proprietor firm.

Since the appointment of the new partnership firm by the firm name shall be deemed to be the appointment of all the persons who are partners in the firm at the time of appointment, the auditors' report and other documents may be signed or authenticated by any partner in the firm appointed, subject to the matters discussed in the preceding paragraphs.

2.4 **OMISSION OF PHRASES FROM THE SPECIFIED FORMAT OF AUDITORS' REPORT ON THE FINANCIAL STATEMENTS OF A PRIVATE LIMITED COMPANY**

Inquiry: This is with reference to our telephonic conversation on April 12, 2004 regarding the above subject matter, we seek further clarification from Technical Committee as follows: -

Do Auditors of Private Limited Company, while expressing their opinion on the financial statements of the company, have authorization of SECP, ICAP, any other Governmental / Non Governmental body or legislation / Ordinance to omit following phrases from the Auditors' report to the members?

- i. The second paragraph line 2 of Auditors' report **"the approved accounting standards and"**
- ii. Sub para (c) of third paragraph of Auditors' report **"conform with approved accounting standards as applicable in Pakistan, and"**

For your reference the extract of Section 234 of Companies Ordinance 1984 and specimen of Auditors' report is attached in which above mentioned phrases are underlined. (Only relevant paragraphs of Form 35A and Notes thereon reproduced – DTS)

In addition to above please clarify if a private limited company that has not declared / paid any dividend to its shareholders during the financial year and as a result no deduction of zakat thereon, should Auditors add following phrases in their report?

"in our opinion Zakat deductible at source under the Zakat and Ushr Ordinance, 1980 (XVIII) of 1980), was deducted by the company and deposited in the Central Zakat Fund established under section 7 of that Ordinance".

Or should replace the above phrases with the following.

"no Zakat was deductible at source under the Zakat and Ushr Ordinance, 1980"

Your earliest response on above subject matter will be highly appreciated.

THE COMPANIES ORDINANCE, 1984
[See section 255(3) and rule 17A]

Form 35A
AUDITORS' REPORT TO THE MEMBERS

It is the responsibility of the company's management to establish and maintain a system of internal control, and prepare and present the above said statements in conformity with **the approved accounting standards** and the requirements of the Companies Ordinance, 1984. Our responsibility is to express an opinion on these statements based on our audit.

- (c) in our opinion and to the best of our information and according to the explanations given to us, the balance sheet, ¹ profits and loss account, cash flow statement and statement of changes in equity together with the notes forming part thereof **conform with approved accounting standards as applicable in Pakistan, and**, give the information required by the Companies Ordinance, 1984, in the manner so required and respectively give a true and fair view of the state

of the company's affairs as at ----- and of the ^{*3} profit/loss, its cash flows and changes in equity for the year then ended; and

- (d) **in our opinion ^{*4} Zakat deductible at source under the Zakat and Ushr Ordinance, 1980 (XVIII of 1980), was deducted by the company and deposited in the Central Zakat Fund established under section 7 of that Ordinance.**

NOTES

Where applicable—

- *1. Substitute “income and expenditure account” in case of association not for profit.
- *2. Where there is no change in the accounting policy(ies) the portion “except for the changes as stated in note(s) with which we concur” may be omitted.
- *3. Substitute “surplus or deficit” in case of association not for profit.
- *4. Where no Zakat is deductible, substitute “no Zakat was deductible at source under the Zakat and Ushr Ordinance, 1980”.

Opinion:

The appropriate Committee of the Institute is of the opinion that the wordings of the format of Auditors' Report to the members as prescribed in Form 35-A can not be amended except for those paragraphs which have been allowed in the Notes of the format which also deal with your enquiry relating to deduction of Zakat.

The appropriate Committee also wishes to clarify that the phrases, for which you wish to know the authority for deletion, are the very basis on which an auditor forms and expresses an opinion. The following paragraphs 17 and 19 of ISA 700 – *The Auditor's Report on Financial Statements* issued by IFAC and adopted by ICAP will help you to appreciate the situation more fully:-

17. The opinion paragraph of the auditor's report should clearly indicate the financial reporting framework used to prepare the financial statements and state the auditor's opinion as to whether the financial statements give a true and fair view (or are presented fairly, in all material respects) in accordance with that financial reporting framework and, where appropriate, whether the financial statements comply with statutory requirements.

19. The financial reporting framework is determined by IASs, rules issued by recognized standard setting bodies, and the development of general practice within a country, with an appropriate consideration of fairness and with due regard to local legislation. To advise the reader of the context in which the auditor's opinion is expressed, the auditor's opinion indicates the framework upon which the financial statements are based. The auditor refers to the financial reporting framework in such terms as:

“... in accordance with International Accounting Standards (or [title of financial reporting framework with reference to the country of origin])”

This designation will help the user to better understand which financial reporting framework was used in preparing the financial statements.

For an elaboration of financial reporting framework in Pakistan, the Committee would like you to refer to Circular No. 01/2003 dated February 24, 2003 issued by the Professional Standards and Technical Advisory Committee of the Institute.

(May 8, 2004)

2.5 QUALIFICATION OF GOING CONCERN ASSUMPTION FOR A DORMANT COMPANY

Inquiry: As the part of audit, auditors are required to consider appropriateness of management's use of going concern assumption in preparation of financial statements.

In the light of IAS and ISA 570 we seek your opinion on the appropriateness of going concern assumption of a private limited company. The fact about the company are given as under:-

- The company was incorporated as a private limited company in June 1997 under the Companies Ordinance, 1984 to carry on cargo business and rendering allied services.
- The issued, subscribed and paid up capital of the company is Rs. 300/- (Rupees three hundred) against authorized share capital of Rs. 1,000,000/- (Rupees one million only).
- There are no liabilities except payables to associated concern (that are managed by the same directors). The liabilities consist of payments made against expenses of incorporation, fees of auditors and other fees of SECP paid from time to time. The company is discharging all its statutory obligations including audit of financial statements, filing of statutory returns to SECP, Income Tax returns, Sales Tax Returns and paying the govt. fees where required etc.
- The company has no third party liability except legal and professional charges and all the payable are due to the associated companies under the same management.
- Company has no employees and has not started any business since incorporation as no feasible business opportunity could be generated so far. The management of the company intends to run the company, and there is neither intention nor necessity of its liquidation.
- The company has not prepared income statement since incorporation in 1997. All expenses incurred for incorporation and subsequently to discharge legal obligations are presented as deferred cost.
- There are no non-current assets or non-current liabilities. In view of the above facts the management believes the question of Going Concern Assumption of the company does not arise, as company has never started its business and prepared income statement or profit and loss statement. There is no business for which there is any possibility of closing down.

From the above situation we believe that the audit report does not attract any qualification on Going Concern Assumption, therefore we request your good self to give your opinion on the above case. The auditors of the company are of the opinion that company is not a going concern and they shall issue audit report with the qualification that the company is not a going concern.

We hope you will look into the matter and do the needful at the earliest.

Opinion: Your attention is drawn to the following paragraphs of IAS 1

23. ***When preparing financial statements, management should make an assessment of an enterprise's ability to continue as a going concern. Financial statements should be prepared on a going concern basis unless management either intends to liquidate the enterprise or to cease trading, or has no realistic alternative but to do so. When management is aware, in making its assessment, of material uncertainties related to events or conditions which may cast significant doubt upon the enterprise's to continue as a going concern, those uncertainties should be disclosed. When the financial statements are not prepared on a going concern basis, that fact should be disclosed, together with the basis on which the financial statements are prepared and the reason why the enterprise is not considered to be a going concern.***
24. In assessing whether the going concern assumption is appropriate, management takes into account all available information for the foreseeable future, which should be at least, but is not limited to, twelve months from the balance sheet date. The degree of consideration depends on the facts in each case. When an enterprise has a history of profitable operations and ready access to financial resources, a conclusion that the going concern basis of accounting is appropriate may be reached without detailed analysis. In other cases, management may need to consider a wide range of factors surrounding current and expected profitability, debt repayment schedules and potential sources of replacement financing before it can satisfy itself that the going concern basis is appropriate.

In view of the above paragraphs and the circumstances you have mentioned in the enquiry especially the paragraph 'Company has no employees and has not started any business since incorporation as no feasible business opportunity could be generated so far' the Committee is of the view that the going concern assumption appears to be inappropriate.

(May 8, 2004)

2.6 ROTATION OF AUDITORS

Inquiry:

In accordance with the Code of Corporate Governance, every listed company is required to change their auditor (or at least the audit partner) who have been auditing for last five years. In this regard we request clarification regarding the following.

Our firm was a sole proprietorship up to January 2003 and was converted into partnership. Previously Mr. A. was signing the accounts, but since the partnership I am the audit partner of all listed companies.

- Q. 1 Will our firm fall within the requirement of rotation of auditor by December 2003.
- Q. 2 What is the status of two firms, which are merged?
- Q. 3 Is it the name of the audit firm that matters or the structure of firm i.e. sole proprietorship / partnership.

At the time of entering into partnership we were considering the change of name of the firm, but the same was deferred and we are now considering the change in the near future.

- Q. 4 If we plan to change the name of our firm, what will be the status of our firm in respect of following: -
- a) Will the QCR (satisfactory status) already issued to our firm remain valid.
 - b) Will this change of name cause casual vacancy in the office of the auditor of listed and unlisted companies or will we be required to carry the old name up to the AGM of the Companies and in the AGM the new name will be proposed.
 - c) Will the requirement of rotation of auditor (as per the listing rules) apply retrospectively to the new named firm.

Your early reply will be highly appreciated.

Opinion:

The appropriate Committee of the Institute would like to state that the purpose of introduction of rotation clause in the Code of Corporate Governance was to bring more transparency and independence in audit and this objective would not be achieved if firms change their names or merge with any other firm or do few cosmetic changes just to avoid rotation.

Therefore the Committee is of the opinion that mere change of firm's name or conversion of sole proprietorship into partnership or merger may not be treated as a new firm with regards to the applicability of rotation of auditors.

Following are the responses to the queries you have raised: -

1. Yes, for the reason we have mentioned above;
2. Though the merger of two firms will constitute a new firm, for rotation purposes it would not change the status as it was before merger. If two firms A & B merge into AB & Co. and if A or B were due for rotation then AB will also be due for rotation.
3. Neither the name nor the conversion from sole proprietorship to partnership will make any difference for rotation purpose;
4.
 - a. Your firm will not be subject to a fresh Quality Control Review (QCR);
 - b. You will carry your old name up to the AGM of companies when the new name may be proposed. Please refer section 47 of the Partnership Act, 1932 as quoted below:

47. Continuing authority of partners for purposes of winding-up. – After the dissolution of a firm the authority of each partner to bind the firm, and the other mutual rights and obligations of the partners, continue notwithstanding the dissolution, so far as may be necessary to wind up the affairs of the firm and to complete transactions begun but unfinished at the time of the dissolution, but not otherwise:

- c. Please see reply at 1 above.

(December 5, 2003)

2.7 TECHNICAL OPINION ON ISA 505

Inquiry: BACK GROUND

We are the company engaged in manufacturing. The sale of our product is made through distributors designated by the company. These distributors collect and deposit the amount in our sales collection accounts opened in the branches of the commercial bank situated in urban and rural areas all over Pakistan. These accounts are non-checking accounts (i.e. the company cannot issue cheque or transfer the amount to any account other than the designated sales collection control account). These accounts are opened under an agreement with a reputable commercial bank, under which the branches are required to transfer the amounts collected on next working day to our designated sales collection control account maintained for the collection of sale receipts. The accounts opened are well in excess of 85 in number.

INQUIRY

The International Standard on Auditing 505 External Confirmations requires that the auditors may confirm balances with the banks directly. Keeping in view, the nature and number of these accounts some of the letters circularized by the auditors remain unattended by the branches, despite various reminders and follow up:

In this regard we seek your opinion, whether the auditors are required to circularize the letters to the branches of the banks with which the company is maintaining such accounts. If it is necessary, could the auditors satisfy themselves and sign the auditors report on the financial statements on the basis of the bank statements received by the company from time to time and checking subsequent transfer of the amounts in the main sales collection account, in case the replies are not received directly by the auditors till the date of signing of auditors report.

Opinion: The appropriate Committee of the Institute would like to draw your attention towards the following paragraphs of International Standard on Auditing 505: -

2. The auditor should determine whether the use of external confirmations is necessary to obtain sufficient appropriate audit evidence to support certain financial statement assertions. In making this determination, the auditor should consider materiality, the assessed level of inherent and control risk, and how the evidence from other planned audit procedures will reduce audit risk to an acceptably low level for the applicable financial statement assertions.

4. External confirmation is the process of obtaining and evaluating audit evidence through a direct communication from a third party in response to a request for information about a particular item affecting assertions made by management in the financial statements. In deciding to what extent to use external confirmation the auditor considers the characteristics of the environment in which the entity being audited operates and the practice of potential respondents in dealing with requests for direct confirmation.

In view of the above, the Committee is of the opinion that, though audit evidence from external sources is more reliable than audit evidence generated internally, it is the discretion of auditor whether he wants to send the request or not for balance confirmation.

Further following paragraph of ISA 505 also provides guidance when an auditor is unable to obtain a response in reply to his balance confirmation request:

31. The auditor should perform alternative procedures where no response is received to a positive external confirmation request. The alternative audit procedures should be such as to provide the evidence about the financial statement assertions that the confirmation request was intended to provide.

You would appreciate that the external auditor has the sole discretion in the matter. He may, therefore, be within his rights to insist on receiving a response to his request for confirmation directly before rendering his opinion.

(May 8, 2004)

3. CORPORATE LAW

3.1 PRESERVATION OF BOOKS OF ACCOUNT

Inquiry: We will be grateful for your help if you kindly inform us about the existence of any law in Pakistan relating to the retention of corporate documents in electronic form by use of imaging systems.

Whether the laws of Pakistan which require the storage of accounting records (such as vouchers, invoices, statements) allow for such accounting record in imaging system.

If your answer is positive please briefly provide details as to the conditions imposed for the keeping of such accounting records in imaging systems.

Your early action is highly appreciated.

Opinion: As regards to your question whether the laws of Pakistan allow for accounting records to be preserved in an imaging system, we would like to draw your attention towards the enclosed ICAP Circular 06/2002 dated July 13, 2002 that summarizes requirements of different statutes on preservation of accounting and auditing records.

Please note that though the statutes prescribe the time period for preservation of books of account, the medium of preservation i.e. whether it should be in hard form or soft form is not laid down in any of the statutes.

In the absence of any clarification by the statutory authorities and the law being silent on the issue, reference is made to the definition of "Document" as stated in the Black's Law Dictionary:

"Document. An instrument on which is recorded, by means of letters, figures or marks, the original, official, or legal form of something, which may be evidentially used. In this sense the term "document" applies to writings; to words printed, lithographed, or photographed; to maps or plans; to seals, plates, or even stones on which inscriptions are cut or engraved. In the plural, the deeds, agreements, title-papers, letters, receipts, and other written instruments used to prove a fact. As used as verb, to support with documentary evidence or authorities.

Within meaning of the best evidence rule, document is any physical embodiment of information or ideas; e.g. a letter, a contract, a receipt, a book of account, a blue print, or an X-ray plate."

The Committee is of the view that the terms lithographed/ photographed/ X-ray plate as used in the above definition may be stretched to include electronic imaging as a form of document.

The above view appears to stand valid in light of the provisions of Section 722 and 723 of the UK Companies Act 1985, that are reproduced below: -

722. Form of company registers, etc.

- (1) Any register, index, minute book or accounting records required by the Companies Acts to be kept by a company may be kept either by making entries in bound books or by recording the matters in question in any other manner.

- (2) Where any such register, index, minute book or accounting record is not kept by making entries in a bound book, but by some other means, adequate precautions shall be taken for guarding against falsification and facilitating its discovery.

723. Use of computers for company records

- (1) The power conferred on a company by section 722(1) to keep a register or other record by recording the matters in question otherwise than by making entries in bound books includes power to keep the register or other record by recording those matters otherwise than in a legible form, so long as the recording is capable of being reproduced in a legible form.

Therefore, in our opinion, books of account of a company may be preserved/ retained in an electronic form by use of imaging systems. Further, as there are no separate conditions stipulated for the preservation of accounting records in an imaging system, period and place of preservation of such records would have to be derived as per the relevant statutes."

(January 3, 2004)