
SELECTED OPINIONS

Volume X

(July 1, 2004 to June 30, 2005)

COMPILED BY

TECHNICAL SERVICES DIRECTORATE

OF

**THE INSTITUTE OF CHARTERED
ACCOUNTANTS OF PAKISTAN**

INTRODUCTION

This report is the tenth compilation of selected opinions issued by the Technical Advisory Committee on inquiries raised by the members and other agencies during the period from July 2004 to June 2005 for the general guidance of the members of the Institute. Volume I to IX are now available 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.

Shahid Hussain
Director Technical Services

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CONTENTS

1. ACCOUNTING

- 1.1 Applicability of Actuarial Valuation for those companies where post Employment Benefits are not in practice
- 1.2 Change in Accounting Policy for valuing Fixed Assets
- 1.3 Clarification regarding IAS-12 (Revised 2000) paragraph 81 (c)
- 1.4 IAS 39 – Financial Instruments – Fair Values in Financial Statements of Provident Fund
- 1.5 Inquiry regarding Reclassification of Financial Assets held for trading into available for sale
- 1.6 Sale and Leaseback (IAS 17)
- 1.7 Shares issued at discount – Treatment of Deferred Cost
- 1.8 Should we Consolidate the Financial Statements of Software House in our books?
- 1.9 Treatment of Increase in Investment

2. AUDITING

- 2.1 Appointment of External Auditors
- 2.2 Identification of Financial Statements in Auditors' Report
- 2.3 Implementation of ATR-14
- 2.4 Is Pirated Software a Company's Assets?
- 2.5 Partnership Arrangements with previous auditors

1. ACCOUNTING

1.1 APPLICABILITY OF ACTUARIAL VALUATION FOR THOSE COMPANIES WHERE POST EMPLOYMENT BENEFITS ARE NOT IN PRACTICE

Enquiry: I would like to obtain ICAP Technical Committee's opinion in respect of below-mentioned scenario: -

AUDITORS' VERSION

As per Auditors' report of June 30, 2004 a qualification has been made on our accounts. The exact wording is reproduced below: -

Provision for gratuity and leave encashment incorporated in the accounts on the basis of last drawn gross salary is subject to verification through actuarial valuation as required by International Accounting Standard "19"

MANAGEMENT'S VERSION

We have the following employees' retirement benefits plans: -

1. Gratuity

The Company has established an approved gratuity fund under defined contribution plan covering all its employees who have completed the minimum qualifying period of six months of the service. The fund operates under a trust administered by the Board of Trustees. The amount of gratuity admissible, shall be a sum equal to last salary drawn immediately preceding the date of his service of the Company, for each completed year of service in the Company.

2. Leave Encashment

The Company provides a facility to its employees for accumulating their annual earned leave. Unutilized earned leave can be used at any time subject to the Company's approval. Up to 100 days of accumulated leave can be encashed on retirement.

The Company management has a different point of view and is of the opinion that:

- (i) Company has defined contribution plan where no actuarial assumptions are involved as per IAS-19
- (ii) Company is not having a policy to pay any sort of Post Employment Benefits i.e.
 - Pensions
 - Medical Care to employee and their dependents after retirement; and
 - Death benefits to the dependents of former employees

Actuarial valuation is required only for Post employment benefits and actuarial assumptions are needed to estimate the size of the future (post-employment) benefits that will be payable under a defined benefits scheme. The main categories of actuarial assumptions are not applicable on our retirement benefits plans, these assumptions are reproduced below for ready reference: -

- (a) Demographic assumptions are about mortality rates before and after retirement, the rate of employee turnover, early retirement, claim rates under medical rates
- (b) Financial assumptions are the discount rate to apply, the expected return on plan assets, future salary levels (allowing for seniority and promotion as well as inflation) and the future rate of increase in medical costs.

We are readjusting provision of retirement benefits at each balance sheet date as per our accounting policy of "Provisions" which is reproduced here: -

"Provisions are recognized when the Company has a legal or constructive obligation as a result of a past event, and it is probable that outflow of resources embodying economic benefits will be required to settle the obligation and a reliable estimate can be made of the amount of obligation. However, provisions are reviewed at each balance sheet date and adjusted to reflect current best estimate.

For your reference we are also enclosing Printed Accounts for the year ended June 30, 2004. Please guide us in this respect whether actuarial valuation is required in our case or not? An early response shall be highly appreciated.

Opinion:

First of all the Committee would like to inform you that IAS 19 'Employee Benefits' is applicable to all employee benefits, be short-term or long-term. For this your attention is drawn towards the following paragraphs of IAS 19:

- 1 This Standard should be applied by an employer in accounting for employee benefits
- 7 Employee benefits are all forms of consideration given by an enterprise in exchange for service rendered by employees.

The Committee would also like to point out that your policy with regard to the gratuity fund does not appear to be very much clear. On the one hand it has been stated that "*The amount of gratuity admissible, shall be a sum equal to last salary drawn immediately preceding the date of his service of the Company, for each completed year of service in the Company*" which gives an impression that gratuity scheme is a defined benefit plan as the Company is liable to pay gratuity on the basis mentioned above irrespective of the availability of funds in the Gratuity Trust Fund. But on the other hand it has been mentioned in your letter under reference that the fund is a defined contribution plan, which does not appear to be in consonance with the earlier statement.

Anyway before reaching any opinion the Committee would like to draw your attention towards the following paragraphs of IAS 19 '

Post-employment benefit plans: are formal or informal arrangements under which an enterprise provides post-employment benefits for one or more employees.

Defined contribution plans; are post-employment benefit plans under which an enterprise pays fixed contributions into a separate enterprise (a fund) and will have no legal or constructive obligation to pay further contributions if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods.

Defined benefit plans: are post-employment benefit plans other than defined contribution plans.

Further paragraphs 24 to 28 of IAS 19 clearly distinguish between defined contribution plan and defined benefit plan and in the light of them the Committee is of the opinion that if an organization is required to pay either legally or constructively the full amount of promised benefits whether or not sufficient assets are held in the fund or not, in other words if the enterprise is required to make up the deficit of the gratuity fund then that entity will be required to determine the present value of its fund obligations and the related current service cost and where applicable past service cost using the actuarial valuation method i.e. Projected Unit Credit Method.

However with regard to leave encashment the Committee is of the view that this appears to fall under 'Other long-term employee benefits' and this is also subject to actuarial valuation. For further details you may refer to paragraphs 126 to 131 of IAS 19.

1.2 CHANGE IN ACCOUNTING POLICY FOR VALUING FIXED ASSETS

Enquiry: We seek your opinion / guidance on the treatment of a change in accounting policies. The issue and facts of the case are as under: -

ISSUE

Whether change in accounting policy for valuing the fixed assets from "Allowed Alternative Treatment" (Revaluation of Fixed Assets) to "Bench Mark Treatment" (Historical Cost Convention) is allowed as per IAS 16, IAS 8, and other applicable provisions of the Companies Ordinance, 1984.

FACTS

We have adopted Allowed Alternative Treatment in accordance with IAS 16 (Property, Plant and Equipment) for our land, building, and plant and machinery. Accordingly revaluation was carried out and incorporated in books of account.

Now management of the Company is of the opinion that Benchmark Treatment of IAS 16 shall give better presentation of financial statements. Accordingly the change in policy for stating fixed assets from "Valuation" to "Historical Cost Convention" is desired.

Numeric data is as under: -

Description	Revalued Carrying Amount as on Sep. 30, 2003			Un-depreciated revaluation surplus as on Sep. 30, 2003
	Valuation Rs.000'	Post valuation Accumulated Depreciation Rs.000'	Book Value Rs.000'	
Land	5,868	---	5,868	3,168
Building	81,013	34,634	46,379	20,977
Plant & Machinery	320,998	90,741	230,257	100,346
TOTAL	407,879	125,375	282,504	124,491

The above referred revaluation surplus of Rs.124,491,925/= had been reflected in the balance sheet as on September 30, 2003 as under:-

Surplus on revaluation of fixed assets = 82,028,480

Deferred tax (being 35% of Revaluation Surplus on building and machinery) = 42,463,446

Had there been no revaluation, the status of fixed assets based on historical cost would have been as follows:-

Description	Cost Rs.000'	Accumulated Depreciation Rs.000'	Written Down Value Rs.000'
Land	2,700	0	2,700
Building	62,621	37,219	25,402
Plant & Machinery	362,523	232,612	129,911
TOTAL	427,844	269,831	158,013

Now you are requested to please give your opinion as to:

- i) Whether the change in accounting policy in valuing the fixed assets from "Allowed Alternative Treatment" (Revaluation of fixed assets) to "Bench mark treatment" (Historical cost convention) is allowed as per IAS 16, IAS 8, and other applicable provisions of the Companies Ordinance, 1984; and
- ii) If the change mentioned above (i) is allowed then, the following entry is justified along with other required disclosure of the effects of change in policy as mentioned in IAS 8.

	Debit (Rupees)	Credit (Rupees)
Surplus on revaluation of fixed assets	82,028,480	
Deferred Tax	42,463,446	
Plant and Machinery	41,524,380	
Accumulated Depreciation (Building)		2,585,370
Accumulated Depreciation (P&M)		141,870,808
Building a/c.		18,392,333
Land a/c		3,167,795

Opinion: You attention is drawn to the following paragraph 29 of IAS-16, Property, Plant and Equipment: -

29. Subsequent to initial recognition as an asset, an item of property, plant and equipment should be carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses. Revaluations should be made with sufficient regularity such that the carrying amount does not differ materially from that which would be determined using fair value at the balance sheet date.

In view of the above paragraph the Committee is of the opinion that once an entity undertakes revaluations, these must continue to be made with sufficient regularity so that the carrying amounts in any subsequent balance sheet are not materially at variance with the current fair values. In other words, if an entity adopts the allowed alternative treatment, it cannot report balance sheets that contain obsolete fair values, since that would not only obviate the purpose of the allowed treatment, but would actually make it impossible for the user to meaningfully interpret the financial statements.

Further your attention is also drawn towards the following section sub-section (2) of section 235 of the Companies Ordinance, 1984,

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

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

Provided further that incremental depreciation arising out of revaluation of fixed assets may be charged to surplus on revaluation of fixed assets account

From the above it can also be inferred that once the revaluation surplus is recognized in the financial statements, the law does not appear to allow its reversal or its use for any other purpose other than the purpose described in the above sub-section.

However if the management is of the opinion that an asset may be impaired and its carrying amount needs to be written downward then it should do so as per guidance provided in IAS-36 *Impairment of Assets*.

(July 28, 2004)

1.3 CLARIFICATION REGARDING IAS-12 (REVISED 2000) PARAGRAPH 81 (C)

Enquiry: IAS 12 para 81(c) of IAS 12 (Revised 2000) requires to provide disclosure regarding explanation of relationship between tax expenses (income) and accounting profit.

My question is whether a company which is subject to minimum tax under section 113 of the Income Tax Ordinance, 2001 or subject to PTR (presumptive tax regime) required to give above said disclosure?

I request you or the relevant Committee of the Institute to clarify the above-mentioned situation.

Opinion: The appropriate Committee of the Institute has examined your query and concludes that IAS 12 paragraph 81(c) requires an explanation of the relationship between tax expense and accounting profit. This explanation, in Committee's views, enables the financial statements users to understand the relationship, whether reconciling items are unusual and to understand the significant factors that could affect relationship in future.

In view of the above, the reconciliation is required to be disclosed in all circumstances.

(November 6, 2004)

1.4 IAS 39 – FINANCIAL INSTRUMENTS – FAIR VALUES IN FINANCIAL STATEMENTS OF PROVIDENT FUND

Enquiry: I shall be obliged to have the views of the Technical Committee in the matter.

Para 1(c) of IAS 39 excepts employers' assets and liabilities under employee benefit plans, to which IAS. 19, *Employee Benefits*, applies.

Prima facie, Provident Fund assets (mainly investment in securities & shares in listed companies) could not be categorized as "employer's assets", therefore, the Recognition and Measurement criteria stipulated in the Standard becomes applicable as follows:

- i. Investments in Government Savings Schemes or other Government or private debt instruments may not be categorized as “held for trading” since trustees do not invest for short-term gains.
- ii. Investment in Government Savings Schemes or other debt instruments could be categorized as “held-to-maturity” investments in the normal course.
- iii. Investment in shares and debt instruments listed on the stock exchange will fall to be categorized as “available-for-sale”
- iv. Neither Investments nor debt instruments fall in the category of “Loans and receivables originated by the enterprise”.

Para 66 – (Initial recognition) Investments purchased are to be recognized at cost (fair value of the consideration including the transaction costs).

Para 69- After initial recognition, fair values are to be substituted except in cases of:

- (b) held-to-maturity investments
- (c) where a quoted market price in an active market is not available.

Para 73- Investments that have a fixed maturity are to be measured at amortized cost using the effective interest rate method.

Gains and Losses on Re-measurement to Fair Value

Para 103 – (a) a gain or loss on a financial asset.. “*held for trading*” should be included in net profit or loss for the period in which it arises – **not applicable in case of a provident fund**

- (b) a gain or loss on an “available for sale “financial asset should be either
 - (i) included in net profit or loss for the period in which it arises; or
 - (ii) recognized directly in equity, through the statement of changes in equity

Following aforesaid edict:

- Fair value of Government securities & debt securities listed on stock exchange would be purchase cost as these are “held to maturity” investments.
- Investment in shares listed on stock exchange may be “market” and the quoted price may be taken as “fair value”

Fair value gain under para 103 (b)(i) leads to distribution of unrealized gains, which presumably may balance out in the long run. However, some funds have rules restricting distribution of capital gains realized on disposal of investments. In such a situation, distribution of unrealized / gain in fair value could be taken as contravention of Provident Fund Rules in the Trust Deed. Where a restrictive rule exists, it seems that the only option available would be “recognition through equity”.

I look forward to your guidance in the matter.

Opinion: Regarding the applicability of IAS 39 to retirement benefit plans, the Committee would like to draw your attention toward the following paragraphs of IAS 26 and IAS 39:

2. Retirement benefit plans are sometimes referred to by various other names, such as 'pension' schemes', superannuation schemes or retirement benefit schemes'. This Standard regards a retirement benefit plan as a reporting entity separate from the employers of the participants in the plan. All other International Accounting Standards apply to the reports of retirement benefit plans to the extent that they are not superseded by this Standard.

(IAS 26)

32. Retirement benefit plan investments should be carried at fair value. In the case of marketable securities fair value is market value. Where plan investments are held for which an estimate of fair value is not possible disclosure should be made of the reason why fair value is not used.

(IAS-26)

3. This Standard does not change the requirements relating to:

- (d) employee benefit plans that comply with IAS 26 *Accounting and Reporting by Retirement Benefit Plans.*

(IAS 39)

From the above it may be inferred that IAS 39 does not apply to investments pertaining to retirement benefit plans and all provisions of IAS 39 which give the option of taking a gain or loss on an available-for-sale financial asset either to include in net profit or loss or to recognize it directly in equity, are not relevant in the case of provident fund investments. (IAS 39.103)

Moreover IAS 26 does not have a concept of equity or reserves. It instead has the concept of "Net assets available for benefits" which are defined as "assets of a plan less liabilities" (IAS 26.08). As such question of transfer of a gain or loss on valuing financial assets on fair value to an equity account in a provident fund does not arise.

As such all gains or losses arising out of application of IAS 26.32 whether realized or unrealized shall be credited or debited to members accounts.

However the trustees of a provident fund may provide in the rules a mechanism to prevent distribution of unrealized gains to members.

(October 2, 2004)

1.5 INQUIRY REGARDING RECLASSIFICATION OF FINANCIAL ASSETS HELD FOR TRADING INTO AVAILABLE FOR SALE

Enquiry: Your opinion is required for the following matter in the light of International Accounting Standard – 39 (IAS -39) *Financial Instruments : Recognition and Measurement* whether reclassification is possible for financial assets from held for trading to available-for-sale or not.

As per IAS 39 we are of the view that reclassification is not permitted for financial assets held for trading to financial assets available-for-sale as per paragraph No. 107 which is as under:

Because the designation of a financial asset as held for trading is based on the objective for initially acquiring it, an enterprise should not

reclassify its financial assets that are being re-measured to fair value out of the trading category while they are held. An enterprise should reclassify a financial asset into the trading category only if there is evidence of a recent actual pattern of short-term profit taking that justifies such reclassification.

Based on the view that the company is not eligible to reclassify its investment in the category of financial assets available-for-sale if a company acquired an investment and shown under category of held for trading for the objective of generating a profit from short-term fluctuations in price but later on the investor decides to hold this investment for a longer period as it is more beneficial (profit in shape of dividend or bonus issues etc.) for the company due to better future prospectus of the investee company.

So we would be very thankful to you if you provide us your opinion on this issue whether reclassification is permitted in the light of the International Accounting Standard-39.

Opinion: The appropriate Committee of the Institute, apart from paragraph 107 of IAS 39 you have mentioned in your above query, would also like to draw your attention towards following question and its answer given in IAS 39 Implementation Guidance:-

**Paragraph 107
Question 107-2
Reclassification to trading: decision to sell**

If an enterprise decides to sell a financial asset that is not classified as held for trading in the near future, should it reclassify that asset into the held-for-trading category?

Answer

No. IAS 39.107 specifies that the designation of a financial asset as held for trading is based on the objective for initially acquiring it. A decision to sell a financial asset does not make that asset a financial asset held for trading. On the other hand, if the asset is part of a portfolio of similar assets for which there is a recent pattern of trading, for instance, a portfolio of treasury notes classified as available-for-sale financial assets, they would be reclassified into the trading category.

Further the Committee would also like to draw your attention towards the following paragraph of revised IAS, which has superseded both the paragraph 107 and question 107-2 of previous IAS 39:

Reclassifications

50. *An entity shall not reclassify a financial instrument into or out of the fair value through profit or loss category while it is held or issued.*

In view of the above paragraph the Committee is of the opinion that IAS 39 does not appear to allow reclassification of financial instruments from 'Held for Trading' to any other category or vice versa.

(June 4, 2005)

1.6 SALE AND LEASEBACK (IAS 17)

Enquiry: We are in the process of finalizing our annual financial statements and we have come across some problem in the context of sale and leaseback in the context of IAS 17. Problem is as follows:

Scenario

ABC Ltd sold and leased back an asset from DEF Ltd - a leasing company

	Rs
Purchase cost of asset incurred by ABC	100
Sold and leased back at	90

Treatment 1

As per para 64 of IAS 17, no loss would be recognized on such “sale and leaseback” being a financing arrangement (para 60) unless there has been an impairment in value of the asset. Entries would be as follows:

Sr	Description	Debit	Credit
1	Bank	90	
	Lease liability		90
	(Finance received against leaseback)		
2	Leased asset	100	
	Owned asset		100
	(Sale of owned asset)		

Consequence:

If we pass the above entries, it goes against para 20 of IAS 17, which states that at inception of lease term, leased asset and liability both should be recognized at **equal amount**.

Treatment 2

If we assume that such sale and leaseback is just financing arrangement and by the same token, bank has provided 90% finance against the asset having a fair value of Rs 100, then we should credit owned asset with Rs 90 only considering 90% asset subject to finance lease. As a result, no gain/loss will arise on such transactions. Scheme of entries would be as follows:

Sr	Description	Debit	Credit
1	Bank	90	
	Lease liability		90
	(Finance received against lease back)		
2	Leased asset	90	
	Owned asset		90
	(Sale of owned asset)		

Consequence:

In case of default, will leasing company either forfeit the 100% asset or sell and repay the 10% share in sale proceed to ABC?

Treatment 3

Sale and leaseback are two separate independent transactions:

- Sale of asset (as title is transferred to leasing co)
- Leasing back the asset

If it is so, we should recognize gain/loss on such transaction. In above scenario, we have sold the asset at Rs 90 having the book value of Rs 100 resulting in a loss of Rs 10. Entries would then be as follows:

Sr	Description		Debit	Credit
1	Bank		90	
	Loss on sale		10	
		Owned asset		100
	(Sale of owned asset at less than carrying amount)			
2	Leased asset		90	
		Lease liability		90
	(Booking of lease asset & related liability)			

Keeping in view the above, your valuable opinion is sought that which of the above or some else treatment would be correct?

Your early response would be highly appreciated for timely completion of our financial statements.

Opinion:

First of all the appropriate Committee of the Institute would like to draw your attention towards following paragraphs of IAS 17:

- 63 For operating leases, if the fair value at the time of a sale and leaseback transaction is less than the carrying amount of the asset, a loss equal to the amount of the difference between the carrying amount and fair value should be recognized immediately.
- 64 For finance leases, no such adjustment is necessary unless there has been impairment in value, in which case the carrying amount is reduced to recoverable amount in accordance with the International Accounting Standards dealing with impairment of assets.

In the light of above paragraphs the Committee is of the view that if there is no impairment in the value of fixed asset then the treatment 1 as given in your above enquiry appears to be appropriate.

However, the Committee does not agree with your concern that the leased asset and the liability both should be recognized at equal amount as the Committee is of the view that paragraph 20 of IAS 17 also states that "Any initial direct costs of the lessee are added to the amount recognized as an asset".

(March 5, 2005)

1.7 SHARES ISSUED AT DISCOUNT – TREATMENT OF DEFERRED COST

Enquiry:

While reviewing the financial statements of one of our clients, we have come across a situation where the client has issued shares at discount. The discount amount is being treated as deferred cost and amortized over a period of 5 years. We require clarifications in the light of the revised 4th Schedule to the Companies Ordinance, 1984 and applicable International Accounting Standards.

Revised 4th Schedule to the Companies Ordinance, 1984

The original 4th Schedule to the Companies Ordinance, 1984 allowed discount on shares to be deferred for a period of five years.

Revised 4th Schedule to the Companies Ordinance, 1984

The concept of deferred cost has been deleted in the revised 4th Schedule to the Companies Ordinance, 1984 giving rise to the presumption that any cost incurred during the year not qualifying the criteria of capitalization should be charged to profit and loss account.

Companies Ordinance, 1984

Section 234(1)

The said section allows that where any item of expenditure, which may in fairness be distributed over several years, has been incurred in any one financial year, the whole amount of such expenditure shall be stated with the addition of the reasons why only a portion of such expenditure is charged against the income of the financial year.

Section 84 (1)

Subject to the provisions of this section, it shall be lawful for a company to issue shares at discount.

Section 83 (3)

Issue of shares at discount shall not be deemed to be reduction of capital.

Section 84 (4)

Every prospectus relating to the issue of shares, and every balance sheet issued by the company subsequent to the issue of shares, shall contain particulars of the discount allowed on the issue of shares or of so much of that ***discount as has not been written off at the date of issue of the prospectus or balance sheet.***

Issue

The relevant provisions of the Companies Ordinance, 1984 and the revised 4th Schedule to the Companies Ordinance have become contradictory as there is no concept of deferred cost in the revised 4th Schedule while the highlighted section 84(4) allows deferment of discount offered on issue of shares.

In light of the above, we seek guidance on the following issues:

1. If a company issues shares at discount, what would be the appropriate treatment of discount offered on such issue? Charging the entire discount amount to the profit and loss account in the year of issue of shares would have a substantial impact on the profitability and would limit the ability of the company to pay dividends to its members.
2. Whether discount on shares can be set off directly against the equity without charging it through the profit and loss account?
3. What would be the treatment of the amount of deferred cost being carried by the company before the applicability of the revised 4th Schedule? Can the company continue deferring the discount amount at the same rate (over five years) or the remaining cost can be deferred at any other rate considered appropriate by the management in the best interests of the shareholders?

We would appreciate your prompt response.

Opinion: The issue raised by you was deliberated in detail and the Committee is of the view that sub-section (1) of section 234 only refers to distribution of an item of expenditure over several years subject to fairness of the reasons why only a portion of expenditure should be charged against income of the financial year. Fairness of said distribution has to be judged against an accounting framework which in case of Pakistan are International Accounting Standards and such Accounting Standards no longer carry the concept of deferred cost. Therefore any deferment of expenditure by an entity will not be according to International Accounting Standards adopted by us. IAS – 9, which used to allow deferment of certain expenses has already been superseded by IAS 38 way back in 1999.

We would also like to mention that previously the Fourth Schedule was only allowing deferment of expenditure up to five years including the year in which it was incurred. Whereas the interpretation as mentioned in your letter under reference would provide a carte blanche to the listed companies to defer expenditure for an unlimited period of time thus leading to distortion of published financial statements.

The appropriate Committee of the Institute would also like to draw your attention to Opinion No. 1.1 of Volume VII of the Selected Opinions where this issue has been discussed in detail in the context of law which existed at that time wherein it was recommended that the best possible treatment would be to show the amount of discount on issue of shares as a deduction from equity.

With regard to your concern that there is a contradiction between Section 84(4) and revised 4th Schedule the Committee is of the view that the said section neither allows nor prohibits companies to defer discount allowed on issue of shares. Instead it requires the companies who issue shares at discount to show the amount not written off, if any, in the balance sheet at the time of issuing balance sheet or a prospectus.

In the light of the above discussion the response to your enquiries are as follows:

1. & 2 As stated above, the best possible way would be to show the amount of discount on issue of shares as a deduction from equity.
3. With regard to your 3rd enquiry the Institute had, before the receipt of your enquiry, already recommended to SECP to issue the following clarification:

The companies who are carrying deferred cost in their financial statements as on July 5, 2004 may be allowed to continue to treat such cost according to the requirement of the superceded Fourth Schedule. However after July 5, 2004 the companies should not be allowed to include any further deferred cost in their financial statements.

This recommendation has been accepted by SECP. Please see SECP Circular No. 01 of 2005 dated January 19, 2005 which is also available on ICAP website.

(December 4, 2004)

1.8 SHOULD WE CONSOLIDATE THE FINANCIAL STATEMENTS OF SOFTWARE HOUSE IN OUR BOOKS?

Enquiry: This is with reference to our telephonic conversation this morning, I would be grateful if you can advice me on the following:

We are running a brokerage house as a Public Un-Listed Company apart from this as of June 30, 2003 we had the following subsidiaries:

1) Software House	Private Limited Company	Holding 99.98%
2) Marketing Company	Private Limited Company	Holding 85.00%
3) Travel Agency	Private Limited Company	Holding 55.00%

Software House

We had written off the entire investment in software house from our (parent company) books at June 30, 2003 and subsequently in April 2004 this company was liquidated as well. So this company has no existence as on June 30, 2004.

Now the question is should we consolidate the financial statements of software house in our books?

Marketing Company

This company was dormant for a long time and in March 2004 this company was also liquidated. We have received the amount of surplus distributed by the subsidiary company to its shareholders against which we have set off our investment. So this company is also not in existence as on June 30, 2004.

Now the question is should we consolidate the financial statements of marketing company in our books?

Travel Agency

This company issued further shares on July 22, 2003 and we had not exercised the rights because of this reason our shareholding diluted in such a manner that this company became an Associate. From July 22, 2003 till to date (June 30, 2004) we are maintaining the same status with this company.

Now the question is should we consolidate the financial statements of travel agency in our books?

Note the Accounting Years of all companies are July to June.

Your cooperation in this regard is highly appreciated.

Opinion: The Committee deliberated your enquiry in detail and is of the view that once the parent /holding company ceases to have control of the subsidiary or subsidiaries the parent company should not consider such subsidiary or subsidiaries in preparation of consolidated balance sheet.

However the said parent company, even if it does not have any other subsidiary, would be required to prepare and issue consolidated financial statements provided the company had prepared and issued consolidated financial statements in the immediate preceding year. The only reason for this is to make the readers aware of the previous year's figures and to help them compare the financial position of current year with the previous year. In this regard your attention is drawn toward the following paragraph of IASB Framework.

42. Because users wish to compare the financial position, performance and changes in the financial position of an enterprise over time, it is important that the financial statements show corresponding information of the preceding periods.

Here the Committee would like to point out that consolidated balance sheet included in the consolidated financial statements and the parent company's own balance sheet will remain the same because parent company is no more holding any subsidiary.

With regard to the preparation of consolidated income statement the Committee would like to draw your attention towards the following paragraph of IAS 27 which is self explanatory:

Para 23 The results of operations of a subsidiary are included in the consolidated financial statements as from the date of acquisition, which is the date on which control of the acquired subsidiary is effectively transferred to the buyer, in accordance with IAS 22 *Business Combinations*. The results of operations of a subsidiary disposed of are included in the consolidated income statement until the date of disposal which is the date on which the parent ceases to have control of the subsidiary. The difference between the proceeds from the disposal of the subsidiary and the carrying amount of its assets less liabilities as of the date of disposal is recognized in the consolidated income statement as the profit or loss on the disposal of the subsidiary. In order to ensure the comparability of the financial statements from one accounting period to the next, supplementary information is often provided about the effect of the acquisition and disposal of subsidiaries on the financial position at the reporting date and the results for the reporting period and on the corresponding amounts for the preceding period.

You are advised to be guided by the above.

(September 11, 2004)

1.9 TREATMENT OF INCREASE IN INVESTMENT

Enquiry: Our company, a public limited company had equity investment in two leasing companies which was classified as "Available for sale Investment". During the year both these leasing companies were merged into a bank and we were issued shares of the bank according to their swap ratio. Our investment in leasing companies was 2,000,000 shares at Rs. 10 each amounting to Rs. 20,000,000 but bank's shares of 2,500,000 were issued at Rs. 10 each amounting to Rs. 25,000,000. What would be the treatment of additional amount of Rs. 5,000,000 by which our investment has increased. Whether we should treat the additional shares as bonus shares or we should charge Rs. 5,000,000 to equity or profit & loss.

Opinion: The appropriate Committee of the Institute has examined the query raised by you and is of the opinion that unless these investments fall under IAS 28 'Investments in Associates', the investment portfolio of your company should be accounted for using IAS 39 which requires that all equity investments be either classified as "available for sale" or "held for trading". In both cases, after initial recognition at cost, such investments have to be remeasured and carried at fair value (market value for listed investments).

Hence you would have been accounting for your investments in the leasing companies already at fair value with fair value changes either being taken to the profit and loss account or directly to reserves as the case may be in accordance with your accounting policy.

In view of the above, the impact of this transaction on your financial statements would be as follows:-

1. If you classify these investments as "held for trading" or you classify these investments as "available for sale" and account for fair value changes in the available for sale portfolio in the profit and loss account, then you would take the difference between the

market values of the old and new shares and record the same through the Profit and Loss. You would of course have to change the description and number of shares also in your books to reflect receipt of the new shares.

2. If you classify these investments as “available for sale” and report all fair value movements directly in reserves, then you would account for this transaction by de-recognizing the existing shares at their latest market price and recording a gain or loss in the profit and loss account (on the assumption that the market would have already factored the impact of any favorable or un-favorable swap ratios). Hence, there would be no amounts left in reserves in respect of these shares. This market price should be considered to be the consideration given for obtaining the new shares and hence be the assigned cost thereof at initial recognition. Subsequently, the new shares should be remeasured at fair value.

(March 5, 2005)

2. AUDITING

2.1 APPOINTMENT OF EXTERNAL AUDITORS

Enquiry: The appointment of external auditors is governed by the following: -

1. Regulation (xxxiii) of Code of Corporate Governance (CCG) states that Audit Committee (AC) shall be responsible for recommending to the Board of Directors (BOD) the appointment of external auditors by the listed company's shareholders.
2. Recommendation of the AC for appointment of retiring auditors or otherwise shall be included in the Directors Report as per Regulation (xxxix) of CCG.
3. And Regulation (xli) of CCG says that listed companies are required to change their external auditors every five years.
4. Section 253 of the Companies Ordinance 1984 states that a notice shall be required for a resolution at a company's AGM appointing as auditor a person other than a retiring auditor. The notice shall be given by a member to the company not less than 14 days before the AGM.

In respect of above we seek clarification as under:

Where AC recommends name/names to change auditors after five years, is it necessary that a member should also give notice for the same name/names to the company at least 14 days before the AGM to comply with the requirements of Section 253.

If a member proposes another name other than proposed by AC can that be considered for appointment as auditors without being recommended by AC. In such a situation should voting be held between name recommended by AC (not proposed by member) and name proposed by member (not recommended by AC).

We take up a practical example. In SNGPL notice of AGM for December 29, 2003 item 4 of agenda was **quote** "to appoint auditors for the year ending June 30, 2004. The retiring auditors being eligible also offer themselves for re-appointment" **unquote**.

In the directors report to the shareholders it was mentioned **quote** "present joint auditors A.F. Ferguson & Co. and Ford Rhodes Sidat Hyder & Co. are retiring and eligible for reappointment, however on the recommendation of A.C. the BOD have proposed change in the retiring auditors A.F. Ferguson & Co." **unquote**.

Ten days before the meeting, notice was sent to all the shareholders that certain shareholders have proposed name of M. Yousuf Adil Saleem & Co., Riaz Ahmed & Co. and Hameed Choudhry & Co. Chartered Accountants for appointment of auditors.

Voting was held among all the above-referred five firms and M/s. Ford Rhodes Sidat Hyder & Co. and Riaz Ahmed and Co. were appointed as auditors after securing highest votes.

The points need consideration:

- The AC did not recommend any other name except Ford Rhodes Sidat Hyder & Co. If joint auditors were to be appointed was it not required to recommend name of any other firm as required under Regulation (xxxix) of CCG?
- Although name of A.F. Ferguson & Co. was not recommended by AC but their name was also included for shareholders to vote. Were they eligible for voting although AC did not recommend.
- Riaz Ahmed & Co. were appointed as auditors but A.C. did not recommend their name, without recommendation of A.C. can they be appointed as auditors?

The above is quoted only to learn and educate. Our main point is about compliance of Section 253 vis-à-vis Regulation (xxxix) of CCG.

Opinion: Before examining the issue raised by you it would be pertinent to keep the following provisions of the Companies Ordinance, 1984, clause (xxxix) of the Code of Corporate Governance and question No. 3 of Frequently Asked Questions on the Code of Corporate Governance as placed by SECP on its Website.

Companies Ordinance, 1984

Section 253 Provision as to resolutions relating to appointment and removal of auditors.- (1) A notice shall be required for a resolution at a company's annual general meeting appointing as auditor a person other than a retiring auditor.

Code of Corporate Governance

Clause (xxxix) The Board of Directors of a listed company shall recommend appointment of external auditors for a year, as suggested by the Audit Committee. The recommendations of the Audit Committee for appointment of retiring auditors or otherwise shall be included in the Directors' Report.

Frequently Asked Questions

Q3. Does the Code conflict with the Companies Ordinance, 1984?

The SEC considers the Code to be an extension of the requirements of the Companies Ordinance, 1984 rather than in conflict with it. A number of amendments have recently been made in the Companies Ordinance, 1984 for greater harmonization between the provisions of the Code and the Companies Ordinance. Furthermore, the SEC draws support from the decision of the Karachi High Court in the matter of Messrs. Data Textiles Limited vs. Karachi Stock Exchange and another, 1999MLD 108. The Honourable High Court held, inter alia, that provisions contained in (Section 249 of) the Companies Ordinance, 1984 do not override and cannot be interpreted to be in derogation with the Listing Regulations framed under the Securities and Exchange Ordinance, 1969, as both the enactments cover separate and distinct spheres.

With regards to your first query, the appropriate Committee of the Institute is of the opinion that it is necessary that, where AC recommends name/names to change auditors after five years, a member should also give notice for the same name/names to the company at least 14 days before the AGM to comply with the requirements of Section 253.

Notwithstanding the SECP viewpoint regarding Companies Ordinance, 1984 and Code of Corporate Governance, the Committee is of the opinion that the requirements of section

253 of the Companies Ordinance, 1984 override all provisions and as the law stands today a member of a company has an inviolable right to propose any chartered accountant in practice to be the auditor of a company and the members have a right to elect an auditor by a majority vote, which may not necessarily be the same as proposed by the Board of Directors on the recommendation of the Audit Committee.

(July 28, 2004)

2.2 IDENTIFICATION OF FINANCIAL STATEMENTS IN AUDITORS' REPORT

Enquiry: Please refer to Institute's Circular No. 4/99 dated June 17, 1999 whereby the members of the Institute have been directed that as the preparation of financial statements of an enterprise is the responsibility of the management and not of the auditors, therefore, the financial statements of an enterprise should not be stamped or signed by the auditors unless there is a statutory requirement to do so.

I have also gone through the opinion of the Technical Advisory Committee published in the ICAP's Newsletter of April 2004 wherein the Institute's decision for not signing or stamping the financial statements being audited has been fortified by giving following two reasons:

- i) The responsibility for preparing the financial statements is solely that of the management and the auditor is only required to render an opinion thereon; and
- ii) 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.

In this regard I would like to add here that; firstly by merely initialing or stamping the financial statements by the auditors for identification purposes only neither the management would be absolved nor the auditors would assume the responsibilities for preparing the financial statements and secondly the policies and procedures should be formulated to facilitate the majority of the people and should not be such which would cause inconvenience to the majority of the people.

We are following the practice of not signing or stamping the financial statements being audited by us and usually these financial statements are printed on the plain paper or in some cases on the companies' letterheads. We have often been asked by our clients to sign or stamp the financial statements as their bankers ask them that how can they verify that these are the same financial statements which have been audited. In some cases we have also been sent the financial statements from the lending institutions to confirm that these are the same financial statements that have been audited by us.

Although the foregoing issue has been dealt with in the Institute's Circular No. 9/2004 dated August 11, 2004, whereby it has been stated that the confirmation may be done through a confirmation letter. This means that the confirmation letter would state that 'we confirm that the annexed financial statements are the same that have been audited by us'. The problem still persists that how would we identify the annexed financial statements and without any identification mark on financial statements such confirmation would not be of any use. Moreover, such a confirmation would also be a time consuming exercise as we have to compare the accounts sent by the bankers with our copy time and again.

In this context, I would like to draw your attention to paragraphs 8 and 11 of the ISA 700 "The Auditor's Report on Financial Statements" which are reproduced hereunder for your perusal;

“8. The auditor’s report should identify the financial statements of the entity that have been audited, including the date of and period covered by the financial statements’.

“11. An illustration of these matters in an opening (introductory) paragraph is:

‘We have audited the **accompanying**⁵ balance sheet of the ABC Company as of December 31, 20XX, and the related statements of income and cash flows for the year then ended. ----

Footnote 5 has been explained as under:

“⁵ The reference can be by page numbers.”

The requirements regarding identification of the financial statements in the auditor’s report as stated in the foregoing para of ISA-700, include the following identifications;

- i) Description of the financial statements being audited e.g. balance sheet, profit and loss account, cash flow statement and statement of changes in equity along with related notes;
- ii) Date of and period covered by the financial statements e.g. as at December 31, 20XX in case of balance sheet and for the year or half year, three months ending December 31, 20XX etc. in case of profit and loss account and cash flow statement; and
- iii) Reference to the accompanying or annexed financial statements being audited e.g. from page No. XX to Page No. XX as explained in paragraph 11 of ISA 700.

To my mind, presently we (all the practicing firms) are only complying with the requirements of ISA 700 regarding financial statements identification enumerated at (i and ii)above and are not complying with the requirement of ISA 700 enumerated at (iii) above by not giving any reference to the financial statements being audited by us.

The Institute should consider this matter and suggest a suitable way for referring the financial statements being audited in the auditor’s report in order to fully comply with the requirements of the ISA 700. The reference may be made in one of the following ways:

- i) by inclusion of the brackets and words, “(duly initialled and stamped by us for identification purposes)” after the word “annexed” appearing in the introductory paragraph of the auditor’s report; or
- ii) by referring to the annexures at the end of the auditor’s report after date and place of signing the report as under:

“Encl./Annex: Balance Sheet, Profit and Loss Account, Cash Flow Statement, and Statement of Changes in Equity along with notes 1 to XX, duly initialled and stamped by us for identification purposes”.

The stamp for identification should be a special stamp which may contain the words “STAMPED FOR IDENTIFICATION ONLY’ apart from the name and address of the audit firm.

Keeping in view the foregoing discussion you are requested to kindly clarify the following matters:

- i) How can we identify/refer the financial statements being audited by us in the confirmation letter if these are sent back to us by our clients/bankers for confirmation? and
- ii) If you suggest a way to identify/refer the financial statements as stated above then why we cannot follow the same procedure at the time of signing the auditor's report?

Any early response to the above shall be highly appreciated.

Opinion: The appropriate Committee of the Institute has examined the issue raised by you in detail and is of the opinion that this particular issue has already been discussed twice after the issuance of circular 4/99 dated June 17, 1999 and all the concerns raised by you were also taken into cognizance at that time. However the Committee has again reconsidered the above issue based on your inquiry and is of the view that opinion published in Newsletter of April 2004 is appropriate and does not need any revision.

With regard to your concern on requirement of paragraph 11 of ISA 700 relating to reference of page numbers which our members are not complying with and further your suggestion that reference may be made by either including the words 'duly initialed and stamped by us for identification purposes' in the bracket or referring to the annexures at the end of the auditor's report. In this regard the Committee is of the view that first of all this is not a mandatory requirement as report format i.e. Form 35 A does not have any such requirement. Secondly even if we suggest the requirement of referring page numbers in the auditors' report format as stated in paragraph 11, the concern raised by you does not appear to be addressed.

Regarding your query that how you can identify/refer the financial statements audited by you if these are sent to you for confirmation. In this regard the Committee does not see any issue relating to verification of financial statements as you just have to confirm to the bank by giving the reference and date of their letter that financial statements received by you were the same which you had audited. You are therefore not required to identify the financial statements by initialing them.

(September 11, 2004)

2.3 IMPLEMENTATION OF ATR-14

Enquiry: Please refer to ATR-14 concerning minimum audit fees to be charged from companies.

Case 1

We would seek your guidance for determination of minimum audit fee of a private limited company for the year ended June 30, 2003, with following financial parameters as at the year-end:

Paid-up share capital	Rs. 1,000
Accumulated Retained earnings carried forward	Rs.13,562,312
Fixed Assets (Accumulated cost)	Rs. 5,731,443
Turnover	Rs.30,401,057
Profit/(Loss) for the year before tax	(Rs.4,054,688)
Net Profit/(Loss) for the year after tax	(Rs.4,206,693)

Further, we would seek clarification regarding the following two excerpts of the subject ATR:

1. ".....the following parameters.... shall govern the determination of a minimum prescribed audit fee based on the applicability of any two parameters within a category. In case of applicability of a combination of parameters in a specific situation, the highest prescribed minimum audit fee shall be applicable."
2. "..... in case where less than two of the aforesaid parameters are attracted for whatever reason..... the prescribed minimum audit fee chargeable by the practising members shall be (Rs. 25,000/- for listed companies and Rs.15,000/- for other companies)."

The clarification is mainly required in the following respects:

Case 2

- We have been approached by a number of companies that are neither sick nor have they discontinued their operations, but they fall in the category A as per the ATR. These companies maintain that they fall under para 2 as above, and audit fee should be accordingly Rs.25,000 or Rs.15,000/- as the case may be.

Case 3

- In a situation where a company falls in category D for one parameter whereas in category A for two parameter, what audit fee shall be charged by auditors.

We would request a timely response on the above so that confusion over implementation of the ATR is settled.

Opinion:

The appropriate Committee of the Institute has examined the three cases cited by you and in its opinion the fees to be charged should be as follows:-

Case 1

In this case the total of accumulated retained earnings and paid up capital is Rs.13,563,312/- and turnover Rs.30,401,057/-. As such this company falls in category "B" and being a private limited company the minimum fee to be charged should be Rs.50,000/-

Case 2

It has been mentioned that the companies are neither sick nor they have discontinued their operations and they fall in the category "A" as per the ATR but no reason for their categorization under para 4 of the ATR-14 has been mentioned. As they fall in category "A" the minimum fee would be Rs.60,000/- or Rs.40,000/- as the case may be.

Case 3

In this case as the company falls in category "D", the minimum audit fee would be Rs.125,000/- or Rs.100,000 as the case may be.

(October 2, 2004)

2.4

IS PIRATED SOFTWARE A COMPANY'S ASSETS?

Enquiry:

While auditing fixed assets your members in practice must be verifying or 'auditing' the veracity of the value placed on software, which can be a very large asset in a lot of companies. These days some companies may not be able to function without using the software they 'own' or claim to own.

Assets are either owned or leased by companies. In the case of a company using copied or commonly known as 'pirated software' which in most cases has been acquired for nominal value when its real value is very high what is the ICAP policy of the impact on the auditors' work? Most companies are given a clean opinion whereas the fact is that some businesses are using stolen assets that can neither be classified as owned or leased. In my view a company using stolen assets cannot be given a clean audit report; however auditors rely on the management representation letter or the fact that the management is responsible if it uses stolen property (which cannot be its assets).

It is not difficult to establish whether for example a key business control system used by a company is licensed or not. Just as a debtor's circularization establishes to some degree the value of amounts receivable I would suggest that the ICAP Technical Committee evolve a method or guidance for auditors to satisfy themselves that a significant software asset is indeed owned or licensed as the case may be. Furthermore the Disciplinary Committee should be empowered to hear cases where professional members are involved in either selling or using stolen software.

Opinion:

The appropriate Committee of the Institute would like to draw your attention towards the following paragraphs of ISA 250 '*Consideration of Laws and Regulations*'

2. When planning and performing audit procedures and in evaluating and reporting the results thereof, the auditor should recognize that noncompliance by the entity with laws and regulations may materially affect the financial statements. However, an audit cannot be expected to detect noncompliance with all laws and regulations. Detection of noncompliance, regardless of materiality, requires consideration of the implications for the integrity of management or employees and the possible effect on other aspects of the audit.
3. The term "noncompliance" as used in this ISA refers to acts of omission or commission by the entity being audited, either intentional or unintentional, which are contrary to the prevailing laws or regulations.

Responsibility of Management for the Compliance with Laws and Regulations

9. It is management's responsibility to ensure that the entity's operations are conducted in accordance with laws and regulations. The responsibility for the prevention and detection of noncompliance rests with management.

The Auditor's Consideration of Compliance with Laws and Regulations

11. The auditor is not, and cannot be held responsible for preventing noncompliance. The fact that an annual audit is carried out may, however, act as a deterrent.

Reporting of Noncompliance

33. If in the auditor's judgment the noncompliance is believed to be intentional and material, the auditor should communicate the finding without delay.

To the Users of the Auditor's Report on the Financial Statements

35. If the auditor concludes that the noncompliance has a material effect on the financial statements, and has not been properly reflected in the financial statements, the auditor should express a qualified or an adverse opinion.

In view of the above paragraphs, the Committee is of the opinion that the concern expressed by you is appropriately addressed by the above said paragraphs of ISA 250, which are required to be complied with by all the practicing members of the Institute who carry out the audit, therefore, there appears to be no need to issue any further guideline as suggested by you.

(September 11, 2004)

2.5 PARTNERSHIP ARRANGEMENTS WITH PREVIOUS AUDITORS

Enquiry: I have been appointed as the external auditor of XYZ Ltd., in its AGM held on January 30, 2004 and previous auditors M/s. ABC & Co. were not re-appointed due to Statutory Regulation No. xli of Code of Corporate Governance i.e. rotation of audit. Now I have bright chances to have partnership arrangements in future with M/s. ABC & Co.,

With reference to above paragraph, kindly advise us about any clause/interpretation of Code of Corporate Governance which restrains newly appointed auditors to form partnership with previous auditor who was not re-appointed due to Statutory Regulation No. xli of Code of Corporate Governance.

An early advice on the above issue will be highly regarded.

Opinion: We would like to draw your attention towards the following clause (xli) of Listing Regulations 38 relating to Code of Corporate Governance:-

- (xli) All listed companies are required to change their external auditors every five years. If for any reason this is impractical, a listed company may at a minimum, rotate the partner in charge of its audit engagement after obtaining the consent of the Securities and Exchange Commission of Pakistan.

As the above regulation does not address your specific enquiry, the Committee, therefore, is of the view that it is the responsibility of the merging firm to ensure that the object of the regulation should not appear to be defeated.

(August 7, 2004)