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SECTIONAL INDEX

PART I

SECTION C TECHNICAL RELEASES

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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 has issued fifteen IFRSs (i.e. IFRS 1 to 15) and it has made changes to various International Accounting Standards (IASs). In Pakistan, all of the IFRSs, except for *IFRS 1, 9, 14 and 15*, have been adopted and notified by the SECP on the recommendation of the Institute.

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 has also been cognizant of the difficulties faced by small and medium sized entities for complying with full set of IFRSs that have been made applicable for listed companies.

Even the IASB has recognized the need for a simpler set of standards for small and medium sized entities. In 2009 IASB issued International Financial Reporting Standard for Small and Medium Entities (IFRS for SMEs) a self-contained standard of about 230 pages tailored for the needs and capabilities of smaller

businesses. The standard was a result of a five-year development process with extensive consultation of SMEs worldwide.

On the recommendation of the Institute the SECP vide SRO No. 929/2015 dated September 10, 2015 has notified the '*International Financial Reporting Standard for Small and Medium Sized Entities (IFRS for SMEs)*' and '*Revised Accounting and Financial Reporting Standards (AFRS) for SSEs*' issued by ICAP. These standards are applicable on annual financial period beginning on or after January 1, 2015.

Consequently ICAP has withdrawn, for corporate entities, the AFRS for Medium Sized Entities and AFRS for Small Sized Entities issued in the year 2006. However, for non-corporate entities the old AFRS for Small Sized Entities will still be applicable.

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 *Conceptual Framework*, which addresses the concepts underlying the information presented in general purpose financial statements. Although the *Conceptual Framework* was not issued until September 2010, it was developed from the previous *Framework for the Preparation and Presentation of Financial Statements*, which the

IASB adopted in 2001. The objective of the *Conceptual Framework* is to facilitate the consistent and logical formulation of IFRSs. The *Conceptual 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 the accounting standards as applicable in Pakistan which includes the IFRS /IFRS for SMEs and /AFRS, 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 such standards do not override the local statutory provisions under Companies Ordinance, 1984 and the disclosure requirements under the Fourth and Fifth Schedules. Compliance with above mentioned accounting standards shall be mandatory in so far as such standards are not inconsistent with local regulations or standards and directives or pronouncements issued by the Institute.

2.3 Applicability of IFRS for SMEs and Revised AFRS for SSEs

- 2.3.1 Under the SECP directives, IFRS for SMEs is to be applied by:

1. Medium Sized Companies; and
2. Small and Medium Sized Company formed/licensed under Section 42 and Section 43 which has an annual gross revenue including other income / revenue of less than Rs.200 million.

Whereas the ‘*Revised Accounting and Financial Reporting Standards for SSEs*’ is applicable on Small Sized Companies.

- 2.3.2 The Institute directs its members that while expressing an opinion on financial statements of MSEs and SSEs they shall ensure compliance with the IFRS for SMEs Revised AFRS for SSEs and existing AFRS for SSEs (for non-corporate entities) respectively.
- 2.3.3 Following classes of companies have been defined in the Fifth Schedule to the Companies Ordinance 1984:

Medium Sized Company (MSC)

A non-listed company which is not a:

- a) Public Interest Company; or
- b) Large Sized Company; or
- c) Small Sized Company other than a non-listed public company

Public Interest Company (PIC)

A non-listed company which is:

- a) a public **sector** company as defined in the Public Sector **Companies** (Corporate Governance) Rules, 2013;
- b) a public utility or similar company carrying on the **business of essential public service**;
- c) holding **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) in the process of filing its financial statements with the Securities and Exchange Commission of Pakistan (SECP) or other regulatory organization for the purpose of issuing any class of instruments in a capital market.

Large Sized Company (LSC)

A non-listed company

- a) which has a paid-up capital of Rs.200 million or more; or
- b) turnover of Rs.1 billion or more.

Small Sized Company (SSC)

Other than a non- listed public company having:

- a) Paid up capital not exceeding Rs.25 million; and
- b) Turnover not exceeding Rs.100 million

2.4 Effective Date

Effective date as per the SECP SRO 929 dated September 10 2015 is annual financial periods beginning on or after January 1, 2015.

- 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 MSC or SSC as per the definition given in paragraphs 2.3.3 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 SECP, they shall ensure compliance with the 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 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 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.

(271st meeting of the Council January 9, 2016)

Before the revision, the TR was as follows:

ACCOUNTING

TR-5 (Revised 2006)

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.

(186th 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**2.1 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

2.2 Physical inventory of fixed assets

Physical verification of fixed assets should be carried out on at regular interval and should be reconciled with the fixed assets records and adjusted accordingly.

This revised TR – 6 (2012) supersedes the requirement as contained in TR – 6 of 2004.

(230th meeting of the Council – December 17, 2011)

The TR -6 before this revision reads as under

ACCOUNTING

TR-6 (Reformatted 2004)

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:

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- (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.

(165th and 166th 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.

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

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).

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.

(151st meeting of the Council – April 26-27, 2002)

IAS-12, INCOME TAXES (REVISED 2000)**1.0 THE ISSUE**

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 aforementioned situations.

TECHNICAL COMMITTEE RECOMMENDATIONS**2.0 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.

ACCOUNTING

TR-27 (Revised 2012)

- 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
- 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.

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 includes 60% sales that are subject to collection/ deduction of tax.

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

4.1 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

4.2 DEPRECIATION PER ACCOUNTS

Year	On Original	On	On	On	On	Total
	Cost	Additions	Additions	Additions	Additions	
		20B	20C	20D	20E	
	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

4.3 TAX WDV

Year	Cost			Depreciation			NBV
	Beginning Of year	Addition	End of Year	Beginning Of year	For the Year	End of Year	
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

4.4 TAX DEPRECIATION

Year	On Original	On	On	On	On	Total
	Cost	Additions	Additions	Additions	Additions	
		20B	20C	20D	20E	
	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

4.5 TEMPORARY DIFFERENCES

Year	NBV per Accounts	Tax WDV	Cumulative Temporary Difference	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

- 4.6** 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.

(230th meeting of the Council held on December 17, 2011)

The TR-27 before this revision reads as under:

ACCOUNTING

TR-27 (REVISED 2003)

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.

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

Year	On Original Cost	On Additions 20B	On Additions 20C	On Additions 20D	On Additions 20E	Total
	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

Year	Cost			Depreciation			NBV
	Beginning of year	Addition	End of Year	Beginning of year	For the Year	End of Year	
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

Year	On Original Cost	On Additions 20B	On Additions 20C	On Additions 20D	On Additions 20E	Total
	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	Tax WDV	Cumulative	Increase	Non-Supplies	Provision	Cumulative
	Accounts		Temporary	In Temporary	Temporary	@ 35%	Provision
			Difference	Difference	Difference		
					@ 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.

(152nd meeting of the Council – July 19-20, 2002)

DIRECTOR'S LOAN**THE ISSUE**

- 1.1 Lately it has been observed that various practices are being followed in accounting for director's loan to an entity. Therefore it was felt that guidance from the Institute should be issued to have consistency in accounting within the industry. The principal issues involved are whether the amount received by the entity from director is in the nature of financial liability or equity, valuation basis on initial recognition (fair value or face amount) and determination and treatment of difference between fair value and face amount, if any, arising on initial recognition.
- 1.2 There can be multiple scenarios like:
 - a. The terms of the director's loan are documented or there are no written terms available. The loan is repayable on demand or after a fixed period of time or payable at the discretion of entity;
 - b. The loan is return/interest free or carries below market rate of return/interest ;

ACCOUNTING TREATMENT

2. **The following discussion provides the principles and basis for the accounting guidance provided in paragraph 3.**
- 2.1 IAS 32 contains the principles for distinguishing between liabilities and equity issued by an entity. The substance of the contractual arrangement of a financial instrument, rather than its legal form, governs its classification. **The overriding criterion is that if an entity does not have an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation, the contract is not an equity instrument.**

Relevant definitions

- 2.2 The International Accounting Standards Board's (IASB) definition of liability is 'a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from entity of resources embodying economic benefits'. [Framework paragraph 4.4 (b)]

Obligations do not have to be legally binding, but they do not include future commitments. Liabilities include those provisions that require estimation. [Framework paragraphs 4.15 to 4.19]

- 2.3 Equity is a residual item – that is the residual interest in the assets of the entity after deducting all its liabilities. [Framework paragraph 4.4 (c)]
- 2.4 A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity. (IAS 32 paragraph 11)
- 2.5 IAS 32 defines a financial liability as any liability that is:
- a. a contractual obligation
 - i. to deliver cash or another financial asset to another entity; or
 - ii. to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or
 - b. a contract that will or may be settled in the entity's own equity instruments and is:
 - i. a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or
 - ii. a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include puttable instruments and obligations arising on liquidation that are classified as equity, rights issues denominated in a currency other than the functional currency of the issuer if they meet certain conditions or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.
- 2.6 An equity instrument is defined as any contract that evidences a residual interest in an entity's assets after deducting all of its liabilities. [IAS 32 paragraph 11]. A residual interest is not necessarily a proportionate interest ranking *pari passu* with all other residual interests, for example, it may be an interest in a fixed amount of the entity's shares that may rank first in preference. An instrument is an equity instrument if, and only if, both of the conditions below are met:

- 1) The instrument includes no contractual obligation:
 - to deliver cash or another financial asset to another entity; or
 - to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity.
- 2) If the instrument will or may be settled in the issuer's own equity instruments, it is:
 - a non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments; or
 - a derivative that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments. For this purpose, rights and other issues denominated in any currency are equity instruments provided certain conditions are met. Also for this purpose, the issuer's own equity instruments do not include puttable instruments and obligations arising on liquidation that are classified as equity or instruments that are contracts for the future receipt or delivery of the issuer's own equity instruments.

2.7 The elements of income and expenses are defined as follows:

- a. Income is increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, **other than those relating to contributions from equity participants.**
- b. Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, **other than those relating to distributions to equity participants.** [Framework para 4.25].

Relevant provisions of IFRSs and Analysis

2.8 An issuer of a financial instrument should classify a financial instrument, or its component parts, on initial recognition as a financial liability, a financial asset or an equity instrument **in accordance with the contractual arrangement's substance** and the definitions of a financial liability, a financial asset and an equity instrument. [IAS 32 paragraph 15].

- 2.9 The key feature of the definition of financial liability is contractual basis of the financial liability. All financial instruments are defined by contracts. The rights or obligations that comprise financial assets or financial liabilities are derived from the contractual provisions that underlie them.

‘Contract’ or ‘contractual’ refers to an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law. Contracts, and thus financial instruments, may take a variety of forms and need not be in writing. [IAS 32 paragraph 13].

Liabilities or assets that are not contractual (for example obligations established from local law or statute, such as income taxes) are not financial liabilities or financial assets. Similarly, constructive obligations, as defined in IAS 37, do not arise from contracts and are not financial liabilities. [IAS 32 paragraph AG12].

- 2.10 The role of ‘substance’ in the classification of financial instrument should be restricted to considering the instrument's contractual terms. Anything that falls outside the contractual terms should not be considered for the purpose of assessing whether an instrument should be classified as a liability under IAS 32. The impact of relevant local laws, regulations and the entity’s governing charter in effect at the date of classification should also be considered but not expected future amendments to those laws, regulations and charter [IFRIC 2 paragraph 5].

- 2.11 A contractual right or contractual obligation to receive, deliver or exchange financial instruments is itself a financial instrument. Some common examples of financial instruments that give rise to financial assets representing a contractual right to receive cash in the future for the holder and corresponding financial liabilities representing a contractual obligation to deliver cash in the future for the issuer are as follows:

- Trade accounts receivable and payable
- Notes receivable and payable
- Loans receivable and payable
- Bonds receivable and payable

In each case, one party’s contractual right to receive (or obligation to pay) cash is matched by the other party’s corresponding obligation to pay (or right to receive). [IAS 32 paragraph AG 4].

Determining the capacity in which transaction is carried out

- 2.12 An entity should assess the facts and circumstances to determine whether the lender is acting in its capacity as shareholder in the transaction.

Contributions from owners in their capacity as owners of the entity are distinguished from transfers that arise from trading activities in the normal course of business.

Contributions are non-reciprocal in nature. In essence, they are a gift. They can be assets or services given or liabilities forgiven, without the transferee being obliged to give anything of benefit in exchange. Where a company receives consideration from one or more shareholders without a contractual obligation to repay it (a gift or a 'capital contribution'), this is an increase in equity. Typically, such amounts are recorded in a separate reserve. Under IAS 1, capital contributions are presented in the statement of changes in equity as a transaction with owners in their capacity as owners.

Determining the value for transaction recognition

- 2.13 There are no requirements in IAS 32 on the initial recognition and measurement of equity. In many instances, equity is recorded at the proceeds of issue, net of transaction costs, and is not subsequently re-measured.

- 2.14 When a financial asset or financial liability is recognised initially, an entity shall measure it at its fair value plus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability. (IAS 39 paragraph 43)

After initial recognition, an entity shall measure all financial liabilities at amortised cost using the effective interest method. There are certain exceptions that are explained in IAS 39 paragraph 47.

Related party disclosure and valuation of non-arm's length transaction

- 2.15 Directors loans meet the definition of related party transactions (IAS 24 paragraph 9). The disclosures required by IAS 24 paragraphs 12 - 22 must be given in sufficient detail to enable the effect of the loans on the financial statements to be understood. Where there are significant

uncertainties, such as the expected terms of a loan, the disclosures should refer to this.

Such loans are commonly made on a non-arm's length terms (i.e. terms that are favourable or unfavourable in comparison to the terms available with an unrelated third party lender). For example, such loans are often:

- interest free or have a below-market rate of interest; and/or
- made with no stated date for repayment / subordinated to external liabilities.

- 2.16 These loans with contractual obligation are within the scope of IAS 39. The fair value of such loans is not usually the same as the loan amount, and as stated above IAS 39 paragraph 43 requires both parties to initially record the asset or liability at fair value. Given that there is no active market for such loans, fair value will usually need to be estimated. The appropriate way to do this is to determine the present value of future cash receipts using a market rate of interest for a similar instrument (IAS 39 AG paragraph 64).

The difference between fair value and loan amount then needs to be accounted for.

- 2.17 Where the loan is from a parent to a subsidiary or shareholder acting in its capacity as shareholder, it would be inappropriate to recognise a gain or loss for the discount or premium; in substance this is an additional contribution by the parent/shareholder (or a return of capital/distribution by the subsidiary). Contributions from and distributions to "equity participants" do not meet the basic definition of income or expenses (Framework 70 4.25).

- 3. Based on above discussion and principles the accounting for the multiple scenarios relating to director's loan (for the purpose of this TR it is assumed that the director is also an equity participant) identified in paragraph 1.2 is explained below:**

3.1 Contractual Director's Loan that is Interest-Free

3.1.1 A director might provide a loan to an entity that bears no interest, but the loan agreement does include a fixed date for repayment.

3.1.2 As the contractual obligation to deliver cash exists the transaction is to be recorded as financial liability. When a financial liability is recognised initially, IAS 39 requires the entity to measure it at its fair

value. In this case the consideration given or received (say the face amount) is not the financial instrument's fair value as the loan carries no interest and therefore part of the consideration received is something other than its fair value. As the loan would have to be recorded initially at its fair value, its fair value has to be estimated. This is a financing transaction, since the loan is made at a non-market rate of return/interest. It is initially recognised at the present value of future payments discounted at a market rate of return/interest for a similar debt instrument. There will be a difference between the cash paid and present value on initial recognition. The entity shall recognise this difference as an addition to its equity. This is to reflect the economic substance of the transaction – that the interest-free element is a capital contribution.

- 3.1.3 In subsequent periods, interest is recognised on the loan in the income statement using the effective interest method. The interest recognised will be the unwind of the difference between present value on initial recognition and the cash received.

3.2 Contractual Director's loans that are interest-free and repayable on-demand

3.2.1 An entity's director might provide a loan to the entity that bears no interest, but the loan agreement specifies that the amount lent is repayable on-demand.

3.2.2 A loan to an entity that is due on-demand is a financial instrument. Upon initial recognition, a loan that is due on-demand is not discounted, as it has no term and can be demanded at any time. It is recognised at the full amount receivable – its face value. Although the loan is made at a non-market rate of interest and is a financing transaction, because the director can demand payment at any time, discounting from the first date when the amount could be required to be paid has no impact.

3.3 Contractual Director's loan that is interest free and repayable at the discretion of the entity

3.3.1 A loan to an entity by the director which is agreed to be paid at the discretion of the entity does not pass the test of liability and is to be recorded as equity at face value. This is not subsequently re-measured.

3.3.2 The decision by the entity at any time in future to deliver cash or any other financial asset to settle the director's loan would be a direct debit to equity.

3.4 Directors loans / financing with no written contractual terms or on-going interest charges

3.4.1 A director might provide financing to the entity. There are no written terms for the repayment of the financing or any on-going interest charges. The financing is not documented in a written contract.

3.4.2 The entity needs to make an assessment of any implied contractual terms, in the absence of an explicit contract.

3.4.3 In the absence of any written or other evidence characterising the financing as a loan or a capital contribution, the substance is likely to be regarded as an on-demand loan. The accounting is the same as for a contractual director's loan that is interest-free / low interest and repayable on-demand.

4. Effective date and transition

4.1 This technical release is applicable for preparation of financial statements for the period beginning on or after 1 January 2016. Earlier application is permitted. If an entity applies this technical release for an earlier period, it shall disclose that fact.

4.2 Change in accounting policy resulting from the initial application of this technical release shall be accounted for retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

(271st meeting of the Council January 9, 2016)