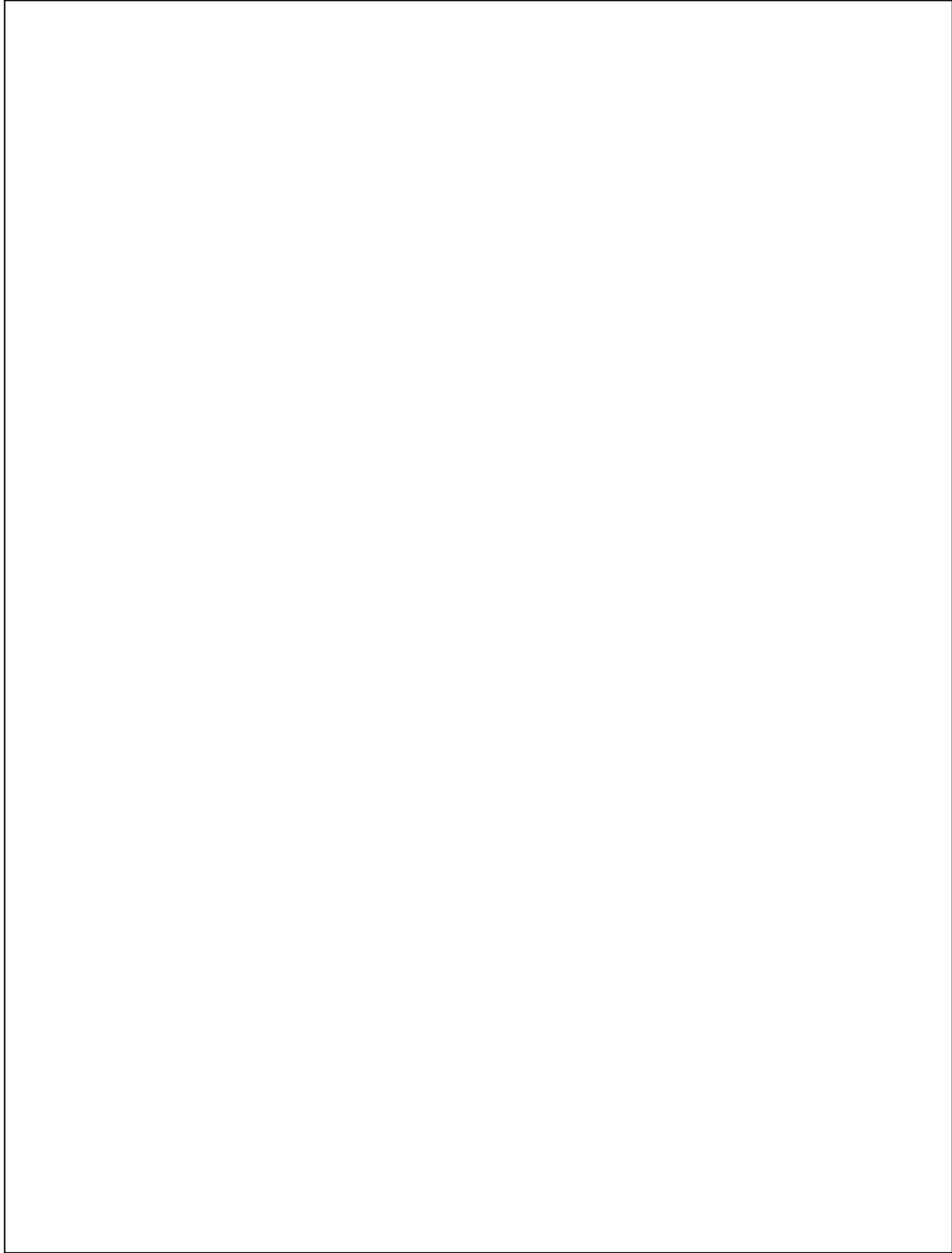


**MEMBERS' HANDBOOK**

**PART V**

**ACCOUNTING**

**THE INSTITUTE OF  
CHARTERED ACCOUNTANTS OF PAKISTAN**



# **MEMBERS' HANDBOOK**

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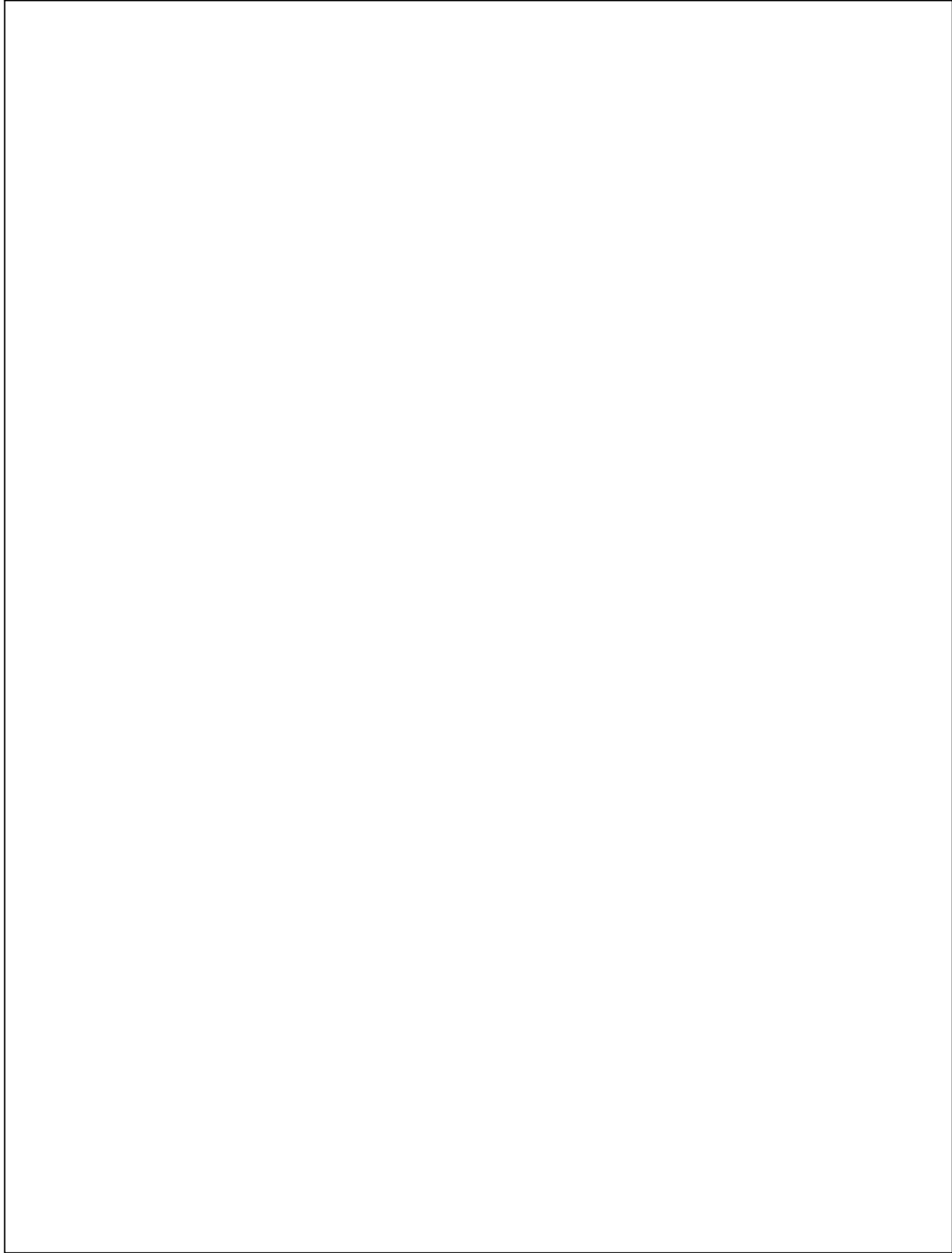
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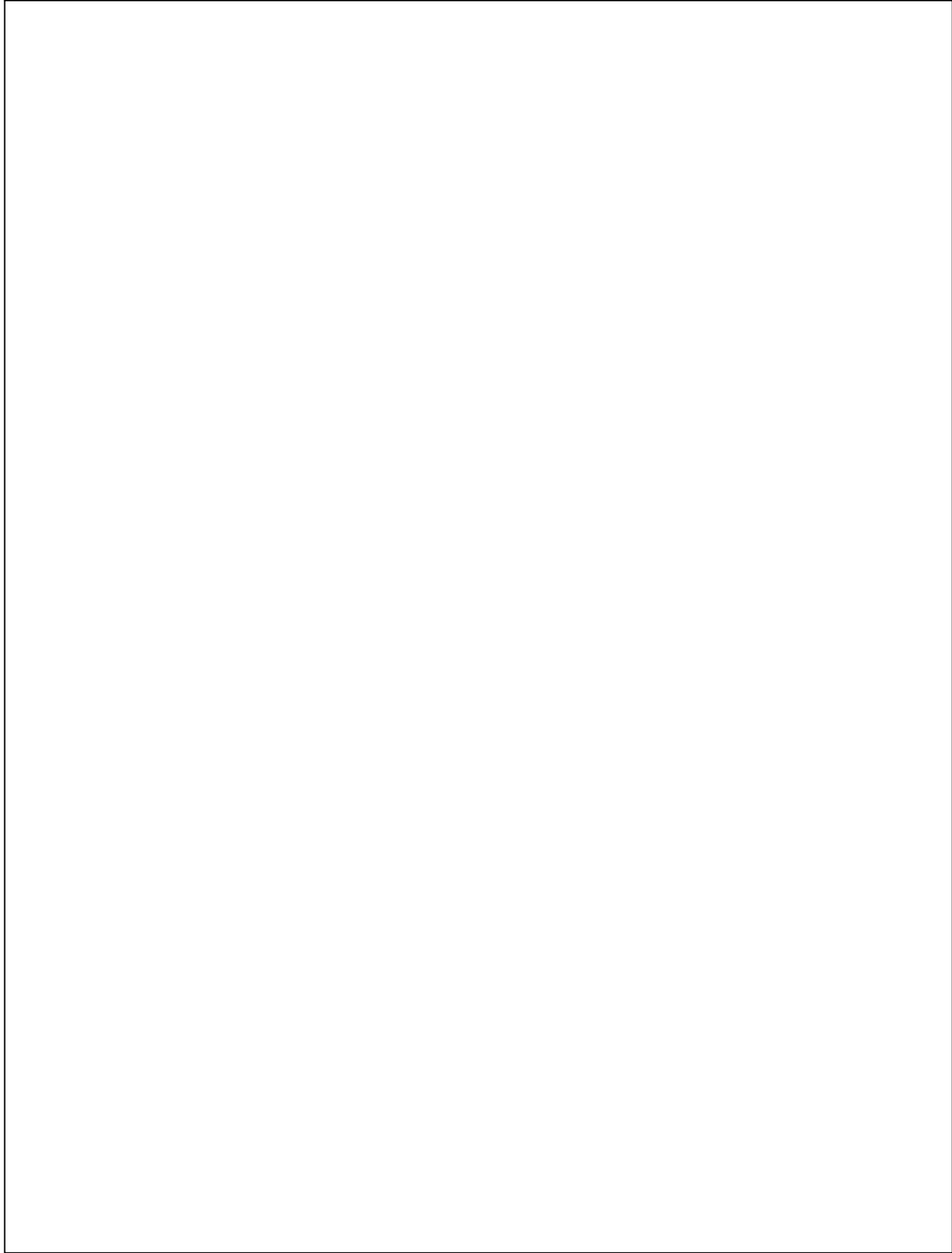
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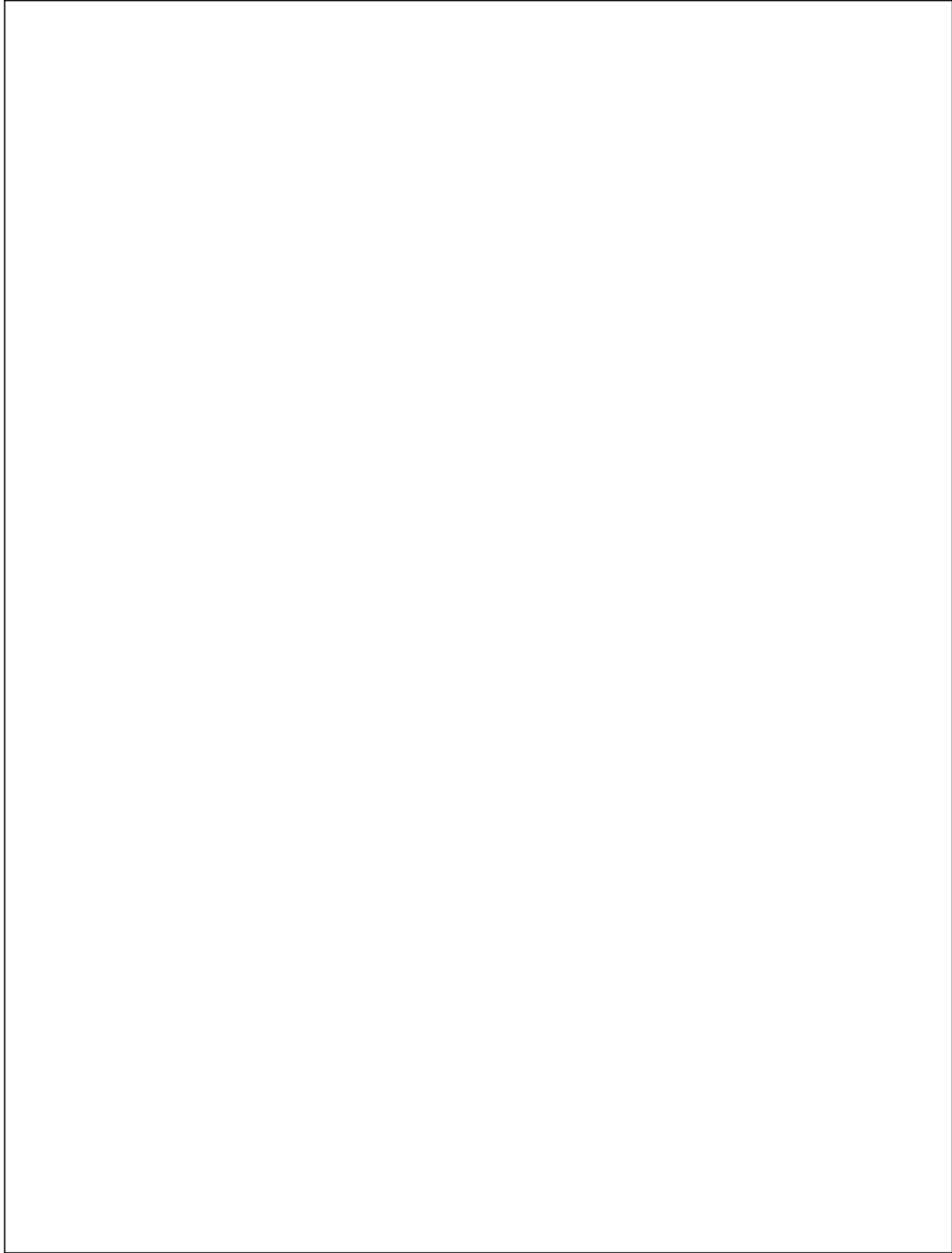
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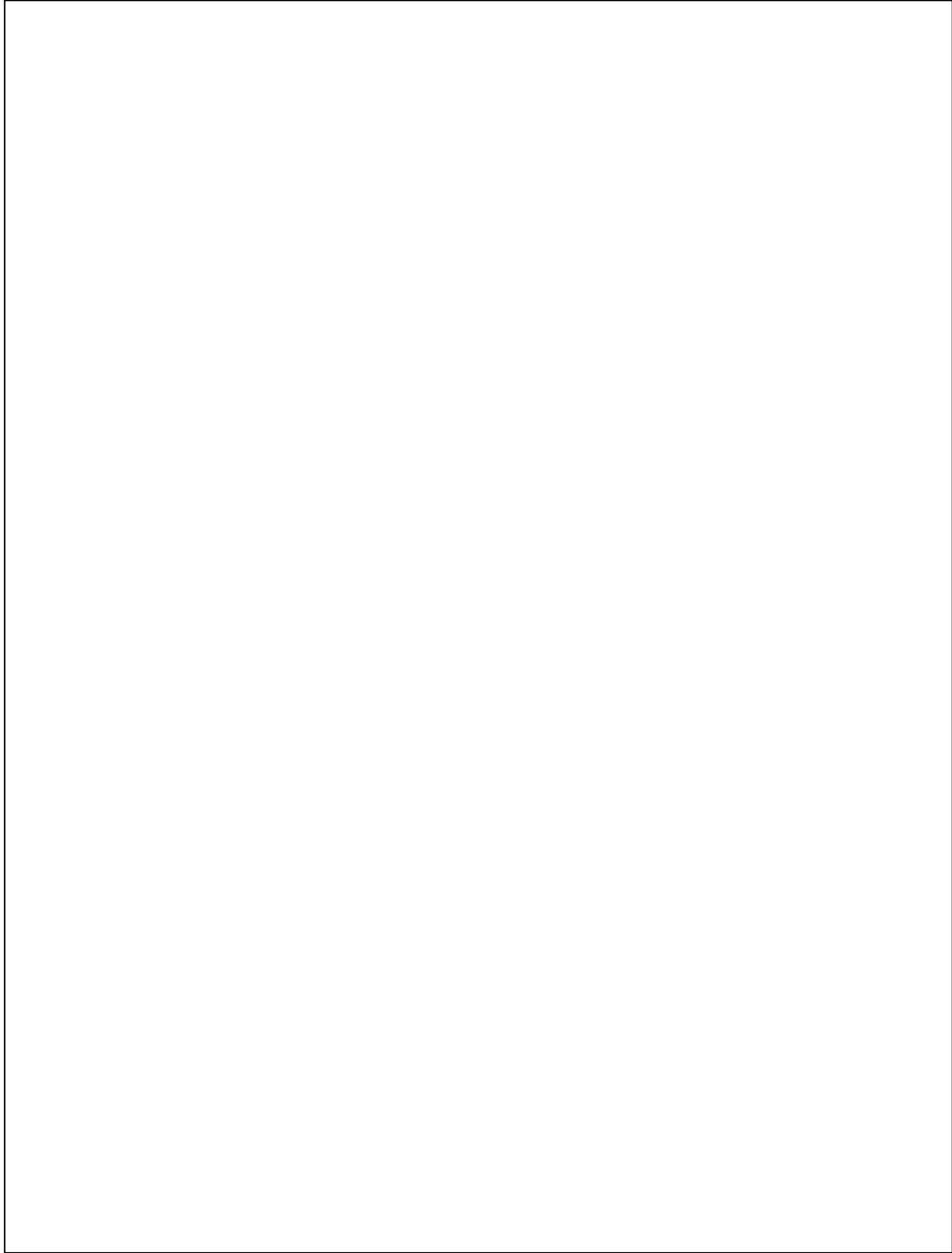
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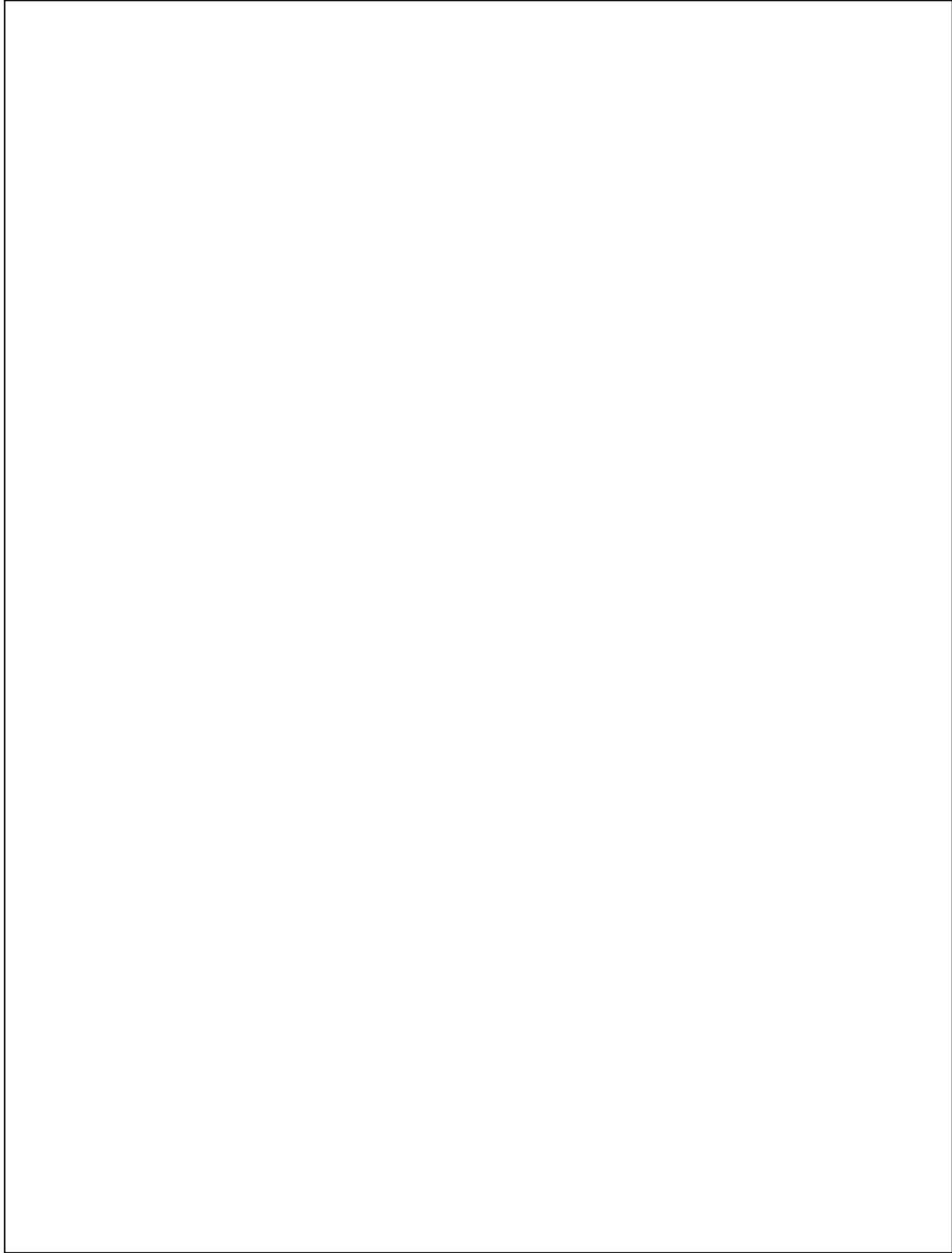
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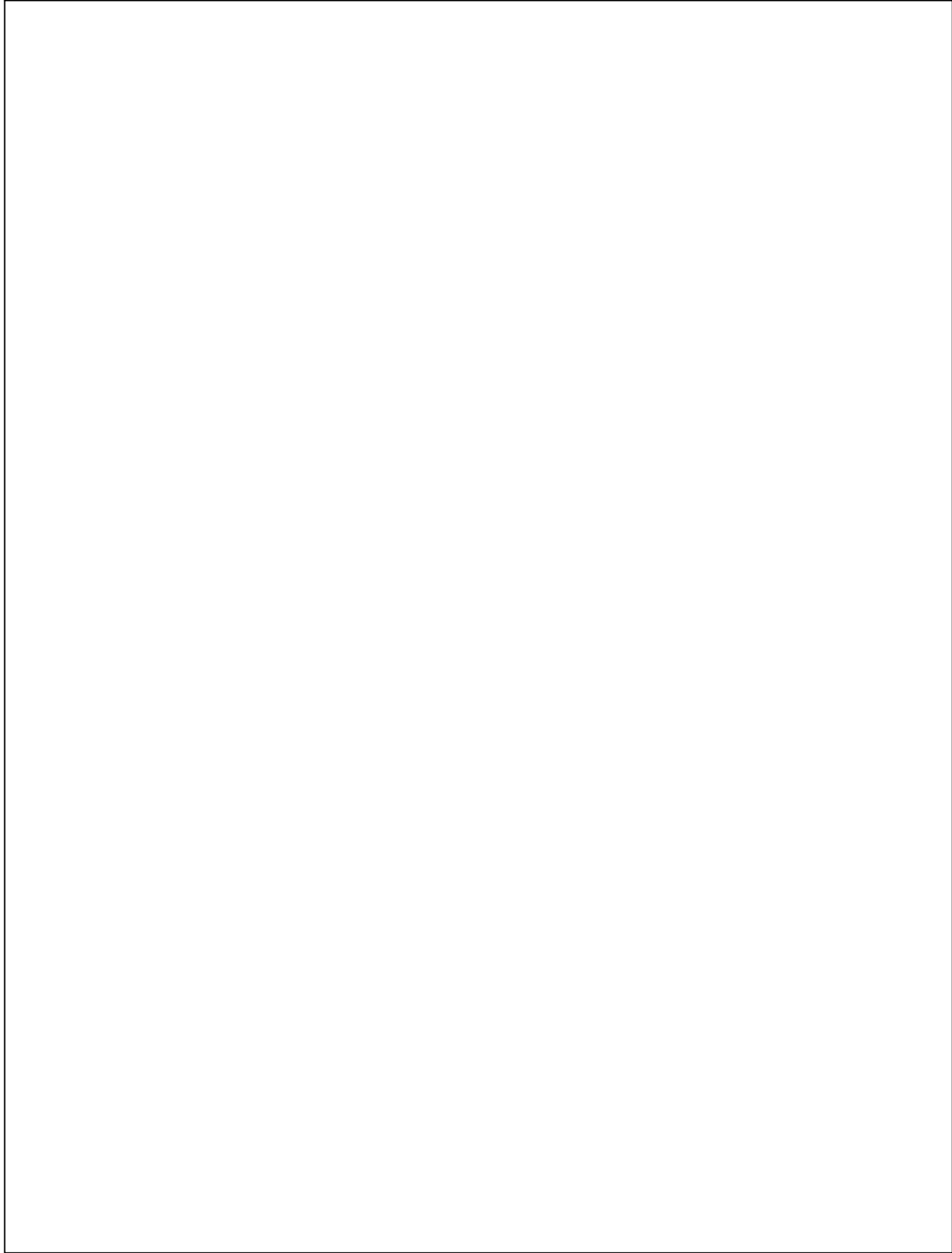
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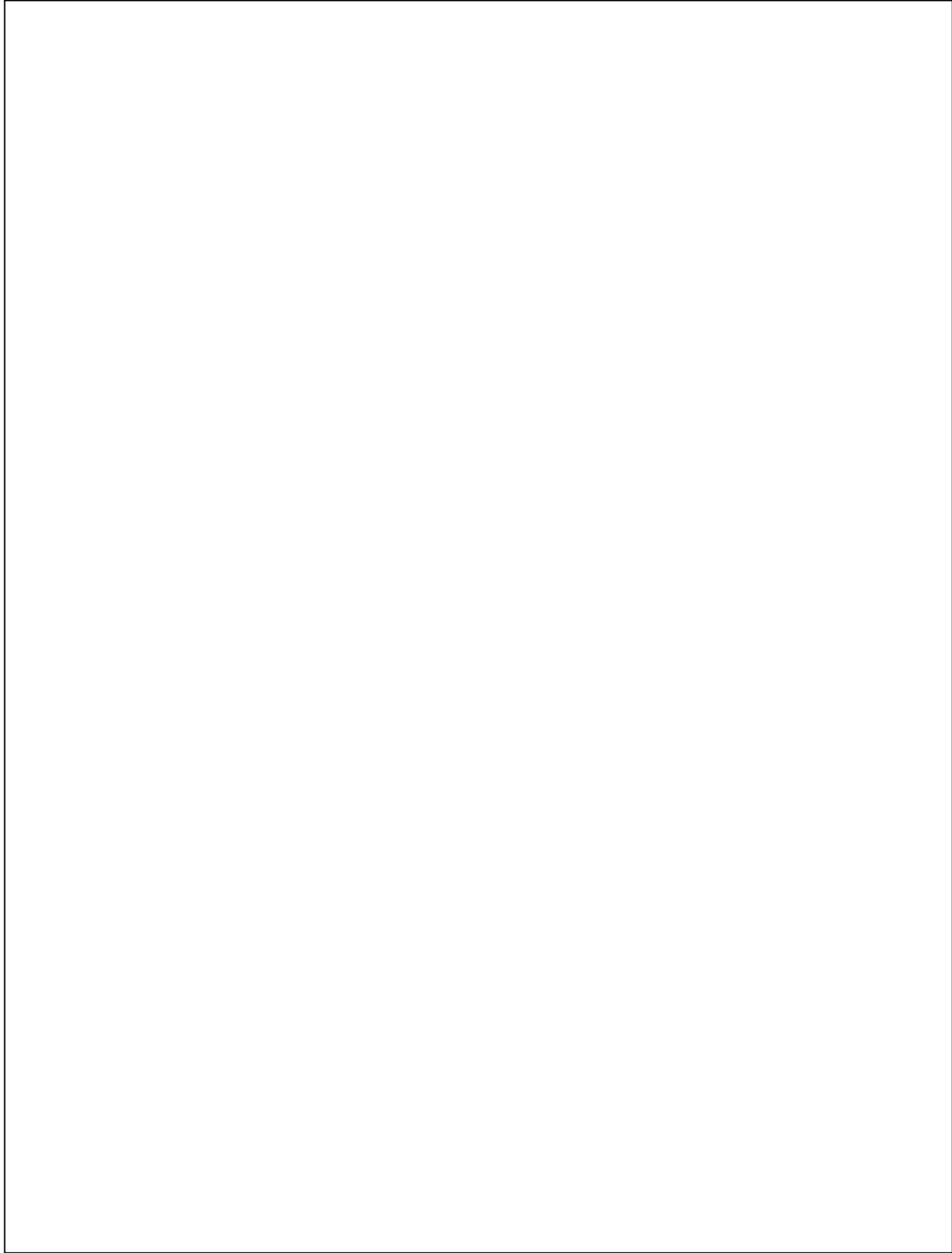
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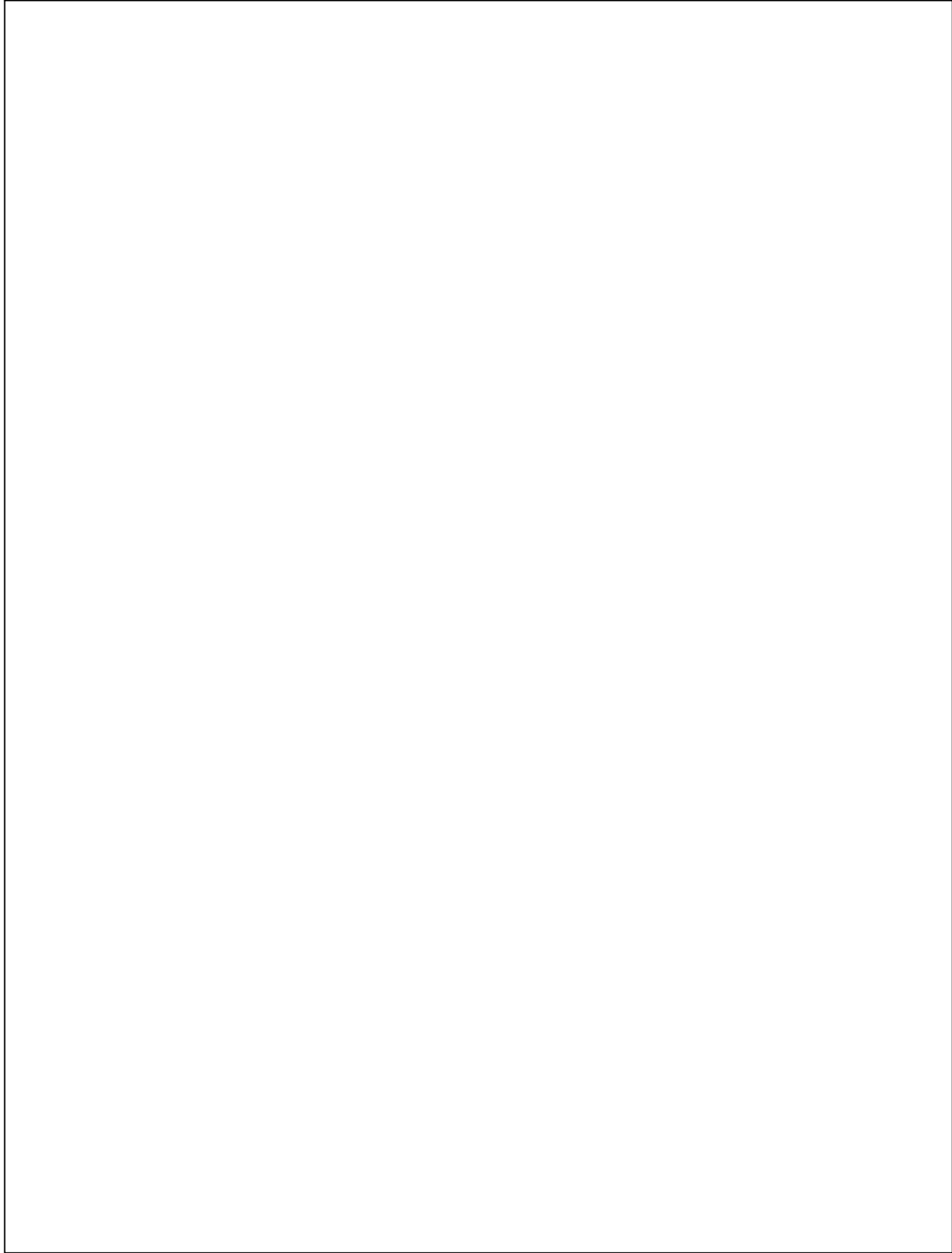
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**IASB STANDARDS-COUNCIL'S STATEMENT ON APPLICABILITY****1. THE ISSUE**

The Institute has been a member body of the International Federation of Accountants (IFAC) ever since its establishment in 1973. In 2004 IFAC issued seven Statements of Membership Obligations (SMOs) and subject matter of one of them i.e. SMO 7 is *'International Financial Reporting Standards (IFRSs) issued by the International Accounting Standards Board (IASB)*. Being a member body of IFAC it is the Institute's obligation to comply with this statement which requires that all member bodies should use their best endeavors:

- (a) To incorporate the requirements of IFRSs in their national accounting requirements, or where the responsibility for the development of national accounting standards lies with third parties, to persuade those responsible for developing those requirements that general purpose financial statements should comply with IFRSs, or with local accounting standards that are converged with IFRSs, and disclose the fact of such compliance; and
- (b) To assist with the implementation of IFRSs, or national accounting standards that incorporate IFRSs.

To date, the IASB (formerly IASC) has issued eight IFRSs (IFRS 1 to 8) and it has made changes to various International Accounting Standards (IASs) that were issued by its predecessor body International Accounting Standards Committee. In Pakistan, almost all of the IASs (except for IAS-29 and IAS-41) have been adopted and notified by the SECP on the recommendation of the Institute, while the remaining standards are in the process of adoption. The Council has also decided to gradually adopt all IFRSs for the use of public interest entities.

While the Institute has been pursuing the objective of adoption and use of international standards for the preparation of general purpose financial statements over the years, it is also cognizant of the difficulties faced by small and medium entities (SMEs) for complying with full set of IFRSs that have been made applicable for listed companies. In order to address the needs of the SMEs, the Council of the Institute had initiated a project to develop a separate set of standards for such entities in line with similar efforts in various other countries. Based on the work conducted and recommendations made by various committees working on this project for last two years, the Council is pleased to lay down this framework of accounting standards, including the two SME standards that should be complied with by the members of the Institute while expressing an opinion on the financial statements of SMEs.

## **2. COUNCIL'S DIRECTIVE**

2.1 The Council wishes to draw the attention of all members to paragraphs 5, 8 and 9 of the revised Preface to International Financial Reporting Standards which read as under: -

“5. All Standards and Interpretations issued under previous Constitutions continue to be applicable unless and until they are amended or withdrawn. The International Accounting Standards Board may amend or withdraw International Accounting Standards and SIC Interpretations issued under previous Constitutions of IASC as well as issue new Standards and Interpretations.

When the term IFRSs is used in this Preface, it includes standards and interpretations approved by the IASB, and International Accounting Standards (IASs) and SIC Interpretations issued under previous Constitutions.

8. IFRSs set out recognition, measurement, presentation and disclosure requirements dealing with transactions and events that are important in general purpose financial statements. They may also set out such requirements for transactions and events that arise mainly in specific industries. IFRSs are based on the *Framework*, which addresses the concepts underlying the information presented in general purpose financial statements. The objective of the *Framework* is to facilitate the consistent and logical formulation of IFRSs. The *Framework* also provides a basis for the use of judgement in resolving accounting issues.
  9. IFRSs are designed to apply to the general purpose financial statements and other financial reporting of all profit-oriented entities. Profit-oriented entities include those engaged in commercial, industrial, financial and similar activities, whether organized in corporate or in other forms. They include organizations such as mutual insurance companies and other mutual cooperative entities that provide dividends or other economic benefits directly and proportionately to their owners, members or participants. Although IFRSs are not designed to apply to not-for-profit activities in the private sector, public sector or government, entities with such activities may find them appropriate.”
- 2.2 The Council desires to direct all members to ensure that in accordance with the obligations undertaken by the Institute the auditor, while expressing an opinion on financial statements, should satisfy himself that they do comply with IASs/IFRSs in all material respects and that in the event of any departure from or inconsistency with such standards, the auditors’ report should contain suitable qualification. It should however be emphasized that IASs/ IFRSs do not override the local statutory provisions under Companies Ordinance, 1984 and the disclosure requirements under the Fourth and Fifth Schedules. Compliance with IASs/IFRSs shall be mandatory in so far as such standards are not inconsistent with local regulations or standards, directives or pronouncements issued by this Institute.

- 2.3 The Council is conscious of the present set of circumstances prevailing in Pakistan, in relation to compliance with some of the IASs / IFRSs and in view thereof has decided that for auditors of all companies while expressing an opinion on financial statements the compliance with the following standards shall, until notified otherwise, not be deemed to be mandatory:

IAS	29
IAS	41
IFRS	1, 4, 7 and 8

2.4 **Applicability of Accounting and Financial Reporting Standards for Medium-Sized Entities and Small-Sized Entities**

- 2.4.1 The Institute has developed and the Council in its meeting held on July 28, 2006 has approved two separate sets of accounting and financial reporting standards for Medium-Sized Entities (MSEs) and Small-Sized Entities (SSEs). These standards will be called as ‘Accounting and Financial Reporting Standards for Medium-Sized Entities and Small Sized Entities’.
- 2.4.2 The Institute directs its members that while expressing an opinion on financial statements of MSEs or / SSEs (whichever is applicable) they shall ensure compliance with the Accounting and Financial Reporting Standards for MSEs or / SSEs.
- 2.4.3 Entities qualifying as MSE or SSE are defined below:

## **QUALIFYING ENTITIES**

### **Medium-Sized Entity (MSE)**

A Medium-Sized Entity (MSE) is an entity that:

- a) is not a listed company or a subsidiary of a listed company;
- b) has not filed, or is not in the process of filing, its financial statements with the Securities and Exchange Commission of Pakistan or other regulatory organisation for the purpose of issuing any class of instruments in a public market;
- c) does not hold assets in a fiduciary capacity for a broad group of outsiders, such as a bank, insurance company, securities broker/dealer, pension fund, mutual fund or investment banking entity;
- d) is not a public utility or similar entity that provides an essential public service;
- e) is not a economically significant entity on the basis of criteria as defined below; and
- f) is not a Small-Sized Entity (SSE) as defined below.

### **Economically Significant Entity**

An entity is considered to be economically significant if it has:

- (i) turnover in excess of Rs. 1 billion, excluding other income;
- (ii) number of employees in excess of 750;

- (iii) total borrowings (excluding trade creditors and accrued liabilities) in excess of Rs. 500 million.

In order to be treated as economically significant any two of the criteria mentioned in (i), (ii) and (iii) above have to be met. The criteria followed will be based on the previous year's audited financial statements. Entities can be delisted from this category where they do not fall under the aforementioned criteria for two consecutive years.

### **Small-Sized Entity (SSE)**

A Small-Sized Entity (SSE) is an entity that:

- (i) has paid up capital plus undistributed reserves (total equity after taking into account any dividend proposed for the year) not exceeding Rs.25 million; and
- (ii) has annual turnover not exceeding Rs.200 million, excluding other income.

In order to qualify as a Small-Sized Entity, both of the above mentioned-conditions must be satisfied.

### **Effective Date**

2.4.4 Medium-Sized and Small-Sized Entities in respect of their annual financial statements shall apply the Accounting and Financial Reporting Standards for accounting periods beginning on or after July 1, 2006.

2.5 The Institute further directs its members that while expressing an opinion on financial statements of entities that do not qualify to be treated as MSE or SSE as per the definition given in paragraphs 2.4.3 above (except for public utility entities or similar entities

that provide an essential public service or regulatory agencies that do not fall under the jurisdiction of Securities and Exchange Commission of Pakistan (SECP), they shall ensure compliance with the International Accounting Standards (IASs)/ International Financial Reporting Standards (IFRSs) as adopted by the Council and notified by the SECP under section 234(3) of the Companies Ordinance, 1984.

- 2.6 Furthermore, while expressing an opinion on financial statements of public utility entities or similar entities that provide an essential public service or regulatory agencies that do not fall under the regulatory jurisdiction of SECP, such entities shall ensure that accounting frameworks as prescribed in their relevant statutes are complied with. However, where the relevant statute is silent or does not prescribe any accounting and financial reporting framework or treatment, the Institute recommends that such entity shall comply with IASs/IFRSs as applicable.
- 2.7 This statement is and shall be deemed to be a directive of the Council and shall be applicable to any International Accounting Standard /International Financial Reporting Standard which may be issued in future unless otherwise specified by the Council. Non-compliance with this directive shall be deemed to be a professional misconduct in terms of clause (3) of Part 4 of Schedule I to the Chartered Accountants Ordinance, 1961.

*(186<sup>th</sup> meeting of the Council – November 8, 2006)*

**FIXED ASSETS INVENTORY AND RECORDS****1. THE ISSUE**

Section 230 of the Companies Ordinance, 1984 requires every company to keep proper books of accounts with respect to all assets of the company. Usually fixed assets comprise a significant portion of a company's assets. No guidance is available for companies as to how the fixed assets records be maintained. Accordingly, it is felt that guidance may be given to our members. Following are important aspects, which require maintenance of proper records that help in preparation of Financial Statements:

- (a) Periodic reconciliation of the underlying records of fixed assets with the accounting records (General Ledger).
- (b) Reconciliation of the periodic physical inventory of fixed assets with fixed assets records.
- (c) Determination of cost and accumulated depreciation of each item of fixed assets at the time of retirement or disposal.

**2. TECHNICAL COMMITTEE RECOMMENDATIONS****1.1. Fixed Assets records**

Adequate itemized record of fixed assets should be maintained which at minimum must indicate following particulars:

- (a) detailed description of each item
- (b) original cost of the item
- (c) date of its acquisition
- (d) classification of the item
- (e) the location and/or the custodian of the item
- (f) the rate of depreciation

- (g) accumulated depreciation
- (h) depreciation charge for the period
- (i) the department / cost center / product to which the depreciation is charged
- (j) date of revaluation (if any)
- (k) revalued amount (if any) of the items
- (l) depreciation on revalued amount
- (m) accumulated depreciation on the revalued amount

### **1.2. Physical inventory of fixed assets**

Physical verification of fixed assets should be carried out on a cyclical basis (perpetual inventory) according to a formal plan once in five year. The physical inventory should be reconciled with the fixed assets records and adjusted accordingly.

*(165<sup>th</sup> and 166<sup>th</sup> meeting of the Council – July 30-31 and September 17-18, 2004)*

**CLARIFICATION REGARDING BASIS OF CALCULATION OF  
WORKERS' PROFITS PARTICIPATION FUND****1. THE ISSUE**

Opinion was sought whether Workers' Profit Participation Fund is to be calculated after or before charging it against the profits of the year. For illustration purposes an example is given here under:

a)	Profit of the Company	:	Rs.250.00
	WPPF @ 5% of Rs.250.00	:	Rs. 12.50
b)	Profit of the Company	:	Rs.250.00
	WPPF @ 5/105 of Rs.250.00	:	Rs. 11.90

**2. TECHNICAL COMMITTEE RECOMMENDATION**

- I. Contribution to Workers' Profit Participation Fund is to be made on the basis of provision contained in clause (b) of sub-section (1) of section 3 of Companies Profits (W.P.) Act, 1968. This provides that the amount should be 5% of its profits before charging such WPPF, as per audited accounts. If there are no profits no contribution is payable. Hence, this is in the nature of an appropriation of profits.
- II. Accordingly, method indicated in example (a) is correct and should be followed.

*(165<sup>th</sup> and 166<sup>th</sup> meeting of the Council – July 30-31 and September 17-18, 2004)*

**DEPRECIATION ON IDLE PROPERTY, PLANT AND EQUIPMENT****1. THE ISSUE**

- (a) Whether depreciation should be charged on property, plant and equipment, which are idle?
- (b) Whether on property, plant and equipment used by a company in business or operation of seasonal nature depreciation be charged commensurate with the extent of their use in a season?

**2. TECHNICAL COMMITTEE RECOMMENDATIONS**

- 2.1 The Committee while examining the above two issues placed reliance on the principles set out in IAS 16 – Property, Plant and Equipment (IAS-16) and was of the opinion that the said IAS lays down comprehensively the principles and standard for depreciation accounting and hence there was no need for a separate standard to deal with the above issues. However, in order to facilitate understanding of the accounting treatment in respect of the above issues, the explanations contained in this Technical Release may provide the necessary guidance.
- 2.2 Property, plant and equipment in a business include assets in use and held with reasonable expectation of these being used. Depreciation should, therefore, normally be charged on all fixed assets. Idle, reserve or stand-by assets should also continue to be depreciated, subject to the periodical review of the useful life of such property, plant and equipment as stated in paragraph 41 to 52 of IAS 16.
- 2.3 Similarly with regard to property, plant and equipment 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.

*(165<sup>th</sup> and 166<sup>th</sup> meeting of the Council – July 30-31 and September 17-18, 2004)*

**BONUS SHARES - ACCOUNTING TREATMENT****1. INTRODUCTION**

- Bonus shares are the shares issued by a company from distributable reserves to its ordinary shareholders, without consideration, by way of either capitalization of its profits or utilization of share premium account.
- Issue of bonus shares is prompted mainly by desire to give the recipient shareholders some separate evidence of part of their respective interests in undistributed profits without distribution of cash, which the Board of Directors deem necessary to retain in the business.

**2. THE ISSUE**

- How should the issue of bonus shares be accounted for by the Issuer and the Recipient?

**3. TECHNICAL COMMITTEE RECOMMENDATIONS****3.1 Accounting by the Issuer**

- A bonus issue does not give rise to any change in either the company's assets or its respective shareholders proportionate interests therein. The company issuing bonus shares shall account for such shares by transferring from Reserves to Issued Share Capital an amount equal to the par value of additional shares issued.
- In the first instance, generally the profits are appropriated and transferred to Reserve for Issue of Bonus shares. The Reserve is then utilized for issue of capital on completion of necessary formalities.

**3.2 Accounting by the Recipient**

Capitalization of accumulated profits by the issue of fully paid bonus shares by a company does not in fact change the net worth of that company and by the same token does not add anything to the assets or income of the recipient shareholder initially. The correct treatment of bonus shares, therefore, in the hands of the recipient would be merely to add to the number of shares it owns without giving any monetary effect in the accounts at the time of right to receive the bonus shares is established.

*(165<sup>th</sup> and 166<sup>th</sup> meeting of the Council – July 30-31 and September 17-18, 2004)*

**DATE OF COMMENCEMENT OF COMMERCIAL PRODUCTION****THE ISSUE**

It is extremely important to establish the date, when the project is deemed to commence commercial production as the expenditure of revenue nature which is permissible to be capitalized upto the date of commencement of commercial production, will have to be charged to income after such date.

Large projects usually involve some time lag between the time when the plant is installed and the date when the commercial production commences due to variety of reasons including time required for trial runs. The trial run period is normally brief but in some cases such period may be unusually long as the plant or the process may require adjustments in order to produce products of the required quality in commercial quantities. In such cases, though the plant is installed and has also started production, it may not be considered ready for commercial production unless the required adjustments and test runs are completed. However, once the plant is ready for the production of intended products in commercially feasible quantities, and the company for any reason, delays commercial production, any expenditure during such intervening period has to be treated as revenue expenditure.

TR-20 Accounting for Expenditure During Construction Period issued by the Institute of Chartered Accountants of Pakistan states in its preamble:

How to treat expenditure incurred during construction period upto the date of commencement of commercial production, if an enterprise is devoting substantially all of its efforts in establishing a new project.

This technical release provides guidance to establish date of commencement of commercial production.

**TECHNICAL COMMITTEE RECOMMENDATIONS**

Date of commencement of commercial production is the date when the plant is ready for the production of intended products in commercially feasible quantities. The cut off date so established is without regard when the plant actually commences commercial production. Where the construction of an asset is completed in parts and each part is capable of being used while construction continues on the other parts, capitalization of costs for each part should cease as it is completed

**BOOK VALUE PER SHARE****THE ISSUE**

Different practices and policies are being used for computing book value (commonly known as break-up value in Pakistan) of shares. For instance in some cases all the assets including intangibles, deferred costs and fictitious assets are included in considering the book value without regard to their recoverability. In some other cases, intangibles are excluded from the shareholders' equity. Practices also vary regarding adjustment of contingent and other losses.

**TECHNICAL COMMITTEE RECOMMENDATIONS**

Book value per share in the equity capital of the company is the amount each share is worth on the basis of carrying value per balance sheet, prepared in accordance with a framework of recognized accounting standards. Such standards provide that:-

- (a) An asset is a resource controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise.
- (b) 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.

**Computation of Book Value Per Share**

Book value per share is computed by dividing shareholders' equity with the number of shares issued. Shareholders' equity includes:-

- a) Paid up capital
- b) Revenue reserves and retained earnings, (less accumulated losses if any).

## ACCOUNTING

TR-22 (Revised 2002)

c) Capital reserves

Where the auditors have issued a qualified report and the qualification has been quantified in monetary terms, that amount should be deducted from equity.

Where the qualification is not quantified then the members issuing a certificate regarding book value should mention this fact in the certificate.

d) Surplus created as a result of revaluation of fixed assets.

If the balance sheet of an entity includes balance of surplus on revaluation, the book value per share should be computed separately both, including and excluding such surplus, to enable comparability with those entities where fixed assets have not been revalued.

The book value for any specific purposes in accordance with any statute would have to be computed per requirements or criteria laid down in that respect by the concerned regulatory agency or as set out in the relevant law.

**(151<sup>st</sup> meeting of the Council – April 26-27, 2002)**

**EXCHANGE RISK FEE – ACCOUNTING TREATMENT****THE ISSUE**

Whether the exchange risk fee paid on foreign currency loans acquired for capital requirements be capitalized after commencement of commercial production or not.

**TECHNICAL COMMITTEE RECOMMENDATIONS**

Exchange risk fee is incurred in order to eliminate, or reduce substantially, the risk of loss from changes in exchange rates. This involves use of forward exchange contract to establish the amount required at settlement date of transaction. *The forward rate established under such contract is not an estimate of what the exchange rate will be at the end of the contract but is essentially a function of (a) spot rate at the date the contract is taken out; (b) in the interest rate differential between the currencies of the two countries.* In consideration of providing assurance that a certain amount of foreign currency will be available by a specific date, at a predetermined rate, the banks make a charge to the entity applying for foreign exchange.

International Accounting Standard 23 Borrowing Costs, provides that borrowing costs include exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs. The exchange risk fee is therefore in the nature of borrowing costs and its accounting treatment should be in accordance with IAS 23, Borrowing Costs. Accordingly, exchange risk fee incurred by an entity after commencement of commercial production should be recognized as expense and not be capitalized.

**IAS-12, INCOME TAXES**

**1.0** IAS-12, Income Taxes (Revised) issued by IASC has become effective for the accounting periods beginning on or after January 1, 2002. It is felt that guidance is required on the applicability of deferred taxation where a company has brought forward tax losses or its sources of income are subject to deduction or collection of tax and the said deduction or collection is treated as full and final tax liability for the purposes of assessment under the Income Tax Ordinance 2001. It is therefore, proposed to issue the following as a guidance to the members on the applicability of IAS 12 (Revised) in Pakistan in relation to the afore-mentioned situations.

**2.0 APPLICATION OF DEFERRED TAXATION**

2.1 The deferred tax accounting does not apply to those companies whose entire income is subject to deduction of tax at source that is taken as a final tax liability (under any provision of the Income Tax Ordinance, 2001), as there will be no temporary differences.

2.2 Difficulty arises in case of those companies that have a portion of income subject to deduction or collection of tax and the said deduction or collection is treated as full and final tax liability for the purposes of assessment under the Income Tax Ordinance 2001 while the remaining portion of the income attracts assessment under normal provisions of the Income Tax Ordinance, 2001.

For instance, temporary differences are likely to arise on that portion of profit, which represents non-supplies. If the ratio between supplies remains the same year after year, it would be easy to calculate effect of temporary differences but since this ratio is not expected to be the same year after year, effect of temporary differences cannot be calculated with accuracy. In such instance, a reasonable estimate for sales relating to non-supplies should be made for the future years and the deferred tax liability provided accordingly.

- 2.3 However, if it is not practicable to develop a reasonable estimate for calculation of deferred tax liability / asset then an entity should evaluate the expectation of future turnover by taking into consideration the turnover trend of at-least three years (including the current year) and recognize and provide deferred tax liability accordingly. If the pattern of supplies and non-supplies remains same in the future also then the company should recognize and provide deferred tax for all temporary differences that could be attributed to non-supplies.
- 2.4 A practical example on the application of Deferred Tax is enclosed assuming that the ratio between non-supplies and supplies is 4:6.

**3.0 TAX LOSSES**

- 3.1 In case in a particular year, current tax liability is calculated under provisions of Section 113 due to taxable loss the effect of temporary differences should be calculated and deferred tax liability/ asset should be recognized.
- 3.2 In Pakistan, normally the tax losses are assessed months or even years after the balance sheet date. While ascertaining the deferred tax asset on the balance sheet date, the loss for the current year should be based on the estimated amount of loss that is likely to be assessed by the tax authorities.
- 3.3 A deferred tax asset should be recognized for the carry forward of unused tax losses and unused tax credits (as allowed under the provisions of the Income Tax Ordinance, 2001) to the extent that it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilized.

## ACCOUNTING

TR-27 (REVISED 2003)

### 4.0 EXAMPLE

Equipment costing Rs.2,000,000 was purchased during 20A. Capital expenditure budget reflects following additions:

20B	700,000
20C	800,000
20D	900,000
20E	1,000,000

Entity's revenue include 60% sales that are subject to collection/ deduction of tax.

Tax Rate	35%
Tax Depreciation	25% WDV
Life	10 Years
Depreciation Policy	Straight Line

### ACCOUNTING NBV

Year	Cost			Depreciation			NBV
	Beginning of Year	Additions	End of Year	Beginning of Year	For the Year	End of Year	
20A	2,000,000		2000,000		200,000	200,000	1,800,000
20B	2,000,000	700,000	2700,000	200,000	270,000	470,000	2,230,000
20C	2,700,000	800,000	3500,000	470,000	350,000	820,000	2680,000
20D	3,500,000	900,000	4400,000	820,000	440,000	1,260,000	3140,000
20E	4400,000	1000,000	5400,000	1260,000	540,000	1,800,000	3600,000

**ACCOUNTING**

**TR-27 (REVISED 2003)**

**DEPRECIATION PER ACCOUNTS**

<b>Year</b>	<b>On Original Cost</b>	<b>On Additions</b>	<b>On Additions</b>	<b>On Additions</b>	<b>On Additions</b>	<b>Total</b>
		<b>20B</b>	<b>20C</b>	<b>20D</b>	<b>20E</b>	
	2000,000	700,000	800,000	900,000	1000,000	5,400,000
20A	200,000					200,000
20B	200,000	70,000				270,000
20C	200,000	70,000	80,000			350,000
20D	200,000	70,000	80,000	90,000		440,000
20E	200,000	70,000	80,000	90,000	100,000	540,000

**X WDV**

<b>Year</b>	<b>Cost</b>			<b>Depreciation</b>			<b>NBV</b>
	<b>Beginning of year</b>	<b>Addition</b>	<b>End of Year</b>	<b>Beginning of year</b>	<b>For the Year</b>	<b>End of Year</b>	
20A	2,000,000		2,000,000	-	500,000	500,000	1,500,000
20B	2,000,000	700,000	2,700,000	500,000	550,000	1,050,000	1,650,000
20C	2,700,000	800,000	3,500,000	1,050,000	612,500	1,662,500	1,837,500
20D	3,500,000	900,000	4,400,000	1,662,500	684,375	2,346,875	2,053,125
20E	4,400,000	1,000,000	5,400,000	2,346,875	763,281	3,110,156	2,289,844

**TAX DEPRECIATION**

<b>Year</b>	<b>On Original Cost</b>	<b>On Additions</b>	<b>On Additions</b>	<b>On Additions</b>	<b>On Additions</b>	<b>Total</b>
		<b>20B</b>	<b>20C</b>	<b>20D</b>	<b>20E</b>	
	2,000,000	700,000	800,000	900,000	1,000,000	5,400,000
20A	500,000					500,000
20B	375,000	175,000				550,000
20C	281,250	131,250	200,000			612,500
20D	210,938	98,437	150,000	225,000		684,375
20E	158,203	73,828	112,500	168,750	250,000	763,281

**TEMPORARY DIFFERENCES**

Year	NBV per Accounts	Tax WDV	Cumulative Temporary Difference	Increase In Temporary Difference	Non- Supplies Temporary Difference	Provision @ 35%	Cumulative Provision
					@ 40%		
20A	1,800,000	1,500,000	300,000	300,000	120,000	42,000	42,000
20B	2,230,000	1,650,000	580,000	280,000	112,000	39,200	81,200
20C	2,680,000	1,837,500	842,500	262,500	105,000	36,750	117,950
20D	3,140,000	2,053,125	1,086,875	244,375	97,750	34,213	152,163
20E	3,600,000	2,289,844	1,310,156	223,281	89,312	31,259	183,422

As per the Revised IAS 12, deferred taxation should be recognized each year using the balance sheet liability method i.e. a provision of Rs. 42,000 (being 35% of 40% Rs.300,000) would be required at the end of 20A and so on. A total of Rs. 183,422 would be recognized as deferred tax liability from year 20A to year 20E assuming that there would be no reversals during this period.

**5.0 DEFERRED TAX RELATING TO LEASING COMPANIES**

Another issue relates to leasing companies only. SECP Circular No. 16 of 1999 required leasing companies to transfer to a capital reserve, amounts equivalent to their deferred tax liability during the period 1 July 1998 to 30 June 2003. The circular was issued to ensure compliance with IAS 12 by the time it became applicable. However, the circular has not specified the treatment of this capital reserve so created when IAS 12 becomes applicable.

Appropriate treatment would be to treat it as a change in accounting policy in accordance with IAS 8 *Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies*. In preparation of financial statements beginning on or after 1 July 2003.

This would require:

- recognition of deferred tax liability as at June 30, 2002 as an adjustment of opening retained earnings;
- charge of deferred tax liability for 2002-2003 to 2003-2004 financial statements (i.e. to restate comparative figures) presented for comparison purposes and charge deferred tax liability for 2003-04 to profit and loss account ; and
- transfer capital reserve for deferred tax to retained earnings in 2003-2004 financial statements.

**CARRY-OVER-TRANSACTIONS (COT)****THE ISSUE**

The Karachi Stock Exchange (Guarantee) Limited (KSE) had enforced Carry-Over Transactions Regulations (“the Regulations”) with effect from 11 January 1993. These regulations were introduced to enhance the stock market liquidity and parallel regulations were also enforced by the other stock exchanges of the country. Following paragraphs summarise the mechanism of COT along with its accounting treatment generally being followed.

1. Carry over transaction, as defined in section 2(e) of the Regulations, means the combination of two transactions taking place simultaneously and settled in two clearings in sequence. According to section 4(iii) of the Regulations, the buyer of shares in current clearing period (“the first transaction”) would become seller of the same shares in the immediate next clearing period (“the second transaction”) and the seller of shares in current clearing period (“the first transaction”) would become buyer of the same shares in the immediate next clearing period (“the second transaction”).
2. Buyer / Seller enters into the first transaction on Friday after normal trading hours and its settlement takes place on succeeding Wednesday through Clearing House of KSE along with settlements of normal transactions. Simultaneously, seller / buyer enters into the second transaction on the same Friday and its settlement takes place through Clearing House but on succeeding second Wednesday. However, the contract ticket of the second transaction (which is prepared on Friday) bears the date of succeeding Monday, not of Friday. Share Price of the second transaction is marked-up and generally does not match with the prevailing market quotes of the succeeding Monday. The marking-up of second transaction is dependent on demand and supply of funds in the Carry-Over Market.

3. Paragraph 10 of International Accounting Standard 39 “Financial Instruments: Recognition and Measurement” defines “*repurchase agreement (Repo) as an agreement to transfer a financial asset to another party in exchange for cash or other consideration and a concurrent obligation to reacquire the financial asset at a future date for an amount equal to the cash or other consideration exchanged plus interest*”. If we consider the series of above two Carry-Over-Transactions as a whole, its commercial effect takes form of a Repo in which lending / borrowing of funds against pledge of shares takes place for one week i.e. from Wednesday to Wednesday.
4. Paragraph 13 of the IAS 18 “Revenue” states that the “*revenue recognition criteria are applied to two or more transactions together when they are linked in such a way that the commercial effect cannot be understood without reference to the series of transactions as a whole*”. Paragraph 13 further gives an example of *an enterprise that may sell goods and at the same time enter into a separate agreement to repurchase the goods at a later date thus negating the substantive effect of the transaction; in such a case the two transactions are dealt with together*”. However, dealing with first and second transactions separately, revenue / expense from COT is generally accounted for as capital gain / loss and not as interest income / expense.
5. Paragraph 27 of IAS 39 states that “*an enterprise should recognise a financial asset or financial liability on its balance sheet when, and only when, it becomes a party to the contractual provisions of the instrument*”. In the case of first transaction COT, generally the buyer recognises purchase of shares as investment in its balance sheet (and not recognise a lending) without considering the second transaction. However, simultaneousness of the second transaction of COT does not constitute the buyer in substance a party to the contractual provisions of the equity instrument.

6. Paragraph 35 of IAS 39 states that “*an enterprise should derecognise a financial asset or a portion of a financial asset when, and only when, the enterprise loses control of the contractual rights that comprise the financial asset (or a portion of the financial asset).*” Further, paragraphs 38 & 39 state that a transferor has not lost control of a transferred financial asset and, therefore the asset is not derecognised if the transferor has the right to reacquire the transferred asset unless either (i) the asset is readily obtainable in the market or (ii) the reacquisition price is fair value at the time of reacquisition. In the case of first transaction of COT, generally the seller de-recognises the investment in shares from its balance sheet (and not recognising a borrowing) without considering the second transaction. However, simultaneousness of the second transaction of COT gives the seller a right to repurchase the shares at a fixed price. Further, the respective shares are not readily obtainable in the market on succeeding Monday because their prices are fixed in advance i.e. on Friday.

Keeping in view the above practice and the form as well as substance of COT a question has arisen whether COT is a Repo or not?

### **TECHNICAL COMMITTEE RECOMMENDATIONS**

The appropriate Committee of the Institute has examined all aspects of the query regarding Carry-Over-Transactions (COT) and is of the opinion that a Carry-Over-Transaction is a Repo transaction as the substance of the transaction and not its form should be considered and accordingly it should be treated as a financing transaction. in the books of accounts.

The aforesaid clarification provides the accounting treatment for Carry-Over-Transactions under International Accounting Standards. However for the purposes of other statutes, the transaction would have the effect according to the relevant provisions of that law.

*(152<sup>nd</sup> meeting of the Council – July 19-20, 2002)*

**FINAL TAX ACCOUNTING****THE ISSUE**

- 1.1 The Technical Advisory Committee (TAC) issued an accounting technical release (TR-27) on April 26, 1996, subsequently revised the same in 2003, to provide guidance on the application of the requirements of IAS – 12 (Income Taxes) in the case of companies which are subject to Final Tax Regime (FTR) as well as Normal Tax Regime (NTR), in the same “tax year”, under the applicable provisions of the Income Tax Ordinance, 2001 (ITO 2001). The guidance emphasised that deferred tax accounting does not apply to those companies which are entirely covered under FTR since such companies, it was argued, do not have a temporary difference which is a fundamental basis on which inter-period tax allocation is done through deferred tax accounting.
  
- 1.2 A member has sought guidance from the Institute with regard to the above TR that in a situation where an entity is taxed under FTR at import stage under the Ordinance and a portion of the imported goods remains unsold at the balance sheet date (held and carried forward as inventory), how should the said final tax be accounted for in the financial statements prepared under the approved accounting standards as applicable in Pakistan i.e. whether:
  - a) The entire amount of final tax paid at import stage be recognised as expense in the period in which goods were imported; or
  
  - b) The final tax paid at import stage be recognized as expense as and when the goods are sold and the related profits are earned.

**TECHNICAL COMMITTEE RECOMMENDATIONS**

- 2.1 IAS – 12 ‘Income Taxes’ is applicable to income taxes which as per its paragraph ‘2’ are based on taxable profits. Taxable profit / (tax loss) has been defined as the profit (loss) for a period, determined in accordance with the rules established by the taxation authorities, upon which income taxes are payable (recoverable).
- 2.2 Section 148 (7) of ITO 2001 (the relevant section for the income tax in case of imports) inter alia states “The tax collected under this section shall be a final tax on the income of the importer arising from the imports”. Hence it is clear that the final tax on imports is actually on the income of the importer arising from imports such that the total amount of tax is a percentage of the import value. In other words, it may be seen as a variable tax rate being applicable on the income of the importer from imports that equates the tax on income to a certain percentage of assessed value.
- 2.3 ITO 2001 gives the timing of the payment of tax on income from imports. However, it is established that whatever be the timing, the tax is on the income of the importer from imports and hence, till the time the income does not so arise, it merely is a pre-payment of tax in relation to such income albeit being final is not refundable but entails future economic benefit that will flow to the tax payer as a direct consequence of import stage taxation in the period when the imported goods are sold.
- 2.4 Para 12 of IAS 12 states “Current tax for current and prior periods shall, to the extent unpaid, be recognised as a liability. If the amount already paid in respect of current and prior periods exceeds the amount due for those periods, the

excess shall be recognised as an asset.” The Committee is of the view that the word ‘due’ is used in this para with respect to taxable profit (tax loss).

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- 2.5 Based on above, the Committee is of the view that in substance the tax paid at import stage entitles the tax payer to future tax benefit or relief in the shape of no further outflow in the form of taxation of profits that maybe earned from the selling of imported goods. Accordingly, any tax paid at import stage in relation to the goods in the inventory at year end should not be recognised as income tax expense rather treated as a pre-payment of tax to be expensed in the period in which such income arises from the sale of these imported goods.
- 2.6 Further, the Committee is of the opinion that the practice of treating final tax as a “period cost” in isolation without undertaking a matching process to determine whether the goods on the value whereof such income tax has been imposed, have been sold or carried over to the next accounting period as inventory negates the very foundation of tax accounting that income taxes considered to be an expense incurred by the company as a consequence of income earned and therefore, are accrued in the same period as the income to which they relate.
- 2.7 In view of the aforesaid, the Committee is of the considered opinion that the tax paid at import stage under FTR should be recognised as a tax expense in the period in which the related goods are sold. Accordingly, the portion of the tax paid that pertains to the unsold inventory should be carried forward in the balance sheet as pre-paid tax, subject to the following conditions:
- a) it is probable that the sale of imported goods would result in sufficient future taxable profits;
  - b) the carry forward of tax shall not relate to the inventories written down to net realisable value in accordance with IAS 2 “Inventories”;

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- c) the tax to be carried forward as explained above shall not constitute value of inventories; and If the above conditions are not met, the tax paid under FTR at import stage shall be fully recognised as a tax expense in the period in which the goods are imported and such tax is paid.

2.8 The Committee further recommends that TR – 27 shall be read in conjunction with this TR

**(196th meeting of the Council – May 6, 2008)**

**ANNUITY METHOD OF DEPRECIATION****THE ISSUE**

- 1.1. Whether Annuity Method of Depreciation is an appropriate method of depreciation under IFRS.

**TECHNICAL COMMITTEE RECOMMENDATIONS**

- 2.1 The annuity method is a compounded interest method whereby the depreciation is calculated based on the assumption that depreciation plus the normal cost of capital to finance the assets are constant over the life of the assets. This results in lower depreciation charges in the earlier years of the assets life and higher charges in the later years.
- 2.2 Although IAS 16 'Property, Plant and Equipment' does neither expressly prohibit the annuity method nor mentions it as a permissible method, it states that the depreciation method should reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity (paragraph 60 of IAS 16). Therefore, depreciation should reflect the actual diminution of the value of the asset or the direct revenue streams arising from such assets duly ignoring indirect and inconsistent revenues and other associated costs which can, however, not be considered to be a part of the pattern of flow of economic benefits from such assets. This implies the straight-line method or the reducing balance method to be more appropriate for most of the leasing assets.
- 2.3 Further it needs to be noted that in case of applicability of annuity method of depreciation, the depreciation charged in the initial years is on the lower side and accordingly, there arises an inevitable risk that the carrying value of such assets would exceed their fair values, which might create accounting issues in future with regard to impairment testing in line with IAS -36 ' .

- 2.4 In view of the aforesaid, the Committee is of the considered opinion that annuity method of depreciation under IFRS is not an appropriate method of depreciation particularly for assets given on operating lease for a determined period.

**(204<sup>th</sup> meeting of the Council – January 23, 2009)**