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# **SELECTED OPINIONS**

*Volume VIII*

(July 1, 2002 to June 30, 2003)

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**COMPILED BY**

**TECHNICAL SERVICES DIRECTORATE**

of

**THE INSTITUTE OF CHARTERED  
ACCOUNTANTS OF PAKISTAN**

## **INTRODUCTION**

This report is the eighth compilation of selected opinions issued by the Technical Advisory Committees on inquiries raised by the members and other agencies during the period from July 2002 to June 2003 for the general guidance of the members of the Institute. Volume I to VII have already been put on the ICAP 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' 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 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 ABC LEASING LIMITED-DEFERRED TAXATION

***Inquiry:***

I refer to the accounts of ABC Leasing Limited for the year ended June 30, 2002.

The Company has set off Rs.70 million from Reserve for Deferred Tax against its tax charge for the year.

In my view, this treatment is against the IAS 1, IAS 8 and IAS 12 and has resulted in understatement of loss of the Company by Rs.70 million. The financial statements also do not give any disclosure about such treatment of reserves. All is left for the user to find out the methods of the Company.

The Company has unrecognized deferred tax liability of Rs.16.2 million and has never made charge for deferred tax against its profit.

The Company has taken advantage of "Creative Accounting" and has transferred Rs.70 million from Reserves to actual charge (above line) and has thus tried to hide its actual losses for the year and to mislead its shareholders, lenders and other users of the financial statements.

Please review and instruct the ABC Leasing Limited to issue revised financial statements as this would enhance the self-regulating status of the Institute of Chartered Accountants of Pakistan and of regulatory control of SECP.

***Opinion***

The appropriate Committee of the Institute has reviewed the financial statements of ABC Leasing Limited (ABC) for the year ended June 30, 2002.

The Committee would like to clarify that the financial statements are prepared in accordance with such IAS as are notified by SECP and related interpretations issued by Standing Interpretation Committee of IASB and requirements of the Companies Ordinance, 1984 and specific directives of SECP and other relevant regulatory bodies, e.g. the State Bank of Pakistan, etc.

The method of recognition of Current and Deferred Tax Liability in the Income Statement and Equity are given in paragraph 58 and 61 of the International Accounting Standard 12 "Income Taxes". The paragraphs are reproduced below for ready reference:

58. Current and deferred tax should be recognized as income or an expense and included in the net profit or loss for the period, except to the extent that the tax arises from:

- (a) a transaction or event which is recognized, in the same or a different period, directly in the equity: or
- (b) a business combination that is an acquisition

61. Current tax and deferred tax should be charged or credited directly to equity if the tax relates to items that are credited or charged, in the same or a different period, directly to equity.

The Securities and Exchange Commission of Pakistan (SECP) vide Circular No. 16 of 1999, directed the leasing companies that in order to achieve compliance with the Revised International Accounting Standard 12, all leasing companies during each of the five financial years beginning July 01, 1998 and ending June 30, 2003, shall provide deferred tax liability arising in that year together with a further amount equal to one fifth of

the un-provided deferred tax liability as at the beginning of the financial year ending June 30, 1999.

However, the Circular provided that subject to full compliance with the provision of IAS 12, the requirement shall be deemed to be met where, during each of the five financial years beginning July 01, 1998 and ending June 30, 2003, a leasing company consistently transfers to a Capital Reserve an amount equal to one-fifth of the aggregate amount determined in accordance with the provisions of the above said paragraph, reduced by the amount, if any, provided for deferred tax liability.

The Circular further provided that the Capital Reserves shall not be available for utilization for any purpose other than to provide for deferred tax liability. However, the method of utilizing the Capital Reserve for providing for deferred tax liability has not been specified in the Circular. Further, the Circular also does not mention the status of the Capital Reserve after June 30, 2003, meaning whether the reserve will continue to be disclosed as Capital Reserve under Equity or transferred to the liability.

Since as clarified earlier, the financial statements are prepared in accordance with IAS notified for adoption by SECP and requirements of the Companies Ordinance, 1984 and specific directives of SECP and other regulators, the treatment accorded by ABC to account for un-provided deferred tax liability as at 01 July 1998 was in accordance with the directives of SECP.

However, question remains as to how the Capital Reserve created for deferred tax would be used to offset the effect of charge for deferred tax liability as at 30 June 2003. As per the generally accepted accounting principles reserves created through appropriation of profit can only be reversed likewise.

It appears from the presentation of accounts that the Company has transferred an amount approximating to Rs. 70 million from Capital Reserves directly to Profit and Loss Account to account for reduction in deferred tax liability.

The Committee is of the view that any amount transferred to any specific reserve through appropriation account, in the absence of any specific provision in the standards and law and directives of the regulators, cannot be taken to profit and loss account. Therefore, the treatment accorded by the Company to account for reduction in deferred tax liability whereby Profit and Loss account is directly credited with corresponding debit to Capital Reserve is not in accordance with the generally accepted accounting principles.

(December 14, 2002)

## 1.2 ACCOUNTING OF SPREAD TRANSACTIONS

### *Inquiry:*

After the establishment of Futures market in the stock exchanges, we have started entering into spread transactions for XYZ Income Fund and ABC Stock Market Fund, which consist of two simultaneous transactions, the first for purchase of an underlying security (shares) on the settlement date scheduled (trading plus three days) for the security and the second for selling the security at a higher price for future settlement date.

A security bought and sold under a reverse repurchase transaction, which has to be settled at a future date, is valued by taking the net affect of the complete transaction into account. The income accrued from this transaction is recognized taking into account the allocation of such value or loss over the period between the first settlement date and future settlement date. For all practical purposes, the above transactions constitute similar to a reverse repurchase transaction and not two separate transactions.

The accrual of income over the period of transaction reflects a fair value of the net assets of the respective funds, which is fair for the new investors and also for them who wish to redeem their units.

We seek your concurrence for adopting this policy for spread transactions for the mutual funds managed by us.

**Opinion:** The appropriate Committee has considered the transaction and is of the view that the transaction does not qualify as a reverse repurchase transaction as:

- the future sale has been undertaken to protect against the price risk from fluctuations in the market; and
- sale transaction can be independently completed through settlement of differential in price on the settlement date of the transaction without actual delivery of the underlying security.

Therefore, the sale transaction is in fact a derivative, which has no cost at inception and does not qualify to be recognized as either asset or a liability but is a commitment.

The transaction could have been treated as reverse repurchase transaction if it would have been coupled with actual delivery of the underlying security and would have posed credit risk to the entity rather than the price risk from fluctuations in the market.

The Committee considers that the appropriate accounting of the transaction under IAS 39 would be as follows:

The first part of transaction, the purchase of securities, the investments should be classified as either the available-for-sale or held-for-trading and initially be recognized at cost, being the fair value of consideration given. These should be re-measured to fair value on reporting date and any resultant gain or loss on re-measurement should be taken to either equity or profit and loss account, depending on the classification, under paragraph 103 of IAS 39.

The second part of transaction may be treated as a hedge and can qualify for special hedge accounting if the hedge is deemed as effective. Methods and criteria for assessing the effectiveness of hedge are given in paragraph 146 to 152 of IAS 39.

The hedge under the above transaction can be classified as fair value hedge, as it has been entered into to protect against exposure to changes in fair value of the hedged item, the recognized asset (investments) that will affect the reported net income.

The hedge accounting for fair value hedge is given in paragraph 153 of IAS 39. It specifies two alternate treatments for recognizing gain or loss on re-measurement of a hedge:

- recognize immediately in net profit or loss;
- adjust the carrying value of hedged item and any change is recognized immediately in net profit or loss, even where the change in fair value of hedged item is recognized directly in equity.

If the hedge is deemed as ineffective, the gain or loss on revaluation of hedge should be taken to profit and loss account.

(February 8, 2003)

### 1.3

### ACCOUNTING FOR PRE-OPERATING COSTS.

#### ***Inquiry:***

We would like to draw your kind attention to ICAP's Technical Release (TR) – 20 of 2000 relating to the accounting for expenditure incurred during the pre-operating period when an enterprise is devoting substantially all its efforts in establishing a new project. According to the said TR, the expenditure incurred during the project implementation phase should be treated as under:

- “2. Formation expenses shall be written off during a period not exceeding five years commencing from the financial year in which the costs are incurred as provided in paragraph 5(C) of Part II of the Fourth Schedule to the Companies Ordinance, 1984.
3. Direct project costs should be capitalized. Indirect costs, which are not attributable to a specific asset, shall be allocated to buildings and plant and machinery in proportion to their respective costs.
4. Borrowing costs shall be dealt with in accordance with IAS 23 and provisions of the Companies Ordinance, 1984.
5. Any revenues including profit on trial runs earned during construction period shall be set off against expenditure incurred during construction period.”
2. The above treatment when analyzed in the light of International Accounting Standards (IAS) raises the following issues:

#### **(a) Formation expenses / preliminary expenses**

Paragraph 57 of IAS – 38 “Intangible Asset” states that:

57. In some cases, expenditure is incurred to provide future economic benefits to an enterprise, but no intangible asset or other asset is acquired or created that can be recognized. In these cases, the expenditure is recognized as an expense when it is incurred. For example, expenditure on research is always recognized as an expense when it is incurred (see paragraph 42). Examples of other expenditure that is recognized as an expense when it is incurred include:

- (a) expenditure on start-up activities (start-up costs). Unless this expenditure is included in the cost of an item of property, plant and equipment under IAS 16, Start-up costs may consist of establishment costs such as legal and secretarial costs incurred in establishing a legal entity, expenditure to open a new facility or business (pre-opening costs) or expenditures for commencing new operations or launching new products or processes (pre-operating costs);
- (b) expenditure on training activities;
- (c) expenditure on advertising and promotional activities; and
- (d) expenditure on relocating or re-organizing part or all of an enterprise.

In view of the above, it appears that the above-referred ICAP's TR and the provision of the Fourth Schedule to the Companies Ordinance, 1984 (the Ordinance) so far as they relate to preliminary expenses are inconsistent with the requirements of the IAS – 38. In this connection, it is also argued that the Fourth and Fifth Schedule to the Ordinance primarily deal with disclosure requirements for the financial statements and do not prescribe the accounting principles or

treatments for various items of the financial statements. Accordingly, the requirements of IAS and not the Fourth Schedule to the Ordinance be followed when accounting for preliminary expenses.

**(b) Direct and indirect project costs**

The above-referred ICAP's TR has discussed the accounting treatment of costs incurred during the pre-operating period that are directly attributable to the acquisition of property, plant or equipment or incurred in bringing such assets to the working condition. According to the TR, these costs should be capitalized as part of the cost of the related assets consistent with the requirement of IAS-16 "Property, Plant and Equipment". However, the TR has not dealt with the accounting treatment of costs incurred by service sector enterprises before the commencement of commercial operations (i.e. pre-operating period) when the enterprise is primarily engaged in activities relating to obtaining of rights / license for rendering of desired services, seeking regulatory approvals and other similar activities necessary for provision of services. The cost during such period usually comprises of:

- Legal, professional and consultancy costs including costs relating to project feasibility, surveys, financial plan, appraisals etc.
- Bidding, tendering expenses in relation to servicing rights / license
- Travelling and related expenses
- General administration overheads

The above costs are considered to have resulted in the creation of an intangible asset for the enterprise in the form of servicing rights / license from which future economic benefits are expected to flow to the enterprise. Accordingly, it is argued that, these costs should be recognized as "intangible asset" and amortized over the period of the related servicing rights.

3. The IAS – 38 defines intangible assets as follows:

"An *intangible asset* is an identifiable non-monetary asset without physical substance held for use in the production or supply of goods or services, for rental to others, or for administrative purposes."

Further, the paragraph 19 of the said IAS provides that:

19. *An intangible asset should be recognized if, and only if:*

- (a) *it is probable that the future economic benefits that are attributable to the asset will flow to the enterprise; and*
- (b) *the cost of the asset can be measured reliably.*

Paragraphs 45 states:

45. *An intangible asset arising from development (or from the development phase of an internal project) should be recognized if, and only if, an enterprise can demonstrate all of the following:*

- (a) *the technical feasibility of completing the intangible asset so that it will be available for use or sale;*

- (b) *its intention to complete the intangible asset and use or sell it;*
- (c) *its ability to use or sell the intangible asset;*
- (d) *how the intangible asset will generate probable future economic benefits. Among other things, the enterprise should demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset;*
- (e) *the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset; and*
- (f) *its ability to measure the expenditure attributable to the intangible asset during its development reliably.*

Paragraphs 54 states that:

54. The cost of an internally generated intangible asset comprises all expenditure that can be directly attributed, or allocated on a reasonable and consistent basis, to creating, producing and preparing the asset for its intended use. The cost includes, if applicable:
  - (a) expenditure on materials and services used or consumed in generating the intangible asset;
  - (b) the salaries, wages and other employment related costs of personnel directly engaged in generating the asset;
  - (c) any expenditure that is directly attributable to generating the asset, such as fees to register a legal right and the amortization of patents and licences that are used to generate the asset; and
  - (d) overheads that are necessary to generate the asset and that can be allocated on a reasonable and consistent basis to the asset (for example, an allocation of the depreciation of property, plant and equipment, insurance premiums and rent). Allocations of overheads are made on basis similar to those used in allocating overheads to inventories (see IAS 2, Inventories). IAS 23, Borrowing Costs establishes criteria for the recognition of interest as a component of the cost of an internally generated intangible asset.
4. Additionally, we would like to draw your attention to paragraph 5(C) of Part II of the Fourth Schedule to the Companies Ordinance, 1984 which *inter alia* deals with “deferred costs” and the requirement to amortize it over the period not exceeding five years. We would like ICAP to clarify whether, in view of IAS-38, is it appropriate to account for certain costs incurred having potentially enduring benefit as deferred costs”.
5. In view of the aforesaid, we seek your advice on the following:-
  - What should be the accounting treatment for preliminary expenses / formation expenses under the applicable financial reporting framework in Pakistan.
  - Whether a contract granting rights / licenses to an enterprise for rendering specific services for the design, construction and operation of assets or a combination of assets and services can be regarded an “Intangible Assets” under IAS-38 and if so, at what amount such asset be measured and recognized in the financial statements of an enterprise. Is it proper for all the

expenses incurred during the pre-operating period as discussed in paragraph 2(b) of this letter to be capitalized as part of the cost of intangible asset.

Your prompt response in respect of the above shall be highly appreciated.

**Opinion:** The appropriate Committee of the Institute deliberated your 1<sup>st</sup> inquiry and is of the view that to comply with the International Accounting Standards (IAS) all preliminary expenses should be charged off in the same period in which these are incurred, as IAS no longer have a concept of deferred costs. If an enterprise, to take advantage of concession provided for in the Fourth Schedule, opts for deferring preliminary expenses it can do so as Accounting Framework in Pakistan comprises of IAS and Companies Ordinance and notifications issued by SECP as explained in ICAP Circular No. 1 of 2003.

With regard to your second inquiry, the Committee is of the view that you may charge expenses on contract granting rights / licenses to an enterprise for rendering specific services for the design etc. under the head of 'Intangible Assets' provided they meet the criteria laid down in paragraph 19, 45 and 54 of IAS 38.

(May 17, 2003)

#### 1.4 ADOPTION OF INTERNATIONAL ACCOUNTING STANDARD 40 – INVESTMENT PROPERTY

**Inquiry:** While reviewing the annual audited accounts of XYZ Co. (Pvt.) Ltd. for the period ended December 31, 2001 it has been observed that they have applied IAS-40 in their accounts for the year ended December 31, 2001. In terms of para-8 of the IAS-40 if the portions (used to earn rentals/capital appreciation and used in the production / supply of goods or services) could be sold or leased out separately the accounts for the portions should be bi-furcated / made separately. However, the XYZ Co. accounts do not specify the bifurcation.

It may be pertinent to mention that IAS-40 was adopted and notified by SECP for the accounting periods starting on or after January 1, 2002.

We will appreciate if you consider the matter in reference to Para 70 of IAS-40 and have us your valuable opinion.

**Opinion:** IAS 40 has been adopted by the ICAP Council in its 145<sup>th</sup> meeting held on July 30, 2001 and SECP notified the same vide its SRO 57(I/2002) dated 23<sup>rd</sup> January 2002 for the accounting periods beginning on or after January 1, 2002. However, IASB encourages an earlier application of its standards.

Para 70 of IAS 40 specifies the transitional provisions to be followed at its first time application. The relevant portion of the said paragraph is reproduced below:

*Para 70. " Under the fair value model, an enterprise should report the effect of adopting this Standard on its effective date (or earlier) as an adjustment to the opening balance of retained earnings for the period in which the Standard is first adopted."*

It was observed that while adopting IAS 40 (for the first time) the company had adopted the fair value model. The difference between the carrying value of its building and its fair value was transferred to general reserve (retained earnings).

After considering the whole issue, particularly in the light of Circular No. 2 of 2003 issued by SECP, the Committee is now of the view that the treatment followed by the company was in accordance with the requirements of IAS 40. It is pertinent to note that this treatment is for the first time adoption of IAS 40. In subsequent periods, the treatment will

be different and will be according to requirements of paragraph 55 of IAS 40 as advised in our letter of September 11, 2002.

## 1.5 CAPITALIZATION OF STORES AND SPARES

**Inquiry:** I need to seek an advice regarding the accounting treatment of stores and spares. Following is the detail as desired:

### BRIEF HISTORY OF COMPANY AND PLANT

ABC Fertilizer Company Ltd. was incorporated in 1993 under the Companies Ordinance, 1984. It is listed on all the stock exchanges of Pakistan. The principal objective of the Company is manufacturing and marketing of fertilizers. It has two major plants "DAP Plant" and "UREA Plant".

### CAPITALIZATION OF STORES AND SPARES

We have around Rs.400 million stores and spares lying at our warehouse. Our plant operates 24 hrs a day and therefore it needs constant servicing and repairing. Many of the spare parts are key components and quite expensive as well. So far we have been charging the cost of spare parts to profit and loss account when we use them otherwise they remain in current assets.

According to IAS 16 paragraph 11, major spare parts and stand-by equipment qualify as property, plant and equipment when an enterprise expects to use them during more than one period. Similarly, if the spare parts and servicing equipment can be used only in connection with an item of property, plant and equipment and their use is expected to be irregular, they are accounted for as property, plant and equipment and are depreciated over a time period not exceeding the useful life of the related asset.

Do we need to capitalize the major stores and spares.

### PROBLEMS

As our plants were used plants when Company acquired them, the Company had disbursed lump sum amount for this deal. We don't have any kind of breakup of its cost. The calculation of book value of any component cannot be done in the absence of proper information. If we capitalize any major spare part then how would we write off the existing part. We cannot do estimation here. And some time the replaced part is again fabricated in our workshop and it becomes again useable after incurring some cost on it. In this case how would we write off the existing part.

We have erected a new project, which is a supporting plant to our existing ammonia plant. It is called De-sulphurization plant. Its cost is around Rs.100 million. Company has also acquired its major spares, which will be used in the coming two years. Are we required to capitalize all major spares associated with this new plant.

In the above scenario I would like to seek clarification on the following questions:-

1. Are we required to capitalize the major stores and spares?
2. If we do so, what method should we adopt. That is how should we calculate the book value of existing components. And when should spares be capitalized, at the time of their installation or purchasing?
3. Is it going to be a change in accounting policy?

4. If we capitalize the spares of new project then will this be an inconsistency in accounting treatment or should we continue as it is going.

**Opinion:** The appropriate Committee of the Institute has examined the four queries raised by you and its opinion is as follows:-

1. Yes, you should capitalize major spares. Store items are, however, not capitalized.
2. Major spares should be capitalized at the time of their purchase. Regarding the existing major spares, since you paid a lump sum for the used plant and the spares came with them and you have capitalized the entire lump sum amount, the spares have also been capitalized.

For the existing components, ideally, the lump sum cost paid earlier should have been broken up between the major components of the plant, but, since this information is not available you may assign a token value to them for accounting purpose.

3. Yes, there is a change in accounting policy, which should be appropriately disclosed in the notes to the financial statements.
4. There would be no inconsistency because you have already capitalized your existing major spares and will be capitalizing the new ones when you buy them.

(June 14, 2003)

## 1.6 **CLARIFICATION OF THE PHRASE “FIXED ASSETS” VERSUS “CAPITAL WORK-IN-PROGRESS” UNDER ACCOUNTING LAW AND PRACTICE INTERNATIONALLY AND IN PAKISTAN**

**Inquiry:** We hereby seek clarification from the Technical Committee of the Institute of the phrase “Fixed Assets” and whether “Capital Work-in-Progress” [uninstalled and un-commissioned plant & machinery], as on a Balance Sheet date, is includable in the phrase “Fixed Assets”, under Accounting Law and Practice internationally and in Pakistan.

The Law of Corporate Asset Tax (CAT), under section 12 of the Finance Act, 1991 brings to chargeability value of Fixed Assets held by the Company and shown in the Balance Sheet on a specified date of 30<sup>th</sup> June 1991.

It is common knowledge that “Capital work-in-progress” is distinguishable from “Fixed Assets”, and, as per Accounting Practice, it is shown, under an independent separate head, requiring disclosure about incomplete stage and un-commissioned status and its commitments. Further, no accounting depreciation is charged nor any tax depreciation is entitled.

However, “Fixed Assets” are being interpreted by the Tax Department to include “Capital work-in-progress” for purpose of above tax levy in the absence of any definition either in the CAT Law or even in the Law and Practice of Accountancy or in any authentic accountancy treatise.

Therefore, we seek interpretation of the Institute, being a professional body of Accountancy in Pakistan.

An early response will be appreciated.

**Opinion:** As per the general accounting practice, fixed assets are those assets that are recognized as depreciable assets at the balance sheet date. While CWIP being non-depreciable

asset, is shown separately, such disclosure does not exclude CWIP from being treated as a fixed asset.

Paragraph 61(c) of IAS 16 requires the disclosure of "the amount of expenditures on account of property, plant and equipment in the course of construction". This shows that IAS 16 also treats capital work-in progress as property, plant and equipment i.e. fixed asset.

Sub-section 12(d) of section 12 of the Finance Act 1991 relating to Corporate Assets Tax defines "value of assets" as "*the value of all fixed assets held by the company and shown in its balance sheet as on the specified date*".

### **CONCLUSION**

The above definition is silent on the 'depreciability' of assets, therefore in Committee's opinion, for the purposes of any levy under Corporate Assets Tax, the amount of fixed assets would be inclusive of capital work-in-progress.

Further you may also refer to the Lahore High Court's judgment in Writ Petition No. 20763 of Mehtab Industries Limited vs. D.C.I.T. and reported at 2002 PTD 324 and Income-tax Appellate Tribunal's decision in I.T.As. Nos 987/LB etc. in D.C.I.T. vs. Fatima Enterprises and reported at 2002 PTD(Trib) 1581.

(August 24, 2002)

## **1.7 CLARIFICATION ON SIGNIFICANT INFLUENCE IN RELATION TO ASSOCIATED/ SUBSIDIARY COMPANY**

### ***Inquiry:***

We would like to seek your advice in respect of a company, which is an associated company of another company as per agreement between them but may fall under the definition of subsidiary company.

1. Following is the brief status of above two companies:

<b><u>Company name</u></b>	<b><u>Nature of business</u></b>	<b><u>Status</u></b>	<b><u>Year ending</u></b>
AB Limited	Brokerage House	Listed Co.	June 30, 2002
YZ Limited	Asset Management Co.	Unlisted Associated Co.	June 30, 2002

1.1 AB Limited and Mr. X, the Chief Executive Officer and Chairman of AB Limited, each holds 40% of the total shares of YZ Limited, making their combined holding to be equal to 80%. The Board of Directors of YZ Limited comprises of seven (7) Directors, which includes three common directors of AB Limited. The Chairman and Chief Executive of AB Limited is one of the common directors.

1.2 The question is whether or not YZ Limited is to be considered as "subsidiary of AB Limited" owing to the effect of personal holding of 40% shares in YZ Limited by the Chief Executive of AB Limited together with his presence in the Board of Director of both the Companies?

1.3 Apparently, the direct holding of AB Limited in YZ Limited is 40% of voting securities and as such YZ Limited does not qualify as a "subsidiary company" being less than 50% holding as has been stipulated in clause (a) of sub-section 1 of Section 3 of the Companies Ordinance, 1984 reproduced below: -

For the 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 50% of its voting securities or otherwise has power to elect and appoint more than 50% 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:

Provided that, where a central depository holds more than 50% of the voting securities of a company, such company shall not be deemed to be a subsidiary of the central depository save where such voting securities are held beneficially by the central depository in its own behalf

- 2. On the other hand, no agreement in respect of voting rights or to govern the financial and operating policies of the company, exist between the management of AB Limited and YZ Limited.

The Asset Management Rules further restrict the associated company YZ Limited for not handling brokerage business of AB Limited in excess of 30% of its total brokerage transaction.

- 3. In the light of Para 12 of International Accounting Standard 27, control is presumed to exist when parent company owns one half or less of the voting power of an enterprise when there is;
  - (a) power over more than one half of the voting rights by virtue of an agreement with other investors;
  - (b) power to govern the financial and operating policies of the enterprise under a statute or an agreement;
  - (c) power to appoint or remove the majority of the members of the board of directors or equivalent governing body; or
  - (d) power to cast the majority votes at meetings of the board of directors or equivalent governing body.

However, in view of personal holding of 40% by Mr. X, the possibility of exercising significant influence does exist in the matter of governing the financial and operating policies of YZ Limited.

We shall appreciate, if guidance is provided in respect of the matter reflected in paragraph 1.2 of our letter in the light of facts mentioned above.

We look forward to your prompt response.

**Opinion:**

The question of "significant influence" has been a matter of debate among professionals in recent times and your presumption that Mr. X can exercise significant influence in view of his personal holding of 40% in YZ Limited is not entirely unfounded. However, the appropriate Committee of the Institute examined your query in the light of relevant provisions of the Companies Ordinance, 1984 and IAS 27 and is of the opinion that as there is no agreement between the CEO and Chairman of AB Ltd. and AB Ltd regarding the exercise of voting rights or to govern the financial and operating policies of YZ Ltd, the latter does not appear to be a subsidiary of AB Ltd."

(September 7, 2002)

## 1.8

### CLARIFICATION IN RESPECT OF CODE OF CORPORATE GOVERNANCE

#### **Inquiry:**

The Securities and Exchange Commission of Pakistan, vide amendment in listing requirements of Stock Exchanges, made it mandatory for listed companies to comply with the Code of Corporate Governance.

The Code prescribed various clauses relating to Directors, Audit Committee, appointment of CFO, CEO, and Internal Auditors etc.

Modarabas are listed on Stock Exchange yet they are materially different from other listed companies in their status and structure. Affairs of Modaraba are managed by Management Company, which is a non-listed company. Modaraba, itself, does not have Board of Directors, they have no obligation to hold Annual General Meeting and their certificate holders have no voting right. Hence, the requirements of Code are not practical to fulfill by the Modarabas.

In this respect, we have following questions, which as we understand, need, Institute's guidance;

Does Code apply to Modarabas? If yes;

- ◆ To what extent
- ◆ Are Directors of Management Company required to issue Statement of Compliance with Best Practices of Code of Corporate Governance along with the financial statements for the year ended June 30, 2002?
- ◆ Are the Auditors of the Modaraba required to issue review report on the Statement of Compliance with Best Practices of Code of Corporate Governance on financial statements for the year ended June 30, 2002?

We would appreciate if the Institute's Technical Advisory Committee could give their views in this regard.

#### ***Opinion:***

We are reproducing below clause 2 of Regulation 1 and clause (vi) of Regulation 2(1) respectively of the Listing Regulations of the Karachi Stock Exchange (Guarantee) Ltd:

- 1(2) The Regulations shall apply to all companies, and securities applying for listing and those listed on the Exchange
- 2(1)(vi) "Listed security" shall include any share, scrip, debenture, participation term certificate, modaraba certificate, mushariqa certificate, term finance certificate, bond, pre-organization certificate or such other instruments as the Federal Government may by notification in the Official Gazette specify for the purpose and which is accepted for listing on the Exchange in accordance with the Regulations;

Further according to clause (l) of Section 2 of the Securities and Exchange Ordinance, 1969

#### **"security" includes-**

- (i) any stock, transferable share, scrip, Modaraba Certificate, note, debenture, debenture stock, participation term certificate, bond, investment contract, and pre-organization certificate or subscription, and, in general, any interest or instrument commonly known as a "security" and, any certificate of deposit for, certificate of interest or participation in, temporary or interim certificate for, receipt

for, or any warrant or right to subscribe to or purchase, any of the foregoing but does not include currency or any note, draft, bill of exchange or banker's acceptance or any note which has a maturity at the time of issuance of not more than twelve months, exclusive of days of grace, or any renewal thereof whose maturity is likewise limited;

As such the appropriate Committee of the Institute is of the opinion that from the above definitions it appears that Modarabas do fall under the definition of "listed security" therefore, Code of Corporate Governance as incorporated in the Listing Regulations of the three Stock Exchanges would be mandatory for modarabas to comply with.

In the absence of a board of directors in the case of a Modaraba, the compliance with the Code of Corporate Governance, wherever it is possible, would appear to fall on the Board of Directors of the Management Company in respect of the Modaraba being managed by it, which would be reviewed by the statutory auditors of the Modaraba and the report issued in the format prescribed by the Institute

(October 5, 2002)

## **1.9 CODE OF CORPORATE GOVERNANCE**

### ***Inquiry:***

Recently, through the listing regulations of Karachi Stock Exchange, certain requirements have been introduced for listed companies regarding Code of Corporate Governance. Amongst these certain requirements pertain to limited scope review of the half-yearly financial statements and review and certification of statement of compliance with best practices of Corporate Governance. The relevant extracts of the listing regulations are reproduced below: -

#### **Frequency of Financial Reporting**

xxi) All listed companies shall ensure that half-yearly financial statements are subjected to a limited scope review by the statutory auditors in such manner and according to such terms and conditions as may be determined by the Institute of Chartered Accountants of Pakistan and approved by the Securities and Exchange Commission of Pakistan.

#### **Compliance with the Code of Corporate Governance**

xlv) All listed companies shall publish and circulate a statement along with their annual reports to set out the status of their compliance with the best practices of corporate governance set out above.

xlvi) All listed companies shall ensure that the statement of compliance with the best practices of corporate governance is reviewed and certified by statutory auditors, where such compliance can be objectively verified, before publication by listed companies.

In the above context, we shall appreciate if you please clarify the following questions on the subject:

- 1) Whether the above services are to be performed by a Chartered Accountant firm in the capacity of External Auditors of the company?
- 2) If answer to Question No. 1 is yes, then whether they will charge extra fee for these services and whether this will require the approval through AGM.

An early reply is solicited.

**Opinion:** The appropriate Committee of the Institute has examined your queries and is of the opinion that relevant clauses of the Code of Corporate Governance mentioned in above queries are self-explanatory and require only the statutory auditor(s) to review the half-yearly financial statements and review the Statement of Compliance with Best Practices of Corporate Governance by the directors.

The Committee is also of the opinion that the scope of review of Statement of Compliance with Code of Corporate Governance and review of six-monthly financial statements are two distinct jobs and do not fall in the purview of statutory audit. Therefore these should be taken as separate assignments and separate fees should be agreed with the statutory auditor(s).

Clause (b) of sub-section (8) of section 252 of the Companies Ordinance, 1984 relates to remuneration of auditors for statutory audit only. As the two assignments under reference fall outside the purview of statutory audit, approval of fees is not required by the company in general meeting.

(September 7, 2002)

## 1.10 COMPLIANCE WITH IAS-19 IN RESPECT OF GRATUITY

**Inquiry:** Q.1 Is it necessary to use actuarial assumptions using Projected Unit Credit Method (i.e. expected salary in future, expected rise in salary in future etc.)

Or

Can the following policy adopted by a company be considered in compliance with IAS-19 regarding Gratuity.

*The Company operates an unfunded gratuity scheme for all its employees. Liability in respect of gratuity payable to employees has been fully provided for in these accounts. Gratuity dues are arrived at by multiplying the last salary of each employee with the number of years in service. Thus the liability so determined is in fact more realistic and actual considering that the employee might leave on that date and in fact takes into account the effects of discounting rate, increase in salary and return as required by the IAS.*

The question is not regarding whether an actuary shall be involved or not in the actuarial valuation, but whether the basis adopted by the company (as mentioned in the policy above) will tantamount to be in compliance with IAS 19.

As regards that the auditor is satisfied in all material respects to issue a clean report, the effect cannot be determined unless separate working is done by means of actuarial valuation.

We are of the opinion that these liabilities are estimates, and estimates can be worked out by different methods. However we feel that the amount if determined by the actuarial valuation method will not be more than the liability already booked under the above-mentioned policy.

**Opinion:** The appropriate Committee of the Institute has examined various queries raised by you and its views are as under:

1. Yes it is necessary to use actuarial assumptions using Projected Unit Credit Method to comply with paragraph 64 of IAS-19 which requires that "An enterprise should use the Projected Unit Credit Method to determine the present value of its defined benefit obligation and the related current service cost and, where applicable, past service cost"

2. In order to comply with the requirements of IAS the Company has to determine its liability in respect of gratuity by taking into account certain factors of discounting rate, increase in salary and return as required by the IAS.
3. Further if the auditor is satisfied with the assumptions made by the management, in all material respects, then a clean report should be issued.
4. It may also be noted that before this revision, IAS-19 suggested actuarial valuation at least every three years (IAS 19.27).
  27. Because of the potentially significant effect of differences between assumptions and experience, it is necessary to determine the cost of retirement benefits by obtaining actuarial valuations at frequent intervals; at least every three years is appropriate. Additional valuations are appropriate in intervening years when significant changes in the circumstances of the plan are known to have taken place or when events indicate that one or more of the assumptions may have to be modified.

The revised IAS in its paragraph 56 uses the words with sufficient regularity as quoted below:-

56. *An enterprise should determine the present value of defined benefit obligations and the fair value of any plan assets with sufficient regularity that the amounts recognized in the financial statements do not differ materially from the amounts that would be determined at the balance sheet date.*

If an auditor is not satisfied with the provision for defined benefit obligations, he can always seek the assistance of an expert on his own as provided for in paragraph 6 of ISA-620 on *Using the Work of an Expert*.

6. During the audit the auditor may need to obtain, in conjunction with the entity or independently, audit evidence in the form of reports, opinions, valuations and statements of an expert. Examples are:
  - Determination of amounts using specialized techniques or methods, for example, an actuarial valuation.

But the Committee wishes to make it clear that irrespective of the assistance of an expert, the ultimate responsibility for assessing the appropriateness of the provision will lie on the auditor only as detailed in the ISA referred to above.

(June 14, 2003)

## 1.11 CONSOLIDATED FINANCIAL STATEMENTS.

### ***Inquiry:***

We have been requested by our client, ABC Bank to seek a clarification whether or not ABC Bank will be required to prepare consolidated financial statements even though the aggregate assets of the subsidiaries are negligible in the context of total assets of ABC Bank. For this purpose we set out below the relevant requirements of the International Accounting Standards (IAS) and the reasons why ABC BANK did not issue consolidated financial statements for the year ended December 31, 2001.

As per paragraph 12 of Preface to the International Accounting Standards, ***“International Accounting Standards are not intended to apply to immaterial items”***. (Please note that this statement is printed at the beginning of all the IAS).

Paragraph 30 of the Framework for the preparation and presentation of financial statements to the IAS describes materiality as follows:-

***“ Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatements. Thus materiality provides a threshold or cut – off point rather than being a primary quantitative characteristic which information must have if it is to be useful.”***

The estimated financial impact as per the consolidated financial statements compared to the bank’s financial statements as at December 31, 2001 is summarized below:-

	<b><i>Rupees in million</i></b>
Total assets of subsidiaries	1,120
Less: BANK investment which would be eliminated on consolidation	633
	-----
Increase in total assets of the ABC BANK in case of consolidation	487
	=====
Out of the above:	
Minority interest	37
Liabilities	450
	-----
	487
	=====

As against the above, ABC Bank's total assets amounted to Rs. 415,089 million. Therefore, as a result of consolidation, the total assets will increase by only Rs. 450 million or 0.1% and the minority interest in the consolidated financial statements would be reflected at Rs. 37 million viz 0.009% of total assets.

In view of the above facts, you will appreciate that in case the consolidated financial statements are prepared, they would be almost exactly the same as those of the bank and we consider that such financial statements would not serve any useful purpose of any of the users/stake-holders of the bank. Consequently, we consider that the preparation and publication of consolidated financial statements are not required, as the requirements of IAS-27, like the requirements of all other IAS, do not apply to immaterial items.

In the light of the above, we request you to kindly provide us your confirmation that the consolidated financial statements are not required to be prepared by ABC BANK.

**Opinion:**

The appropriate Committee of the Institute has reached the consensus that in view of the recent amendment in section 237 of the Companies Ordinance, 1984, the concept of materiality cannot be applied to the preparation of consolidated financial statements. The holding companies have to prepare consolidated financial statements in respect of all subsidiaries except those excluded by paragraph 13 of IAS 27.

(February 1, 2003)

1.12

## **MATTER OF FREE RESERVE OF ABC RE-INSURANCE COMPANY LIMITED FOR ISSUE OF BONUS SHARES**

### ***Inquiry:***

We are forwarding relevant details pertaining to the subject matter for favour of the opinion of the appropriate committee of the Institute of the matters referred to in paragraph (a) and (b) below:

1. ABC Reinsurance Company Limited (ABC) was incorporated under Companies Ordinance, 1984 pursuant to Presidential Order No.XXXVI of 2000 to takeover business properties, liabilities and rights of XYZ Insurance Corporation (XYZ) on February 14, 2001.
2. XYZ was to be wound up by the Federal Government and manner of such winding up was to be directed by the Federal Government under clause 38 of the relevant Act. The Federal Government has directed no such manner.
3. ABC has taken over Reserves of Rs.1,067.0 million from XYZ including Rs.631.0 million of such reserves, classified as Exceptional Loss Reserve. Such Exceptional Loss Reserve is being treated as capital reserves by the other Insurance Companies of Pakistan.

We need your professional advice on the following matters.

- a) Can reserves taken over by ABC from XYZ be treated as Free Reserves?
- b) Can Exceptional Loss Reserve be treated as available for distribution as bonus shares?

Kindly place the matter in the meeting of the appropriate committee, scheduled to be held on Saturday, November 02, 2002.

### ***Opinion:***

Insurance companies were allowed to create Exceptional Loss Reserves in pursuance to the Income Tax Act, 1922. Under this Act, set aside of a proportion of premium earnings (net of reinsurances) was treated as an allowable deduction in arriving at the taxable income. The Income Tax Ordinance, 1979 subsequently withdrew this option, with retrospective effect to the accounting year ended December 31, 1978. From this time forth, the insurance companies ceased to set aside such amounts however, a few of them have continued to retain Exceptional Loss Reserves created up to December 31, 1978.

Relevant provisions of Income Tax Act, 1922 regarding Exceptional Loss Reserve are reproduced below:

Schedule I – 6 (2)      Where a company sets-aside a portion of its income, profits and gains to meet exceptional losses, so much of such portion as does not exceed ten percent of the premium income of the year in which it is set aside shall be deducted from the balance of the profits referred to in sub-rule (1).

Schedule I – 6 (3)      The amount deducted under sub-rule (2) in any year together with the amounts, if any, deducted or carried to a reserve in earlier years to meet exceptional losses (as reduced or the amounts, if any paid out of such amounts or reserve to meet exceptional losses) shall not exceed the premium income of that year or the average premium income of the three years immediately preceding that year, whichever is the higher.

Schedule I – 6 (4) “Notwithstanding anything to the contrary contained in this Act where any amount is paid, appropriated or diverted out of or from the amounts deducted under sub-rule (2) for purposes other than the meeting of an exceptional loss, such amount shall, together with the other premium income, if any, of the company for the year in which such payment, appropriation or diversion takes place, be deemed to be the premium income of the company for that year; and in the event of the liquidation of the company or the discontinuance of the business to which this rule applies, whichever is the earlier, the aggregate of the amounts deducted under sub-rule (2) (as reduced by the payments made out of such amounts to meet exceptional losses) shall, together with the other income, if any, of the company for the year in which it goes into liquidation or in which such business is discontinued be deemed to be the income of the company for that year”.

### **CONCLUSION**

In view of the explanations detailed above, the appropriate Committee has concluded that if the directors of the company feel that an Exceptional Loss Reserve is no more required or there are no indications that an exceptional loss may occur in the future (for which they need to carry the reserve) then the reserves can only be utilized after routing it through the profit and loss account where the amount will be treated as deemed income of the current year. The reason being that when this reserve was created, it was treated as an admissible expense therefore no tax had been paid on the same. Now if the management wishes to utilize Exceptional Loss Reserve as a free reserve then it has to pay the due share of tax before its distribution as bonus shares.

This response answers your query (a) also.

(November 2, 2002)

### **1.13 OFF-SEASON COST**

#### ***Inquiry:***

As you are aware sugar industry is a seasonal industry and it is a recognized fact that first six months of the accounting year include a peak period when sugarcane is procured and crushed and second six months, “off-season” period during which, at best minimal amount of crushing activity is carried on but the factory cost continues to be incurred. The annual profit and loss account therefore, reflects the combined results of the activities in both these periods.

2. The Companies Ordinance, 1984 requires listed companies to publish interim accounts based on the same accounting principles as those adopted in the preceding annual accounts. As such the frequency of an enterprise’s reporting annual, half-yearly, or quarterly should not affect the measurement of its annual results. To achieve that objective, measurement for interim reporting purposes are made on year-to-date basis (clause 7 of “Introduction” to IAS-34, refers).
3. In the light of the above, we would seek your considered advice regarding the treatment to be given for off-season cost while preparing the interim accounts keeping in mind that almost total production activity is over by end March each year:
4. We are of the view that in case the off-season cost is disregarded while issuing half-yearly interim financial statements, it will result in:

- (a) Portraying a distorted picture of the operating results on account of matching principles.
  - (b) Profit & Loss Account will show inflated gross profit and net profit in the periodical interim accounts.
  - (c) Cost of manufacture in the second half-year will increase upon charging of the off-season cost without there being any manufacturing activity or at best a minimal amount of production.
5. It is important to point out that half-yearly interim accounts of a listed company are also subject to limited scope of audit review and requires the auditors to state that "company's financial statements are presented fairly in all material respects in accordance with the approved accounting standards". In the event the appropriate portion of the estimated off-season cost is disregarded then this would amount to unfair presentation of interim accounts. It is therefore imperative that where the appropriate portion of the estimated off-season cost is not accounted for, a disclosure to this effect be made in the accounts and a reference to this effect be made in the auditors' report.

We would appreciate to receive your advice at the earliest so as to ensure that the sugar industry's interim accounts are presented fairly and on the uniform basis.

The undersigned would be available to appear in person and discuss the matter further should you so desire.

Further your kind attention is drawn to IAS-18 "Measurement of Revenue", which inter alia provides:

**Sale of Goods**

14. Revenue from the sale of goods should be recognized when all the following conditions have been satisfied:
- (a) the enterprise has transferred to the buyer the significant risks and rewards of ownership of the goods;
  - (b) the enterprise retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over goods sold;
  - (c) the amount of revenue can be measured reliably;
  - (d) it is probable that the economic benefits associated with the transaction will flow to the enterprise; and
  - (e) the costs incurred or to be incurred in respect of the transaction can be measured reliably.

A part of the sugar produced during first six months of the financial year is also sold by March end and the total revenue on account of sale, if recognized then the cost to be incurred has to be measured and adjusted against the revenue in order to arrive at the correct operating results in the interim accounts. This process is commonly referred to as the matching revenues and costs. This is only possible if consideration is given for the cost to be incurred during off-season period while recognizing the revenue in the interim accounts.

Further I also enclose a copy of the review report of one of the companies in South Africa having sugar division, where on page 3 of 4 has been stated that:

“The un-audited results of the Group for the half-year ended 30 June 2002 have been prepared on a basis consistent with the prior year’s un-audited interim report and the audited annual financial statements at 31 December, 2001. The principal accounting policies of the Group conform with South Africa Statements of Generally Accepted Accounting Practice. As the earnings of Tongaat-Hulett Sugar are seasonal, 50% of the current year’s estimated results have, as in previous years, been included in the income statement for the half-year. Apart from this, the interim report has been prepared in accordance with accounting standard AC 127 (Interim Financial Reporting)”

We would appreciate to receive Institute’s advice vis-à-vis treatment of off-season cost and revenue recognition for the interim accounts of the half-year ended March 31, 2003.

**Opinion:**

For a meaningful examination of queries raised by you relating to accrual of off-season cost in the interim financial statements, the appropriate Committee of the Institute would like to draw your attention to the following provisions of International Accounting Standards and United States Financial Accounting Standards Board pronouncement on interim financial reporting:

1. IAS 34 – *Interim Financial Reporting* – Paragraph 39:

Costs that are incurred unevenly during the enterprise’s financial year should be anticipated or deferred for interim reporting purposes if, and only if, it is also appropriate to anticipate or defer that type of cost at the end of the financial year.

2. IAS 34 – *Interim Financial Reporting* Appendix B Paragraph 2

The cost of a planned major periodic maintenance or overhaul or other seasonal expenditure that is expected to occur late in the year is not anticipated for interim reporting purposes unless an event has caused the enterprise to have a legal or constructive obligation. The mere intention or necessity to incur expenditure related to the future is not sufficient to give rise to an obligation.

3. IAS 37 – *Provisions, Contingent Liabilities and Contingent Assets* paragraph 10:

A provision is a liability of uncertain timing or amount

A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.

4. Financial Accounting Standards Boards (FASB) – Accounting Principles Board’s opinion 28 paragraph 18

**“Seasonal Revenue, Costs, or Expenses**

Revenues of certain enterprises are subject to material seasonal variations. To avoid the possibility that interim results with material seasonal variations may be taken as fairly indicative of the estimated results for a full fiscal year, such businesses shall disclose the seasonal nature of their activities, and **consider supplementing their interim reports with information for 12-month periods ended at the interim date for the current and preceding years.**”

Off-season cost basically comprises of heavy repairs and maintenance to prepare the plant for the next season operations, salary and wages of skeleton

permanent staff and depreciation. None of these costs can be treated as a liability arising from past events and would not qualify to be provided for. The appropriate Committee is of the opinion that any accrual of off-season cost in interim financial statements would appear to be as not a very appropriate attempt to smooth the operating results over all the interim periods constituting a full fiscal year. It is for this reason that IAS-34 prohibits such anticipation of future expenses unless the future expenditure gives rise to a true liability in the interim period or meets the test of being a contingency which is probable and the magnitude of which may be estimated reasonably.

The Committee is also of the opinion that the various provisions of IAS-18 as quoted by you cannot be applied to accrual of off-season cost.

However the Committee is also of the opinion that the suggestion in the APB opinion as quoted above may be considered by the sugar industry to guide the various stakeholders in respect of their interim financial statements.

Regarding your quotation from the interim report of one of the companies in South Africa – having sugar division, the Committee has sent an e-mail to the company to seek details as the statement in the interim financial report is not very clear. Further AC 127 is same as IAS-34 and notwithstanding the clarification from the industry concerned, the opinion of the Committee as stated above, would not be subject to any review.

(May 17, 2003)

## **1.14 OPINION ON IAS 32 AND IAS 39**

### ***Inquiry***

ABC Corporation is a Non Banking Financial Institution (NBFI). After the adoption of IAS 39 by the Securities and Exchange Commission of Pakistan, we are facing some difficulties in the application of IAS 32 and IAS 39. Our observations are as follows: -

2. Paragraph 69 of IAS 39 states that:

“After initial recognition, an enterprise should measure financial assets, including derivatives that are assets, at their fair values, without any deduction for transaction costs that it may incur on sale or other disposal, except for the following categories of financial assets, which should be measured under paragraph 73:

- (a) loans and receivables originated by the enterprise and not held for trading;
- (b) held-to-maturity investments; and
- (c) any financial asset that does not have a quoted market price in an active market and whose fair value cannot be reliably measured (see paragraph 70)

Financial assets that are designated as hedged items are subject to measurement under the hedge accounting provisions in paragraphs 121-165 of this Standard”

3. Further, paragraph 73 of same IAS states that:

“Those financial assets that are excluded from fair valuation under paragraph 69 and that have a fixed maturity should be measured at amortized cost using the effective interest rate method. Those that do not have a fixed maturity should be measured at cost. All financial assets are subject to review for impairment as set out in paragraph 109-119”.

4. Whereas, paragraph 77 of IAS 32 states that:

"For each class of financial asset and financial liability, both recognized and un-recognised, an enterprise should disclose information about fair value. When it is not practicable within constraints of timeliness or cost to determine the fair value of a financial liability with sufficient reliability, that fact should be disclosed together with information about the principal characteristics of the underlying financial instrument that are pertinent to its fair value".

5. We seek your guidance in deciding the matter that if loans and receivables originated by the enterprise are not required to be measured and carried at fair value, as stated in paragraph 69 of IAS 39 (reproduced above), do we have to give disclosure as per paragraph 77 of IAS 32?
6. Our contention is that when we are not measuring loans and receivables originated by the enterprise at fair value, disclosure of the same is also not required under IAS 32.
7. We further seek your guidance, after adoption of IAS 39, whether it is necessary to disclose all financial assets and liabilities at fair value as prescribed in IAS 32.
8. Your immediate response to the query would be highly appreciated, as we have to finalize our accounts in the first week of August 2002.

### **Opinion**

Before dilating on the issue of disclosure of fair value of financial instruments it is pertinent to note the basic presumptions underlying the financial statements. The basic presumption is that the assets are recorded at values not exceeding their recoverable values and the liabilities are recorded at values not lower than the amount at which these are to be settled. These are the fair values presumptions.

IAS 39 provides framework for recognition and measurement of financial instruments. It provides that the financial assets or liabilities for which active market is available should be valued at market value best reflecting their fair value. Further, the assets and liabilities with fixed maturities and returns are valued at amortized costs. All other assets and liabilities are valued at cost.

IAS 39 provides that financial assets originated by enterprises should be recognised at cost, but impairment of such assets should be considered at criteria prescribed therein. The loans and receivables originated by the enterprises net off impairment losses would effectively reflect their fair values.

In the light of the above the replies to your queries contained in 5, 6 & 7 above are as follows:

5. Yes, loans and receivable originated by enterprise are financial instruments and would need to be disclosed at fair values as required by IAS 32, please also refer to paragraphs 79 to 87 for further guidance.
6. As explained above, the loans and receivable originated by the enterprise net of impairment losses would approximate their fair values, though in some cases the fair values of some loans and receivables may be higher than cost. For example, in term loans and receivables which carry a higher rate of return than present rates prevailing in the market, the fair values may be higher than cost.

Therefore, the contention is not appropriate and these would need to be disclosed in the notes

7. Yes, the fair value of financial assets and liabilities would need to be disclosed in accordance with IAS 32, as IAS 39 only provides framework for recognition and

measurement of financial assets and liabilities whereas IAS 32 provides disclosure requirements relating to these assets and liabilities.

(August 24, 2002)

## 1.15 PRIOR YEARS' ADJUSTMENTS AND DEPRECIATION ON SEASONAL WORKING

**Inquiry:** Your attention is invited to the following IAS for guidance-

1. IAS – 8 as revised in 1993 Clause 18

It has been provided that prior years adjustments and reversal of provisions will be shown under the head "other Income". There seems to be a need of reconsideration as the head "other income" becomes misleading when prior years adjustments are shown under this head. In fact these are not current activity and should not fall under "other income".

2. IAS – 16 Revised 1998

Provides charging of depreciation for full year in spite of limited use. After introduction of Income Tax Ordinance, 2002 when Tax depreciation is to be allowed on the number of operational days, seasonal industries will face a problem. Depreciation should have link to useful life as well as operations and depreciation for idle period should not be required to be charged.

Your early advice shall be appreciated.

Further to my letter dated March 7, 2003, to elaborate my point on IAS-8, there are certain provisions, which due to operation of law, result of Court's decisions or settlements require to be reversed. To show these as "other income" for the year does not seem appropriate. For example in our case Government raised the rate of road-cess during 1991, which was challenged in Courts and provided but not paid. Now through a settlement with Provincial Government that increase has been withdrawn and provision is required to be written back. Showing it as "other income" in current year's Income Statement, to me, seems to be something, which may not give a real and correct picture.

This and similar provisions, which were previously shown as "Prior years adjustments" below the line are in fact "prior years adjustments"

I shall be waiting for considered opinion in the matter.

**Opinion:** To examine your query at (1) above in the proper perspective, the appropriate Committee of the Institute would like to first draw your attention to following paragraph 59 of IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*:

### Paragraph 59 of IAS 37

*" Provisions should be reviewed at each balance sheet date and adjusted to reflect the current best estimate. If it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision should be reversed."*

and the accounting treatment of the estimates is given in paragraphs 26 and 28 of IAS 8 which read as follows:-

### Paragraph 26 of IAS 8

26. *The effect of a change in an accounting estimate should be included in the determination of net profit or loss in:*
- (a) *the period of the change, if the change affects the period only; or*
  - (b) *the period of the change and future periods, if the change affects both.*

**Paragraph 28 of IAS 8**

28. *The effect of a change in an accounting estimate should be included in the same income statement classification as was used previously for the estimate.*

Further IAS 8 allows only fundamental errors to be adjusted retrospectively whereas for the accounting estimates this treatment is not appropriate as these estimates by their nature are approximations that may need revision, as additional information becomes known. Therefore your concerns that the treatment prescribed by IAS 8 for reversal of provisions may not give a real or correct picture is not appropriate.

With regard to your second query that IAS 16 provides charging of depreciation for full year in spite of limited use is not correct, as it is nowhere mentioned in IAS 16 that depreciation is to be provided for full year in spite of limited use. Instead in paragraph 6 of the definition it has been defined that

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

Useful life is either:

- (a) the period of time over which an asset is expected to be used by the enterprise; or
- (b) the number of production or similar units expected to be obtained from the asset by the enterprise.

For your concerns regarding the useful life and the idle period you may refer to the following paragraph 4 of TR-11 issued by ICAP: -

- “4. With regard to assets used in the operations of seasonal nature, the rates of depreciation determined initially, impliedly take into account the useful lives based on such seasonal operations. The rate and consequently the amount of annual depreciation so determined should thus not be adjusted further to commensurate with the length of seasonal operations in an accounting period.”

(April 5, 2003)

**1.16 RECOGNITION OF INTEREST ON DEFENSE SAVING CERTIFICATES HELD BY AN EMPLOYEES' PROVIDENT FUND**

***Inquiry:*** One of our client wishes to incorporate a change in accounting policy relating to Income recognition on interest bearing instruments (i.e. Defence Saving Certificates), by applying Internal Rate of Return (IRR) method.

The characteristics of Defence Saving Certificates (DSCs) are quite different from other fixed interest bearing deposits/certificates. Recognition of interest computed on IRR basis in case of DSCs, may inflate the value of the security. IAS 18, 32 & 39 are not detailed sufficiently to cover DSCs or any similar financial instrument.

In our opinion, IRR method may not be applied in accruing interest on DSCs. Instead, interest may be accrued according to the schedule given at the back of each DSC.

We seek your advice and direction whether IRR method of accruing interest on DSCs can be applied in Pakistan and will be in line with IAS.

**Opinion:** First we would like to draw your attention towards paragraph 10 of IAS-39, which reads:

***Held-to-maturity investments are financial assets with fixed or determinable payments and fixed maturity that an enterprise has the positive intent and ability to hold to maturity (see paragraphs 80-92) other than loans and receivables originated by the enterprise.***

Further according to paragraph 73 of IAS 39, 'Held-to- maturity investments' shall be measured at amortized cost if enterprise has the positive intent and ability to hold the investment to maturity.

The definition paragraph 10 of IAS 39 explains the calculation of amortization to be used as the effective interest method. It is the rate that exactly discounts the expected stream of future cash payments through maturity, or the next market-based re-pricing date to the current net carrying amount of the financial asset or financial liability. That computation should include all fees and points paid or received between parties to the contract. The effective interest rate is sometimes termed the "level yield" to maturity or to the next re-pricing date and is the internal rate of return (IRR) of the financial asset or financial liability for that period.

In view of the above discussions, the Committee is of the opinion that if the Defence Saving Certificates satisfy the criteria mentioned above then these investments should be measured at amortized cost by applying effective interest rate method.

Examples are enclosed in annexure "A" for the sake of understanding the effective interest rate.

**ANNEXURE "A"**

**EXAMPLE 'A'**

**RATE OF INTEREST GIVEN IN DSCS**

Years Nos	Value of Investment Rs	Interest Rs	Interest Rate %
0	100		
1	114.5	14.50	14.50
2	132	17.50	15.28
3	153	21.00	15.91
4	178	25.00	16.34
5	208	30.00	16.85
6	246	38.00	18.27
7	296	50.00	20.33
8	354	58.00	19.59
9	429	75.00	21.19
10	525	96.00	22.38

**425**

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**EXAMPLE 'B'**

**EFFECTIVE RATE OF INTEREST (ERI) AS PER  
IAS 39**

ERI = 18.04%

Years Nos	Value of Investment Rs	Interest Rs	Interest Rate %
0	100		
1	118.0	18.04	18.04
2	139.3	21.29	18.04
3	164.5	25.14	18.04
4	194.1	29.67	18.04
5	229.2	35.02	18.04
6	270.5	41.34	18.04
7	319.3	48.80	18.04
8	376.9	57.60	18.04
9	444.9	67.99	18.04
10	525.2	80.26	18.04

**425.16**

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**Note:**

In the Example 'A' It will be noticed that interest rate is not uniform which is against the spirit of IAS 39

Whereas in Example 'B' rate of interest is uniform and according to IAS 39. This rate is very easy to

calculate by applying IRR formula given in formulae list of MS Excel software or any other spread-sheet software.

(July 6, 2002)

## 2. AUDITING

### 2.1 AUDITOR'S DISCLOSURE ON THE IMPAIRMENT OF ASSETS OF LEASING COMPANIES

**Inquiry:** The lease rentals receivable being shown in the balance sheet of a leasing company is the most important asset of the company.

However, as a practice, the auditors do not mention the total amount of 'infected' lease rentals receivable against which provisions have been made in the accounts for overdue rentals as required by law.

If a total amount of Rs.100 million lease rentals are receivable from a client and only Rs.20 million is 'Overdue' requiring provisions as per law, the fact of infection of the balance Rs.80 million lease portfolio remains un-addressed, unmentioned and undisclosed.

If a client cannot pay Rs.20 million out of Rs.100 million lease rentals receivable, how can one expect him to be able to pay the balance of Rs.80 million or pay it without default.

The total of the lease rentals receivable against which any provisions have been made should be indicated / mentioned in a note form in the balance sheet for the benefit of the users of the accounts.

Shareholders, TFC holders, bankers, depositors or the credit rating company relies on the auditors' reports and comments on the balance sheet for making their decisions and have no access to private information of the status of the leases and it may come to them as a rude shock to find leases going bad without any prior warning / indication.

The above observation is submitted for your necessary action.

**Opinion:** Your assertion that "auditors do not mention the total amount of "infected" lease rentals is not appropriate. The Committee would like to clarify that it is "the board of directors of a company which is responsible for the preparation and presentation of its financial statements. (IAS 1.6) and the

"responsibility of the auditor is to express an opinion on the financial statements based on the audit" (ISA 700.9).

Parameters for audit have been laid down in various ISA, most pertinent to the query under reference are ISA 400 on *Risk Assessment*, ISA 560 on *Subsequent Events* and ISA 580 on *Management Representations*.

As provided in Form 35A, " it is the responsibility of the company's management ..... to prepare and present the financial statements in conformity with the approved accounting standards" which inter alia include IAS 39, *Financial Instruments: Recognition and Measurement*.

Paragraph 112 of IAS 39 states:-

Impairment and uncollectability are measured and recognized individually for financial assets that are individually significant. Impairment and uncollectability may be measured and recognized on a portfolio basis for a group of similar financial assets that are not individually identified as impaired.

You may be aware that IAS 30 is applicable to leasing companies with effect from 1<sup>st</sup> July 2002. Paragraphs 43 to 49 of that IAS very much take care of the issue raised by you.

In the light of above the Committee is of the view that apprehension expressed in your enquiry is adequately taken care of.

(July 6, 2002)

## 2.2 AUDITOR'S RESPONSIBILITY

**Inquiry:** It was observed that a particular note of the financial statements was missed out in the published annual report. The auditor's signed copy available in the audit working papers file contained the note, while the published financial statements did not. The amount involved in the note was not material.

Kindly advise what is auditor's responsibility in such cases.

**Opinion:** The appropriate Committee of the Institute is of the view that there is nothing in the accounting and auditing standards and in the Companies Ordinance, 1984 which deals particularly with the above mentioned issue. ISA 560 on *Subsequent Events* is also silent on this issue.

However the Committee is of the view that auditors should communicate forthwith with the clients and inform them about the omission. Further the auditors should also advise their clients to inform the Securities and Exchange Commission of Pakistan and the relevant stock exchange.

If due to time constraint or any other reason it is not possible for the management to send corrigendum to the shareholders, the auditors should see that the management or board of the directors inform the shareholder about the omission at the AGM at least.

Further according to the explanation of section 255, auditors are entitled to attend Annual General Meeting and may inform the shareholders themselves if management fails to do so.

(July 6, 2002)

## 2.3 AUDITORS' REVIEW REPORT ON THE ACCOUNTS OF THE LISTED COMPANIES FOR THE PERIOD ENDED DECEMBER 31, 2002

**Inquiry:** Your attention is invited to the statutory requirement of circulation of accounts by the listed companies for the above period.

Our submissions are as follows: -

- (i) The Code of Corporate Governance No. xxi as embodied in the Listing Regulations of the Stock Exchanges of Pakistan requires the circulation of half-yearly financial statements subject to limited scope review.
- (ii) The format of Auditors Review Report to the members on the half yearly financial statements has been approved by the SECP vide its letter No. SECP/ICAP/EM/36/2000/117 dated 27-2002 as required by clause xxi of the Code of Corporate Governance.
- (iii) The Code of Corporate Governance code No. xxi and the approved format of the Auditors review report refers to the period of half-year ended on the date of the balance sheet.

- (iv) Section 39 of the Companies (Amendment) Ordinance, 2002 dated 26-10-2002 amends Section 245 of the Companies Ordinance, 1984 to the effect that now listed companies are required to circulate the accounts to the members for each quarter instead of half-year.
- (v) In view of the amendment in the Companies Ordinance, 1984, there is no occasion to circulate half-yearly accounts for the period ended 31-12-2002. The reference to half-year in the approved format of review report is no more relevant.

In view of the above, it is requested to clarify whether we can substitute the words "quarter" for the words "half-year" in the approved format of the Auditors review report.

An early response shall be appreciated.

**Opinion:** 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.

The Committee does agree with you that Companies (Amendment) Ordinance 2002 has substituted the word " half-yearly " with "quarterly" in section 245 of the Companies Ordinance, 1984 but the review of half-yearly financial statements is governed by clause (xxi) of the Code of Corporate Governance as embedded in Regulation No. 37 of the Karachi Stock Exchange. The Companies (Amendment) Ordinance, 2002 has in no way superceded the relevant Listing Regulation. In view of the foregoing the Committee is of the opinion that there is no justification to substitute the word "quarter" for the word "half-year" in the approved format of the Auditors Review Report on Half-Yearly Financial Statements.

For further clarification you may also refer to Circular No. 16 of 2002 dated December 11, 2002 issued by SECP.

(March 6, 2003)

#### 2.4 **FORM OF AUDIT REPORT FOR WPPF ETC.**

**Inquiry:** There is no standard format of Auditors' Report to the Board of Trustees of Workers' Profit Participation Fund, Provident Fund and Gratuity Fund. We seek your opinion on the issue where: -

1. the standard format of Auditors' Report to Trustees/Board of Governors/Management Committee of Societies / NGO's and Charity Organizations as prescribed by ATR-17 may be used for the issuance of Auditors' Report on the financial statements of these funds after necessary modifications (to be suggested by you)? and
2. if not, what would be the standard format of Auditors' report to the Board of Trustees of above stated funds?

An early response shall be highly appreciated.

**Opinion:** The appropriate Committee of the Institute considered your above query and is of the view that the format of audit report given in ATR-17 is applicable to only those organization that are Societies, NGOs and Charity Organizations and is not meant for the Funds you have referred to in your query.

With regard to your second query you may refer to Appendix 2 to ISA 800 'The Auditor's Report on Special Purpose Audit Engagements'.

(April 5, 2003)

## **2.5 MINIMUM FEE FOR AUDIT ENGAGEMENTS**

**Inquiry:** Please refer to ATR -14 (revised) prescribing minimum audit fee for audit engagements.

We seek clarification regarding applicability or otherwise of this minimum fee criteria on the audit clients other than companies, because the same is not conveniently discernible from the ATR.

Included in concerns other than companies are public sector corporations, autonomous bodies, non-governmental organizations, sole proprietorships, partnerships etc.

We shall appreciate an early consideration and guidance on the issue.

**Opinion:** The appropriate Committee of the Institute has deliberated your enquiry and is of the opinion that most of the public sector corporations and autonomous bodies fall within the ambit of a body corporate, and minimum audit fees as prescribed for "Other companies" should be applied to them.

However, for those organizations, which cannot be treated, as above, the minimum hourly rates as mentioned in the revised ATR should be kept in view while agreeing audit fee with the managements of the organizations concerned.

(June 14, 2003)

## **2.6 RESPONSIBILITY AS CO-AUDITORS**

**Inquiry:** We would like to inform you that we are the co-auditors with a big professional firm, of a Listed Company. The other auditors are willing to cover all areas of the audit.

We came to know that the intention of the management of the company of our appointment and involvement was to the extent in review of the work performed by the other auditors and finalization of financial statements.

Your technical advice is sought, whether our firm shall be able to discharge our responsibility by involvement in review of work performed by the other auditors and finalization of the financial statements.

An early reply is awaited as the listed companies are required to circulate their financial statements in four months, i.e. by the end of October 2002 and we have to plan accordingly, therefore kindly expedite.

**Opinion:** The appropriate Committee of the Institute would like to point out that the term "Joint or Co-Auditors" has not been defined anywhere in the Companies Ordinance, 1984, International Standards on Auditing or in the Chartered Accountants Ordinance, 1961. Therefore, if more than one statutory auditor is appointed under Section 252 of the Companies Ordinance, 1984, then, all the auditors will be jointly and severally responsible for the entire audit work and none would be absolved on the basis of any understanding between the joint auditors or management

In view of the above the Committee is of the opinion that as you have all the powers and duties as laid down in Section 255 of the Companies Ordinance, 1984 and ISA, therefore,

mere non-involvement in the fieldwork will not discharge you from the responsibilities, which are placed upon you under the Company Law and ISA.

(October 5, 2002)

**2.7 REVISED ATR-14, MINIMUM HOURLY CHARGE OUT RATES AND MINIMUM FEE FOR AUDIT ENGAGEMENTS**

**Inquiry:** This is in response to the superceded and revised ATR-14 issued in respect of minimum audit fee to be charged by the audit firms.

**1. CLARIFICATION REGARDING SUPERCEDED ATR-14**

The superceded ATR -14 required audit firms to charge Rs.60,000 in cases of unlisted companies where turnover exceeded Rs.20.0 million.

In certain cases we had to increase audit fees for the year 2002 more than 100%. One of our clients in January, 2002 applied to ICAP regarding the increase in fee and they were told that the matter will be placed before the appropriate committee for due consideration. Similarly at the time of our Quality Control Review held in August, 2002, the same was discussed with the ICAP representative and we were informed that the ICAP is considering the matter. As such we informed our clients (who considered such increase unjustified) that the requirements of ATR-14 (now superceded) are to be complied with. However on further clarification from ICAP the audit fee will be adjusted accordingly.

Sir, we require two clarifications in this regard

- Q.1. Based on the above, can we require our client not to pay Rs.60,000/- and pay audit fees as per revised ATR -14, in cases where Rs.60,000 has already been provided in the accounts.
- Q.2 From current year onwards if Rs.60,000 were charged in the accounts (in cases of clients which felt the increase was unjust e.g. more that 100% increase) in the year 2002, can such fee be reduced to the requisite level as per revised ATR -14. Keeping in mind that the substantial portion of increase was made last year mainly due to adoption of ATR-14 rather than increase in work load. So can the fees for the year 2003 be kept at the same level as in year 2001 and be enhanced in three years up to the level as required by revised ATR -14

**2. CLARIFICATION REGARDING REVISED ATR-14**

In accordance with paragraph 3 of revised ATR-14, minimum fee shall be based on the applicability of any two parameters within a category.

Please guide us as to the minimum fee to be charged in the following case where 1 parameter meets each category.

<b>EXAMPLE</b>		<b>CATEGORY</b>
Equity	Rs. 3.0 million or Rs. (3) million	A
Turnover	Rs.180.0 million	D
Fixed Assets	Rs.25.0 million	B

Based on the above details each parameter falls in a different category and two parameters do not fall within a category.

If we assume that parameter "Equity" under Category B (i.e. Rs.10.0 million) means Equity up to Rs.30.0 million, then minimum audit fee shall be Rs.75,000 or will this fall under paragraph 4 of the revised ATR-14 and audit fee shall be Rs.25,000. The above-mentioned example is assumed to be that of a normal running listed company.

Your early clarification shall be highly appreciated.

**Opinion:** The appropriate Committee of the Institute has examined the concerns raised by you in your inquiries and its replies according to your question numbers are as follows:-

1. As you are well aware that whenever a law or pronouncement or guidance is issued or amended it always has a prospective effect unless contrary is mentioned therein, and same is the case with revised ATR 14, which would be applicable to all cases of audit fee fixation on or after April 14, 2003. Therefore the Committee is of the view that reducing the last year minimum audit fee i.e. for Year 2002, would not appear to be appropriate.
2. With regard to your second concern on Para 3 of the revised ATR-14, the Committee here would like to point out that a simple way of determining the minimum prescribed audit fee would be to apply any two parameters within a category but in case of any other situation for example the scenario you have mentioned, the highest review audit fee shall be applicable which in the above mentioned situation would be Rs.125,000.

However, if in the following year, the application of parameters mentioned in the revised ATR-14 results in a figure, which is lower than last year, then a lower fee can be accepted.

(June 14, 2003)

## 2.8 REVIEW OF CORRESPONDING FIGURES IN LIMITED SCOPE REVIEW

**Inquiry:** It has been observed that the statutory auditors, while undertaking the limited scope review of half-yearly financial statements of certain listed companies have qualified their opinion by stating that the corresponding figures were not reviewed by them. This qualification is based on the premise that the review engagements were undertaken for the first time and the corresponding figures had not been reviewed previously.

ISA 910 on "Engagements to Review Financial Statements" is silent on the issue of corresponding figures that have not been earlier reviewed. However, ISA 710 "Comparatives" addresses this issue. Para 8 read with paragraph 6 of the said ISA requires the auditors to obtain sufficient appropriate audit evidence that corresponding figures meet the requirements of relevant financial reporting framework. The auditors are, therefore, required to ensure that the corresponding figures have been correctly reported and are appropriately classified by assessing whether:

- (a) Accounting policies used for corresponding figures are consistent with those of the current period; and
- (b) Corresponding figures agree with amounts and other disclosures presented in the prior period.

We would like to seek ICAP's comments on whether the auditor's responsibilities where financial statements of the prior period were not audited, as established in ISA 710, be applied to review engagements. An early response in this regard would be appreciated.

**Opinion:** The appropriate Committee of the Institute would like to draw your attention towards the wordings of auditors' review report to the members, which explicitly states that:

“ We conducted our review in accordance with the International Standard on Auditing applicable to review engagements”. (i.e. ISA 910)

In view of the above statement and the fact that ISA 910 on “*Engagements to Review Financial Statements*” is silent on the issue of corresponding figures that have not been earlier reviewed, it may be concluded that the auditor's responsibilities as established in ISA 710 may not be applied to such review engagements.

We appreciate that despite the inapplicability of ISA 710 on review engagements, most of the auditors' have decided to include a qualification paragraph in respect of corresponding figures in order to ensure that the users do not unnecessarily rely on the unreviewed corresponding figures being presented in the half-yearly reports.

In this respect the auditors' have taken guidance from paragraph 18 of ISA 710 - *Comparatives* which states that:

**“Prior Period Financial Statements Not Audited**

18. When the prior period financial statements are not audited, the incoming auditor should state in the auditor's report that the corresponding figures are unaudited. Such a statement does not, however, relieve the auditor of the requirement to perform appropriate procedures regarding opening balances of the current period. ***Clear disclosure in the financial statements that the corresponding figures are unaudited is encouraged.***”

However, it has been noted that most of the auditors' have only partially qualified their opinion rather than qualifying the corresponding figures as a whole. The reason being that the corresponding figures of balance sheet taken in the half-yearly financial statements represented audited amounts as they appeared in the annual financial statements of the company. While the corresponding figures of profit and loss account, cash flow statement, statement of changes in equity and the notes forming part thereof, relate to a period that has neither been audited nor reviewed. There are instances also where no such qualification has been mentioned.

In light of the above discussion, the Committee is of the view that:

- a) review engagements do not appear to fall under the scope of ISA 710 – *Comparatives*; and
- b) a partial qualification regarding the corresponding figures is quite appropriate as per the requirement of paragraph 18 of ISA 710 – *Comparatives*.

(June 14, 2003)

## **2.9 STAMPING AND INITIALING OF FINANCIAL STATEMENTS**

**Inquiry:** I have been provided a copy of your circular No. 4/99 dated June 17, 1999 wherein you have advised your members not to sign or stamp the financial statements of an entity whose accounts they have audited unless there is a statutory requirement to do so. In view of the fact that your members continue not to stamp the accounts they audit, I gather that no such statutory requirement has been stipulated yet.

It is not my place to suggest what the ICAP should or should not advise its members on the subject. You are obviously better placed to arrive at a judgment thereon. However, it has been accepted by auditors almost everywhere, that in carrying out their professional responsibilities, they owe a responsibility to all stakeholders, which includes institutions

lending to or financing the entities that the auditors audit. As you know, audited financial statements of the entities are a major factor in assessment of their credit risk by their lending institutions.

In this context, the advice conveyed by your above-referred circular creates a problem for the lending institutions, which needs to be addressed. In respect of financial statements that are published there is no problem but statements whose copies are provided by the entities (usually on plain paper and in some cases on entity's own letterhead) it is impossible to verify that they are the **same accounts** in respect of which their auditor(s) have issued their certificates due to the absence of any indication on those papers to that effect from the entity's auditor(s). We have faced this problem in several cases. In two cases, we sent the statements submitted to us by the entities' to their auditors requesting them to confirm whether these were the accounts they had audited. Surprisingly, they did not accede to our request.

I hope you understand the problem I have pointed out. While I do not suggest that auditors assume responsibilities that are inconsistent with their profession, it is, nevertheless, their obligation to ensure that an important stakeholder like lending institutions are not placed at a disadvantage to safeguard the interests of the auditing profession. I would therefore eagerly awaited your response to this letter.

**Opinion:** The appropriate Committee of the Institute has considered your observations on Circular No. 4/99 dated June 17, 1999 issued by the Institute of Chartered Accountants of Pakistan and concluded that the said circular does not require any amendment. The reason for reaching this conclusion is twofold; firstly the Committee observed that the responsibility for preparing the financial statements is solely that of the management and the auditor is only required to render an opinion thereon which is legally required to be annexed to such financial statements; secondly the Committee felt that if the management intends to mislead the lender or any other person even a stamp or an initial of the auditor on the financial statements may not deter it from doing so.

The Committee would also like to communicate to you that legally an auditor owes a duty of care and primary responsibility to report to the shareholders of a company. While other stakeholders have a reason to derive comfort from audited financial statements, such objective does not detract an audit from its fundamental purpose.