
SELECTED OPINIONS

Volume XI

(July 1, 2005 to June 30, 2006)

COMPILED BY

TECHNICAL SERVICES DIRECTORATE

OF

**THE INSTITUTE OF CHARTERED ACCOUNTANTS OF
PAKISTAN**

INTRODUCTION

This report is the eleventh compilation of selected opinions issued by the Technical Advisory Committee on inquiries raised by the members and other agencies during the period from July 2005 to June 2006 for the general guidance of the members of the Institute.

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

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

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

Shahid Hussain
Director Technical Services

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CONTENTS

1. ACCOUNTING

- 1.1 Accounting treatment regarding the presentation of accrued network liabilities to be financed by long – term loans.
- 1.2 Accounting treatment of standing crops.
- 1.3 Applicability of Companies Profits (Workers' Participation) Act, 1968 (The Act) on Capital Gains Earned from Sale of Shares
- 1.4 Change in Basis for Charging Depreciation
- 1.5 Clarification on Contradiction between IAS 22 and IAS – 36
- 1.6 Clarification regarding Deferred Costs and Restricted Use of Cash and Cash Equivalents
- 1.7 Capitalization of exchange losses.
- 1.8 Early adoption of International Financial Reporting Standards (IFRS) – Clarification
- 1.9 Grant of Leasehold Land by the Government and Leasing out of such Land to Others
- 1.10 IAS – 8, *Accounting Policies, Changes in Accounting Estimates and Errors*
- 1.11 Initial Public Offer (IPO) Expenses – Treatment in Financial Statements
- 1.12 Inconsistent treatment of head office expenses by branches of foreign banks.
- 1.13 Presentation of Investments in Associates in Accordance with the Revised IAS
- 1.14 Residual Value of Assets – IAS 16
- 1.15 Revaluation of Fixed Assets and Treatment of Pagree
- 1.16 Section 226 of the Companies Ordinance, 1984 'Securities and Deposits'
- 1.17 The Continuous Funding Systems
- 1.18 Treatment of Preference Shares / Redeemable / Convertible in the Financial Statements

2. AUDITING

- 2.1 Stock taking Observance without obtaining prior clearance of previous auditors

1. ACCOUNTING

1.1 ACCOUNTING TREATMENT REGARDING THE PRESENTATION OF ACCRUED NETWORK LIABILITIES TO BE FINANCED BY LONG-TERM LOANS

Enquiry: Our Company is engaged in the business of providing cellular mobile telephonic services in Pakistan. It is in the stage of expansion, therefore is making heavy investment in network procurement. To comply with the relevant accounting standards we have to capitalize our network under property plant and equipment upon completion of certain milestones by the vendor. The complex and technical nature of our network results in a considerable amount of time lag between the capitalization and final payments to the vendor therefore for capitalization we accrue the differential between total contract amount and total amount paid up to the date of capitalization. The amount thus accrued appears under current liabilities.

We seek the Institute's advice whether this amount can be disclosed under long-term liability. This we feel can be allowed (ref: para 64 of IAS 1) as this liability will be paid off through long term financing specifically obtained for procurement of network, the facility for which is already in place on the reporting date, though not yet drawn out.

Kindly advise us in this regard and an early response preferably before June 15, 2005 will be highly appreciated.

Opinion: The appropriate Committee of the Institute would like to point out that paragraph 64 of IAS 1 does not appear to deal with the query raised by you as that paragraph relates to re-financing or rolling over of an obligation.

The provisions of IAS 1, which deal with your query, are contained in paragraph 60 as reproduced below: -

60. *A liability shall be classified as current when it satisfies any of the following criteria:*

- (a) *It is expected to be settled in the entity's normal operating cycle;*
- (b) *it is held primarily for the purpose of being traded;*
- (c) *it is due to be settled within twelve months after the balance sheet date; or*
- (d) *the entity does not have an unconditional right to defer settlement of the liability for at least twelve months after the balance sheet date.*

All other liabilities shall be classified as non-current.

As your obligation to pay your vendors appears to fall under the purview of the above-mentioned paragraph, therefore, it cannot be treated as a long-term liability. It is immaterial how this liability is settled which has no relevance to the nature of liability.

(July 2, 2005)

1.2 ACCOUNTING TREATMENT OF STANDING CROPS

Enquiry:

BACKGROUND

The company belongs to the sugar industry. In the recent past, many sugar companies have entered into corporate farming for procurement of sugarcane in view of practical difficulties in securing quality sugarcane in the recent period. Accounting year of Sugar industry ends on September 30 every year.

Sugarcane is a crop of longer duration i.e. 14 – 16 months. Normally it is sown in as per following norm:

<u>Sowing Period</u>	<u>Harvesting Period (Estimated)</u>	<u>Duration in Months</u>
September	November	15
February	March	14

Clearly in every case, the crop takes more than one accounting year from sowing to harvesting. Crushing season of a mill is normally from November to April every year.

TREATMENT REQUIRED BY IAS 41

There is no change proposed as a result of overall revision of IAS. IAS 41 is applicable from the periods beginning on or after January 01, 2003. However ICAP has not adopted this standard and it is stated that this standard would be considered for adoption in due course of time.

IAS 41 requires that a biological asset should be measured on initial recognition and at each subsequent balance sheet date at its fair value less estimated point of sale costs.

Exception to this rule is only available when only little transformation has taken place or fair value can't be measured.

Although the IAS 41 is not applicable in Pakistan, yet we have to match over costs with related revenues. So recording of the asset is necessary.

One example may illustrate the issue

Suppose a company has sugarcane September sowing crop of 10,000 acres in year XO which would be harvested in November X1. As at balance sheet of September 30, X1, the company has incurred the following expenditure:

Total expenditure 25,000 per acre for 10,000 acres	Rs. 250 million
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As for estimate of fair value there are two uncertainties involved. One is the price of sugar cane which is government support price announced in November every year when the accounts are in the final stage. Second is per ton yield of sugarcane, which is finalized even in Dec/Jan X1. So both factors are uncertain and even yield would be calculated separately for each land portion.

In the above situation, it is difficult to estimate fair value. But the practical difficulty in taking cost as value of standing crop is the fact that actual revenue may be less than cost and further it would be very difficult to get these standing crops physically verified by the external auditors.

We are open to any guidance issued by ICAP. However we suggest that auditors on their physical verification at balance sheet date should just take an overview of the crop. The crop may be taken at cost and subject to latest available evidence up to the finalization of financial statements.

Please advise us in the following specific matters so that we may plan well in time accordingly:

1. Whether our assumption that fair value cannot be measured reliably is valid or not?
2. What method is to be adopted for valuation of standing crops?
3. Given the fact that our sugarcane crop is located at nearly 40-50 different locations, to what extent we are required to satisfy our auditors?

Opinion: First of all the appropriate Committee of the Institute would like to inform you that the compliance of IAS 41 is not mandatory as Securities and Exchange Commission of Pakistan has not yet notified the said standard. In view of this the Committee is of the opinion that until IAS 41 is notified, you have an option to either comply with the requirements of IAS 41 or use any other method for the valuation of biological or agriculture assets which is appropriate and reflects a reliable estimate of fair value.

However, the Committee is also of the view that as there is no other guidance available with regard to the valuation of biological or agriculture assets, it is therefore strongly recommended to comply with the requirements of IAS 41 as far as possible.

With regard to your first query the Committee would like to draw your attention towards the following paragraphs of IAS 41 'Agriculture':

12. ***A biological asset shall be measured on initial recognition and at each balance sheet date at its fair value less estimated point-of-sale costs, except for the case described in paragraph 30 where the fair value cannot be measured reliably.***
13. ***Agricultural produce harvested from an entity's biological assets shall be measured at its fair value less estimated point-of-sale costs at the point of harvest. Such measurement is the cost at that date when applying IAS 2 Inventories or another applicable Standard.***

Inability to Measure Fair Value Reliably

30. ***There is a presumption that fair value can be measured reliably for a biological asset. However, that presumption can be rebutted only on initial recognition for a biological asset for which market-determined prices or values are not available and for which alternative estimates of fair value are determined to be clearly unreliable. In such a case, that biological asset shall be measured at its cost less any accumulated depreciation and any accumulated impairment losses. Once the fair value of such a biological asset becomes reliably measurable, an entity shall measure it at its fair value less estimated point-of-sale costs. Once a non-current biological asset meets the criteria to be classified as held for sale (or is included in a disposal group that is classified as held for sale) in accordance with IFRS 5 Non-current Assets Held for Sale and Discontinued Operations, it is presumed that fair value can be measured reliably.***

The Committee is, therefore, of the opinion that you should be guided by the above paragraph of IAS 41.

Further guidance may also be obtained from paragraph 17 to 20 of IAS 41.

With regard to your 3rd query the Committee would like to draw your attention towards the following paragraphs of ISA 501 'Audit Evidence –Additional Considerations for Specific Items':

PART A: Attendance at Physical Inventory Counting

4. Management ordinarily establishes procedures under which inventory is physically counted at least once a year to serve as a basis for the preparation of the financial statements or to ascertain the reliability of the perpetual inventory system.
5. **When inventory is material to the financial statements, the auditor should obtain sufficient appropriate audit evidence regarding its existence and condition by attendance at physical inventory counting unless impracticable.** Such attendance will enable the auditor to inspect the inventory, to observe compliance with the operation of management's procedures for recording and controlling the results of the count and to provide evidence as to the reliability of management's procedures.
6. **If unable to attend the physical inventory count on the date planned due to unforeseen circumstances, the auditor should take or observe some physical counts on an alternative date and, when necessary, perform tests of intervening transactions.**
7. **Where attendance is impracticable, due to factors such as the nature and location of the inventory, the auditor should consider whether alternative procedures provide sufficient appropriate audit evidence of existence and condition to conclude that the auditor need not make reference to a scope limitation.** For example, documentation of the subsequent sale of specific inventory items acquired or purchased prior to the physical inventory count may provide sufficient appropriate audit evidence.

Though the above paragraphs are not meant for the physical verification of biological and agriculture assets, the guidance may be taken from them.

(August 13, 2005)

1.3 APPLICABILITY OF COMPANIES PROFITS (WORKERS' PARTICIPATION) ACT, 1968 (THE ACT) ON CAPITAL GAINS EARNED FROM SALE OF SHARES

Enquiry:

An issue has arisen regarding the treatment of gains recognized in the Profit and Loss Account on investments in equity shares for the purposes of computation of profits distributable under the above Act, where material. Based on a legal opinion, there is a view that net profits, for the purpose of computation of the contributions to the Workers' Profits Participation Fund (WPPF), are to exclude, inter-alia, profits by way of **premium on shares sold**, profits on sale proceeds of forfeited shares, or profits from the sale of the whole or part of the undertaking of the company. The relevant extracts of the opinion are set out below:

“..... while calculating “net profits”, inter alia profits by way of **premium on shares sold**, profits on sale proceeds of forfeited shares, or profits from the sale of the whole or part of the undertaking of the company **are not to be included in the “net profits”**. The rationale is that the profits in which no effort of workers is involved, are not to be included in “net profits” for the purpose of 5% contribution to the Fund; Conversely where the effort of the workers in the earning of the profit is involved but expenditure is made in the form of payment of taxes or duties etc, it is to be included (not excluded) in the ‘net profit’....” (*emphasis is ours*)

There appears to be a concern amongst certain members of the Institute regarding the treatment of gains/(losses) booked in the accounts upon de-recognition of above investments, if material, for the purpose of determination of profits distributable under the Act in view of the following facts, where relevant:

- (b) Any permanent diminution in the value of the above investments recognized in accounts was also deducted in arriving at the profit available for distribution under the Act.
- (c) Interest paid on borrowings that were, directly or indirectly, utilized to acquire such investments was also deducted in arriving at the profit available for distribution under the Act.

You are requested to provide your views on the treatment of such gains for the purposes of computing the ‘net profits’ of the company under the Act.

Opinion:

The Committee discussed the concerns raised by you and is of the opinion that the permanent diminution in the value of investments should be deducted in arriving at the “net profits” available for determination of contribution to WPPF. In reaching the opinion the Committee viewed that “profit by way of premium on shares sold” referred to in the definition of “net profits” under Section 87C(3) of repealed Companies Act, 1913 will not include within its ambit gain/loss on investments. The Committee is also of the view that the legislature views interest on loans and advances as revenue expenditure and as such deductible and has specifically mentioned it in the definition to differentiate it with interest on debentures and otherwise on capital account which are not deductible.

We would like to point out here that the advice given above is a matter of interpretation of the law and is based on the collective experience and wisdom of the Committee members who as you know are not lawyers by profession. In view of this it may be prudent if you also seek a legal opinion in the matter from a lawyer.

(January 7, 2006)

1.4

CHANGE IN BASIS FOR CHARGING DEPRECIATION

Enquiry:

The new IAS-16 has introduced certain changes in accounting for depreciation on property, plant and equipment effective from accounting periods commencing on or after 01 January 2005. These changes, inter-alia, require that an entity should start charging depreciation from the time the asset is available for use till the time it is no longer available. In the past, most of the companies charged full depreciation in the year the asset was acquired, whereas no depreciation was charged in the year it was deleted.

There is certain confusion in accounting circles whether this change is a change in accounting policy or change in estimate.

We shall appreciate if a clarification is issued on this matter by the Institute.

Opinion: The Committee would like to draw your attention to the following paragraphs of IAS 8 and 16:

Definition Paragraph 5 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*:-

A Change in Accounting Estimate is an adjustment of the carrying amount of an asset or a liability, or the amount of the periodic consumption of an asset, that results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities. Changes in accounting estimates result from new information or new developments and, accordingly, are not corrections of errors.

34. An estimate may need revision if changes occur in the circumstances on which the estimate was based or as a result of new information or more experience. By its nature, the revision of an estimate does not relate to prior periods and is not the correction of an error.

IAS 16 '*Property, Plant and Equipment*':

51 The residual value and the useful life of an asset shall be reviewed at least at each financial year-end and if expectations differ from previous estimates, the change shall be accounted for as a change in an accounting estimate in accordance with IAS 8.

In view of the above paragraphs the Committee is of the opinion that if an entity changes its practice of charging full year depreciation in the year of addition and no depreciation in the year of disposal to monthly or quarterly basis then such change would be considered as change in accounting estimates and should be treated as per paragraphs 36 to 40 of IAS 8.

(April 1, 2006)

1.5 CLARIFICATION ON CONTRADICTION BETWEEN IAS 22 AND IAS - 36

Enquiry: ABC Fertilizer was incorporated in Pakistan as a private company limited by shares under Companies Ordinance, 1984, is engaged in manufacturing and selling of chemical fertilizers.

The company was privatized under privatization policy of Government of Pakistan on 14th July 2005 and 100% shareholding of ABC was acquired by XYZ, a company incorporated in Pakistan as a non-listed public company limited by shares. Management of ABC was handed over to XYZ on the said date.

Now amalgamation of XYZ and ABC has been proposed in a way that assets and liabilities of XYZ would be transferred to ABC. It would be a reverse merger. XYZ has paid consideration in excess of fair value of assets acquired which would generate positive Goodwill on amalgamation.

IAS 22, *Business Combinations*, IFRS -3 *Business Combinations* and IAS 36 *Impairment of Assets* specify the accounting treatment of Goodwill. IAS 22 has been superseded by IFRS 3 but the said IFRS has not been adopted in Pakistan so far. Adoption of IFRS 3 internationally has, correspondingly revised requirements of IAS 36 *Impairment of Assets*. IAS 36 which is currently applicable in Pakistan and includes changes brought

about by paragraph 54 of IFRS – 3 which stipulates that subsequent to initial recognition, the acquirer shall measure goodwill acquired in a business combination at cost less any accumulated impairment loss. This is a deviation from the requirements of IAS 22 which specifies that Goodwill should be amortized.

As both the Standards i.e. IAS 22 and IAS 36 are applicable in Pakistan, the Committee's opinion is solicited on the contradiction between requirements thereof.

Opinion: The Committee is aware of the fact that the contradiction has arisen owing to the issuance of IFRS 3 *Business Combinations* and revised version of IAS 36 *Impairment of Assets* simultaneously. Though IAS 22 has been withdrawn by IASB, it is still in place in Pakistan since it has not been withdrawn by SECP through Gazette notification.

In view of the above the Committee is of the opinion that IAS 22 should be complied with until IFRS 3 becomes effective. However, as IAS 36 has been adopted in Pakistan and stipulates that goodwill should be tested for impairment annually (par. IN5 (c)), the Committee recommends that IAS 36 should also be complied with.

(May 6, 2006)

1.6 CLARIFICATION REGARDING DEFERRED COSTS AND RESTRICTED USE OF CASH AND CASH EQUIVALENTS

Enquiry: You are requested to kindly give your opinion on the following two issues.

1) Deferred Costs – As you are aware that the Fourth Schedule to the Companies Ordinance, 1984 has been substituted by the Securities and Exchange Commission of Pakistan (SECP) vide its Notification No. SRO 589 (I)/2004 dated July 05, 2004. Through this revision the provision relating to the deferment and amortisation of costs covered by Para 5(B) of Part II of the substituted Fourth Schedule has been deleted.

According to the deleted Para 5(B), the listed companies were required to defer and amortise the preliminary expenses, **discount allowed on the issue of shares, if any, and expenses incurred on the issue of shares including any sums paid by way of commission or brokerage on the issue of shares.** Now after the deletion of this requirement the question arises what would be the accounting treatment for recognition of these kinds of costs. As the revised Fourth Schedule is silent on this issue, therefore, we would have to refer to the requirements of the International Accounting Standards.

The aforesaid costs may be divided into following three parts.

- a) Preliminary expenses;
- b) Discount allowed on issue of shares; and
- c) Expenses incurred on the issue of shares.

The appropriate Committee of ICAP has already deliberated the issue of accounting treatment for the above kinds of costs and has issued two opinions on the subject reported as Opinion No. 1.1 (Volume VII) and Opinion No. 1.3 (Volume VIII) in the Selected Opinions of ICAP. The accounting treatment suggested by ICAP in these opinions is given hereunder in seriatim:

- i) All preliminary expenses should be charged off in the same period in which these are incurred (first paragraph, opinion 1.3 – Volume VIII);

- ii) Since we have a concept of par value in place therefore the best possible treatment could be to show the amount of discount on issue of shares as a deduction from equity and disclose it (second-last paragraph, opinion 1.1 – Volume VII);
- iii) The transaction costs of an equity transaction should be accounted for as a deduction from equity, net of any related income tax benefit (no specific opinion but discussed in sixth paragraph from last, opinion 1.1 – Volume VII).

The above reported opinions clearly demonstrate the understanding of ICAP for treating these kinds of costs, which is in line with the requirements of the International Accounting Standards.

However, I could not appreciate the rationale behind the recommendations given by ICAP (as stated on ICAP website) to the SECP, in response to which the latter has issued the Circular No. 1 of 2005 dated January 19, 2005. It is further stated on the ICAP website that through this circular SECP has given the so-called relaxation to the listed companies on deferred costs. The relevant portion of the said circular is given hereunder for reference.

“With a view to remove practical difficulties being faced by listed companies and their subsidiaries as a result of revision of Fourth Schedule to the Companies Ordinance, 1984 w.e.f. July 5, 2004, the Securities and Exchange Commission of Pakistan is pleased to clarify that:

- i) The listed companies and their subsidiaries which were carrying deferred costs in their financial statements as on July 5, 2004, **are allowed to continue to treat such costs according to the requirements of the substituted Fourth Schedule.** However after July 5, 2004 such companies are not allowed to include any further deferred cost in their financial statements.....”

If the continuance of treatment of deferred costs in accordance with the requirements of the Fourth Schedule is a relaxation for the listed companies (as claimed by both ICAP and SECP), then to my mind the substance of the above circular is that in future discount allowed on issue of shares and expenses incurred on issue of shares are to be charged off to profit and loss account in the period in which these expenses are incurred. If such is the case then such a treatment will be clearly in conflict with the requirements of the International Accounting Standards. It also appears that ICAP while recommending the above treatment for deferred costs has changed its stance as given in the above-referred opinions.

According to my understanding the treatment of deferred costs as envisaged in the above circular would adversely affect both the company and its shareholders, as charging off the full amount of discount on issue of shares or share issue expenses in period of incurrence would distort the results of the company as well as deprive the shareholders from dividend.

If ICAP or SECP truly wants to give some relaxation to listed companies then the listed companies should be allowed to deduct from the equity all the existing (i.e. discount on issue of shares and share issue expenses incurred and deferred before July 5, 2004) as well as future costs on account of discount on issue of shares and share issue expenses in accordance with the requirements of the International Accounting Standards.

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

- i) Whether the discount on issue of share capital and share issue expenses incurred before July 5, 2004 and carried as on that date as

deferred cost in the financial statements, may be deducted from the equity by adjusting the opening retained earnings in accordance with the requirements of IAS 8;

- ii) Whether the costs incurred on account of discount on issue of share capital and share issue expenses incurred after July 4, 2004 may be charged directly to equity by deducting from the retained earnings. If no, how should these costs be treated in the financial statements; and
- iii) Whether the transaction costs of equity as explained in paragraph 37 of IAS 32 (revised) include underwriters' commission.

2) Restricted use of cash and cash equivalent – Please refer to the Para 57 of IAS 1 (revised 1997) which states:

“57. An asset shall be classified as current when it satisfies any of the following criteria:

..... **(d) it is cash or cash equivalent (as defined in IAS 7 *Cash Flow Statements*) unless it is restricted from being exchanged or used to settle a liability for at least twelve months after the balance sheet date.**

Keeping in view the above stated provision of IAS 1, you are requested to kindly clarify whether share subscription money received by a company from the Rights Issue (made by the Company to generate funds for expansion project) and held in the current / savings accounts of the Company as at balance sheet date is 'cash and cash equivalent restricted in use' for the purposes of Para 57(d) of IAS 1 and should be presented as non-current asset.

Opinion: 1 DEFERRED COST

- i) Whether the discount on issue of share capital and share issue expenses incurred before July 5, 2004 and carried as on that date as deferred cost in the financial statements, may be deducted from the equity by adjusting the opening retained earnings in accordance with the requirements of IAS 8;**

Yes. if the entity wishes to change its accounting policy relating to capitalisation of deferred expenses, it will have to comply with relevant requirements of IAS 8.

However, if the entity decides to continue with its current accounting policy, then the deferred costs should be accounted for in the financial statements of the entity according to the provisions of revised Fourth Schedule to the Companies Ordinance, 1984 and those of Circular 1 of 2005 dated January 19, 2005 issued by the SECP.

- ii) Whether the costs incurred on account of discount on issue of share capital and share issue expenses incurred after July 4, 2004 may be charged directly to equity by deducting from the retained earnings. If no, how should these costs be treated in the financial statements; and**

Yes. All costs incurred on account of discount on issue of share capital and share issue expenses incurred after July 4, 2004 are required to be charged directly to equity by deducting from the reserves.

As far as Selected Opinions of the Institute referred to in the query are concerned, they were issued prior to the issuance of revised Fourth Schedule and SECP Circular 1 of 2005. Opinion No. 1.1 (Volume VII) and Opinion No. 1.3 (Volume VIII) of the Selected Opinions were issued by the Institute in the year 2001-2002 and 2002-2003 respectively; while revised Fourth Schedule and SECP Circular 1 of 2005 were issued on July 5, 2004 and January 19, 2005 respectively. We would like to draw your attention towards the introduction of Selected Opinions which explicitly enunciates that:

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

iii) *Whether the transaction costs of equity as explained in Para 37 of IAS 32 (revised) include underwriters’ commission.*

Prima facie perusal of Para 37 of IAS 32 (revised) reveals that the transaction costs of an equity transaction include underwriters’ commission.

2. CASH AND CASH EQUIVALENT

Whether share subscription money received by a company from the Right Issue (made by the Company to generate funds for expansion project) and held in the current / savings accounts of the Company as at balance sheet date is ‘cash and cash equivalent restricted in use’ for the purposes of Para 57(d) of IAS 1 and should be presented as non-current asset.

From review of revised Fourth Schedule to the Companies Ordinance, 1984, it appears that no specific classification has been prescribed for cash and cash equivalents which are restricted from being used; hence the cash and cash equivalents which are restricted from being used would be classified according to the provisions of paragraph 57 of IAS 1. As far as treatment of cash proceeds of right issue is concerned, the Companies Ordinance, 1984 and Companies (Issue of Capital) Rules, 1996 do not appear to have imposed any restriction on the utilization of cash proceeds of right issue. Hence, provisions of paragraph 57 of IAS 1 would not apply on the cash proceeds of right issue and accordingly the same may be classified as current asset.

(December 10, 2005)

1.7 CAPITALIZATION OF EXCHANGE LOSSES

Enquiry: Prior to revision to the Fourth Schedule to the Companies Ordinance, 1984 there existed two parallel provisions regarding capitalization of exchange losses.

- i. IAS 21 allowed capitalization of only such exchange losses, which arose on recent acquisition of fixed assets (due to 'severe' fluctuation, which can not be hedged).

- ii. Fourth Schedule allowed capitalization of exchange losses on foreign currency (FCY) liabilities incurred for acquisition of fixed assets for entire life of such liabilities, even if they were long-term.

Subsequently the Fourth Schedule was revised and the above provision was removed from the revised the Fourth Schedule so that accounting treatment prescribed in IAS 21 may prevail and capitalization of exchange losses can be restricted.

The matter so far is clear. But the confusion arises from the Circular No. 01 of 2005 issued by SECP. The last paragraph of which reads as follows:

*Regarding capitalization of exchange gain or loss, the listed companies and their subsidiaries which had a policy of capitalizing such exchange fluctuations and which had outstanding liabilities for foreign currency loans as on July 5, 2004 are allowed to capitalize such fluctuations for further three years i.e. up to 30th September, 2007, notwithstanding the fact that any such foreign exchange loan remains outstanding after the later date. **However, in the case of any foreign currency loan contracted on or after July 5, 2004, the aforesaid accounting treatment would not be permissible.***

The issue arises, whether the last line of this circular precludes capitalization of all exchange losses even if incurred on the recent acquisition of fixed assets (and other conditions as envisaged in IAS 21) or losses on long-term (FCY) liabilities only or in other words is the intention to override provisions of IAS 21.

An earlier response in this issue shall be highly appreciated.

P.S.: IAS 21 has itself withdrawn the allowed alternative of capitalization of exchange losses in 2003 revision. However, the revision is effective post January 1, 2005 (Applicable on new financial year of banks and insurance companies with year ended 31.12.05, so far).

Opinion:

Your attention is drawn towards the following Statement of Compliance which was revised by the Institute of Chartered Accountants of Pakistan vide its Circular 01/2003 dated February 24, 2003:

These financial statements have been prepared in accordance with approved accounting standards as applicable in Pakistan and the requirements of Companies Ordinance, 1984. Approved accounting standards comprise of such International Accounting Standards as notified under the provisions of the Companies Ordinance, 1984. Wherever, the requirements of the Companies Ordinance, 1984 or directives issued by the Securities and Exchange Commission of Pakistan differ with the requirements of these standards, the requirements of Companies Ordinance, 1984 or the requirements of the said directives take precedence.

In view of the above the Committee is of the opinion that capitalization of exchange losses on foreign currency loans contracted on or after July 5, 2004 would not be allowable even though paragraph 21 of IAS 21 (before revision) allowed capitalization of such losses in case of a severe devaluation or depreciation of currency, as the SECP Directive appears to override IAS provision.

(July 2, 2005)

1.8 **EARLY ADOPTION OF INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS) – CLARIFICATION**

Enquiry: We are listed on the Karachi Stock Exchange and serve as holding equity to one of the fastest growing IT enabled services group of companies in the world with subsidiaries in Pakistan, North America, Canada and UK.

We would like to adopt the IFRS in their entirety, as applicable to us, with effect from the financial period beginning July 1, 2005. We are aware of the fact that these IFRS have not yet been adopted by ICAP and as such not been notified by the SECP, and we would like to seek your clarification with regard to early adoption of the IFRS in Pakistan.

Early Adoption of IFRS

International financial reporting standards encourage early adoption of most of the standards issued by the IASB. Keeping in view this provision, can a company adopt the international financial reporting standards before their adoption /notification?

Statement of Compliance

Reference is made to Circular 01/2003 dated February 24, 2003 issued by ICAP titled “Statement of Compliance”. What would be the impact on the statement of compliance if we adopt IFRS voluntarily and prepare the financial statements in compliance with the IFRS?

Comparatives

If the IFRS are not adopted, the words “Audited” would appear against the comparative balance sheet to be shown in the interim financial statements. If the IFRS is adopted and the comparative balance sheet is restated, would it be necessary to have the restated comparative balance sheet audited or reviewed by the auditors of the company?

Opinion: The Institute always encourages early application of IAS/IFRS but with regard to the adoption of those IFRS which have replaced some already existing IAS, the Committee is of the opinion that such IFRS should not be adopted unless their corresponding IAS are de-notified by SECP as compliance with the requirements of such IAS is compulsory.

However, with regard to the application of those IFRS which are new and do not replace any existing IAS, the Committee is of the opinion that requirements of such IFRS can be complied with early, provided they do not override any local requirement or regulation.

Further the Committee is also of the view that there would be no change in the “Statement of Compliance” which was issued by ICAP through its Circular No. 01/2003 dated February 24, 2003 if your company voluntarily complies with the requirements of IFRS.

With regard to your third enquiry on comparatives your attention is drawn towards the following paragraphs of ISA 710 on ‘Comparatives’ which are self explanatory:

20. The auditor should obtain sufficient appropriate audit evidence that the comparative financial statements meet the requirements of the applicable financial reporting framework. This involves the auditor evaluating whether:
 - (a) Accounting policies of the prior period are consistent with those of the current period or whether appropriate adjustments and/or disclosures have been made; and

- (b) Prior period figures presented agree with the amounts and other disclosures presented in the prior period or whether appropriate adjustments and disclosures have been made.
21. When the financial statements of the prior period have been audited by another auditor, the incoming auditor evaluates whether the comparative financial statements meet the conditions in paragraph 20 above and also follows the guidance in ISA 510.
 22. When the financial statements of the prior period were not audited, the incoming auditor nonetheless evaluates whether the comparative financial statements meet the conditions specified in paragraph 20 above and also follows the guidance in ISA 510.
 23. If the auditor becomes aware of a possible material misstatement in the prior year figures when performing the current period audit, the auditor performs such additional audit procedures as are appropriate in the circumstances.

(November 19, 2005)

1.9

GRANT OF LEASEHOLD LAND BY THE GOVERNMENT AND LEASING OUT OF SUCH LAND TO OTHERS

Our client is a limited guarantee company who received land as grant from government which they have leased out to others. We are facing the following issues, which need to be resolved on an urgent basis. We also give below our understanding of the relevant sections of regulations governing the situation and need the Technical Advisory Committee's recommendations thereon:

FACTS AND CIRCUMSTANCES

1. Government has provided assistance in the form of a land to our client which is also a government owned entity having a status of a Limited Guarantee Company.
2. Market value of land is not available and further special survey for valuation of land has not been carried out.
3. This land has been leased out to others by our client.
4. Land is given on lease for 99 years lease term with no bargain purchase option, subsequently renewable and cancelable at the option of lessor.

ISSUES

1. Can land be treated as government grant?
2. Whether the grant should be treated as related to Income or Assets
3. At what amount land and related government grant be recorded?
4. What should be the classification of lease?
5. What are the presentation and disclosure requirements?

OUR OPINION

- 1) This land should be treated as a government grant
(Refer Definitions Para 3 of IAS 20)
- 2) It should be taken as government grant related to asset
(Ref: Definitions Para 3 and 23 of IAS 20)
- 3) It will be measured at nominal value i.e. fair value of land less government grant valued at the same amount. Only in case when fair market value is not available, fair value will be the present value of discounted cash flows expected from future intended use of the asset (present value of lease rentals and residual value for a period of 100 years discounted at time and risk adjusted discount rate). As in this case fair market value is not available, present value of lease rentals in the foreseeable future i.e. the lease term may be taken.
(Ref: Para 23 of IAS 20)
- 4) As this lease does not indicate any of the conditions given in paragraph 10 or 11 of IAS 17 and risks and rewards incidental to ownership (fluctuation in the value of land) rest with the lessor therefore this lease may be classified as operating lease.
- 5) Further the land is an Investment Property as per IAS 40 and therefore its requirements should be met and it should be recognized by either using cost model or fair value model.

Further we need to bring your kind attention to Selected Opinion 1.8 Volume III “land lease for 99 years”, which deals with land obtained on lease for 99 years. This opinion requires disclosure of such land under fixed assets and prohibits the classification as operating lease. Keeping in view these provisions:-

- Should lessor classify 99 year lease of land as Finance Lease?
- What are accounting and reporting requirements for Lessor?
- If the lessor classifies it as Finance lease, should disclosure be made regarding the fact that IAS-17 has not been followed along with the reasons?

We seek your advice and the basis thereof regarding these matters.

Opinion: The appropriate Committee of the Institute has examined the above issues and before reaching any conclusion would like to draw your attention towards the following paragraphs of IAS 20, *Accounting for Government Grants and Disclosure of Government Assistance*:-

Definitions

3. The following terms are used in this Standard with the meanings specified:

Government assistance is action by government designed to provide an economic benefit specific to an enterprise or range of enterprises qualifying under certain criteria. Government assistance for the purpose of this Standard does not include benefits provided only indirectly through action affecting general trading conditions, such as the provision of infrastructure in development areas or the imposition of trading constraints on competitors.

Government Grants are assistance by government in the form of transfers of resources to an enterprise in return for past or future compliance with certain

conditions relating to the operating activities of the enterprise. They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the enterprise.

18. Grants related to non-depreciable assets may also require the fulfillment of certain obligations and would then be recognized as income over the periods which bear the cost of meeting the obligations. As an example, a grant of land may be conditional upon the erection of a building on the site and it may be appropriate to recognize it as income over the life of the building.
23. A government grant may take the form of a transfer of a non-monetary asset, such as land or other resources, for the use of the entity. In these circumstances it is usual to assess the fair value of the non-monetary asset and to account for both grant and asset at that fair value. An alternative course that is sometimes followed is to record both asset and grant at a nominal amount.

In the light of the above paragraphs, the Committee is of the opinion that if there is no restriction on transfer of title of land to others, then the land may be considered as grant from the government as given in IAS 20.23 and it would be appropriate to record the land as income as required by paragraph 18 of IAS 20.

However, with regard to the value to be assigned to the land received as grant, the Committee is of the opinion that land should be recorded at its Fair value, as projected future cash flows in the case of land would not be appropriate or feasible as an alternate as these could substantially vary.

With regard to query relating to the classification of lease, the Committee would like to draw your attention towards the following paragraphs of IAS 17 'Leases'

14. Leases of land and of buildings are classified as operating or finance leases in the same way as leases of other assets. However, a characteristic of land is that it normally has an indefinite economic life and, if title is not expected to pass to the lessee by the end of the lease term, the lessee normally does not receive substantially all of the risks and rewards incidental to ownership, in which case the lease of land will be an operating lease. A payment made on entering into or acquiring a leasehold that is accounted for as an operating lease represents prepaid lease payments that are amortized over the lease term in accordance with the pattern of benefits provided.
15. The land and buildings elements of a lease of land and buildings are considered separately for the purposes of lease classification. If title to both elements is expected to pass to the lessee by the end of the lease term, both elements are classified as a finance lease, whether analyzed as one lease or as two leases, unless it is clear from other features that the lease does not transfer substantially all risks and rewards incidental to ownership of one or both elements. When the land has an indefinite economic life, the land element is normally classified as an operating lease unless title is expected to pass to the lease by the end of the lease term, in accordance with paragraph 14. The buildings element is classified as finance or operating lease in accordance with paragraphs 7–13.

Though the above paragraphs do not allow lessee to record the land in its books as an asset unless title is expected to pass to it by the end of the lease term, strictly speaking IAS 17 does not deal with those leasing arrangements where land is leased for a long term period. Like in many

countries including Pakistan the lease period is 99 years. IASB itself in the following paragraphs of Basis for Conclusion of IAS 17 has acknowledged that:

- BC4.** Paragraph 14 of the Standard requires a lease of land with an indefinite economic life *to be normally classified as an operating lease, unless title is expected to pass to the lessee by the end of the lease term*. The previous version of IAS 17 was not explicit about how to classify a lease of land and buildings.
- BC5.** This is a matter of concern in countries where property rights are obtained under long-term leases and the substance of those leases differs little from buying a property. Therefore, the Board decided to deal with this matter in its Improvements project and not to defer its resolution until the more fundamental project on leases was completed.

Now the question arises as to what is the appropriate accounting treatment for such leasehold land in the books of lessee. The Committee after detailed deliberation reached a consensus that owing to the following reasons it appears to be appropriate for lessee to recognize the land in its books as an asset:-

- a) Recording as operating leases the transactions involving long leasehold interests does not accord with the economic reality underlying such transactions. Cases involving purchases of such leasehold interests which typically contain a large component of land costs usually have the following characteristics:-
- (i) the buyer (or lessee) has in fact acquired an asset with an upfront payment;
 - (ii) the lessee has acquired the right to do a variety of things with the leasehold interests just as if these leasehold interests were outright purchases, like freehold properties;
 - (iii) the lessee's interest is for a reasonable long definite period of time;
 - (iv) the lessee can transfer his interest and obligations to others where on the other hand lessor can neither use the land nor it can sell it for a gain if price of such land goes up;
 - (vi) Further the legal structure governing the conveyancing of long leasehold interests in Pakistan effectively treats a sale and purchase of such interests as a complete transfer of risks and rewards incident to ownership of those interests which is the acid test for recognition of an asset.

(January 7, 2006)

1.10 IAS – 8, ACCOUNTING POLICIES, CHANGES IN ACCOUNTING ESTIMATES AND ERRORS

Enquiry: Paragraph 30 of revised IAS 8-Accounting Policies, Changes in Accounting Estimates and Errors states as follows:-

“when an entity has not applied a new Standard or Interpretation that has been issued but is not yet effective, the entity shall disclose:-

- (a) this fact; and
- (b) known or reasonably estimable information relevant to assessing the possible impact that application of the new Standard or

Interpretation will have on the entity's financial statements in the period of initial application".

In view of the above requirement, a question arises whether the IFRSs and IFRIC's Interpretations which have been issued by the IASB and IFRIC but have not been notified by Securities and Exchange Commission of Pakistan and IAS 39 and 40, the applicability of which to banks and DFIs in Pakistan is currently deferred by the State Bank of Pakistan, fall under the above paragraph or not? If yes, then, are companies, banks and DFIs expected to give disclosures in the financial statements for the year ended December 31, 2005 as required under the above paragraph even if the applicability of an IAS/IFRS or IFRIC Interpretation may have been deferred in Pakistan for the time being?

We look forward to receiving the Institute's guidance in this regard at the earliest.

Opinion: The appropriate Committee of the Institute considered paragraph 30 of IAS 8 reproduced in your above-mentioned enquiry and is of the opinion that those IAS/IFRS which have been made effective by IASB but yet to be notified by SECP or notified but deferred either by SECP or SBP (such as IAS 39 and 40 in case of banks and DFIs) for any reason, the disclosure required by paragraph 30 of IAS 8 is not mandatory.

It may be noted that SIC or IFRIC are not separately adopted as the Committee is of the view that they are considered to be adopted automatically when relevant IAS/IFRS are notified

(February 4, 2006)

1.11 INITIAL PUBLIC OFFER (IPO) EXPENSES – TREATMENT IN FINANCIAL STATEMENTS

Enquiry: One of our clients has gone public and has incurred IPO expenses for arrangement of equity to directly finance enhancement of its production facilities. The client is currently extracting profit and loss account to reflect the results of its existing operations. The entire funds raised through the IPO are intended to be used for the expansion of the project. We require clarifications of the accounting treatment of IPO expenses in light of the revised 4th Schedule to the Companies Ordinance, 1984, provisions of Companies Ordinance itself and the revised International Accounting Standard-16 (property plant and equipment).

IAS-16, Property, Plant and Equipment (Revised 1998)

Para – 17 of the said Standard states:

"Administration and other general overhead costs are not a component of the cost of property, plant and equipment unless they can be directly attributed to the acquisition of the asset or bringing the asset to its working condition. Similarly, start-up and similar pre-production costs do not form part of the cost of an asset unless they are necessary to bring the asset to its working condition. Initial operating losses incurred prior to an asset achieving planned performance are recognized as an expense"

Technical Committee Recommendations under Accounting TR-20 (Reformatted 2000)

In the light of Para 17 of the IAS 16 (revised 1998), TR-20 made the following recommendations. An extract of the said TR is reproduced as under:-

“Expenditure incurred during project implementation may be grouped under the following broad heads”

Expenditure	Examples
Formation expense	Preliminary expenses, expenses incurred on issue of shares or TFCs including any sums paid by way of commission or brokerage on the issue of shares or TFCs and other formation expenses.....

Formation expenses shall be written off during a period not exceeding five years commencing from the financial year in which the costs are incurred as provided in paragraph 5(C) of Part II of the Fourth Schedule to the Companies Ordinance, 1984.

IAS 16 Property, Plant and Equipment (Revised December 2003)

Para – 19(d) of the revised IAS 16 excludes administrative and other general overheads giving rise to the presumption that any such costs incurred do not qualify for capitalization and should be charged to profit and loss account.

Companies Ordinance, 1984

Section 234 (1)

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

Related 4th Schedule to the Companies Ordinance, 1984

The repealed 4th Schedule to the Companies Ordinance, 1984 allowed the deferred costs to be amortized over a period of five years.

Revised 4th Schedule to the Companies Ordinance, 1984

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

Issue

The relevant provisions of the Companies Ordinance, 1984, the revised 4th Schedule to the Companies Ordinance, treatment recommended by TR-20 and the revised International Accounting Standards have become contradictory as there is no concept of deferred cost in the revised 4th Schedule.

Keeping in view the above, following issues have arisen:

- 1) What is the status of applicability of TR-20 in relation to IPO expenses considering that the concept of deferred cost has been eliminated in the revised 4th Schedule to the Companies Ordinance, 1984?
- 2) Whether the company is justified to capitalize IPO expenses by transferring it to property, plant and equipment as the funds have been specifically arranged and utilized for the expansion in project.

- 3) Should the entire amount be expensed despite the fact these expenses are not related to results of existing operations of the Company.

We would also like the Institute's opinion, for where a Company is a green field project, the general practice has been to maintain a trial run profit and loss account while the Company achieves its optimal production process. The entire trial run loss including all general and administrative expenses is capitalized as part of property plant and equipment. In light of the revised IAS 16, whether Company is required to draw a separate profit and loss account to show the general and administrative expenses even though it has not yet commenced commercial production.

Opinion:

First of all the Committee would like to inform you that there is no contradiction between IAS and the Companies Ordinance, 1984 with regard to deferred cost. Instead the Committee is of the view that sub-section (1) of section 234 only refers to distribution of an item of expenditure over several years subject to fairness of the reasons why only a portion of expenditure should be charged against income of the financial year. Fairness of the said distribution has to be judged in the light of accounting framework which in case of Pakistan is International Accounting Standards and such Accounting Standards no longer carry the concept of deferred cost. Therefore any deferment of expenditure by an entity will not be according to International Accounting Standards which have been notified by SECP.

Now we come to the three issues raised by you in the above enquiry and our views on them are as follows:

- (1) As TR-20 refers to paragraph 5(C) of Part II of the superseded Fourth Schedule to the Companies Ordinance, 1984 which no more exists in revised Fourth Schedule, therefore, the Committee is of the view that TR-20 related to 'formation expenses' or deferred cost is not applicable anymore.

Further the Committee is also considering withdrawal of TR-20 as all three issues addressed in it have been either superseded or covered in IAS/IFRS.

- (2) With regard to capitalization of IPO expenses the Committee would like to draw your attention to the following paragraphs of IAS 16 *Property, Plant and Equipment*:

16 The cost of an item of property, plant and equipment comprises:

- (a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.
- (b) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.
- (c) the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

17 Examples of directly attributable costs are:

- (a) costs of employee benefits (as defined in IAS 19 Employee Benefits) arising directly from the construction or acquisition of the item of property, plant and equipment;
- (b) costs of site preparation;
- (c) initial delivery and handling costs;
- (d) installation and assembly costs;
- (e) costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment); and
- (f) professional fees.

In view of the above paragraphs the Committee is of the opinion it would not be appropriate to capitalize IPO expenses as they do not appear to be directly attributable costs.

- (3) For your third issue the Committee would like to draw your attention to the following paragraph of IAS 32, *Financial Instruments: Disclosure and Presentation* which is self explanatory:

- 37 An entity typically incurs various costs in issuing or acquiring its own equity instruments. Those costs might include registration and other regulatory fees, amounts paid to legal, accounting and other professional advisers, printing costs and stamp duties. The transaction costs of an equity transaction are accounted for as a deduction from equity (net of any related income tax benefit) to the extent they are incremental costs directly attributable to the equity transaction that otherwise would have been avoided. The costs of an equity transaction that is abandoned are recognized as an expense.

With regard to your query relating to preparation of Profit and Loss Account before commencement of commercial production, the Committee is of the opinion that though commercial production has not yet started, you would be required to prepare profit and loss as IAS/IFRS do not exempt any entity from preparing profit and loss account just because it has not yet started its commercial production

(February 4, 2006)

1.12 INCONSISTENT TREATMENT OF HEAD OFFICE EXPENSES BY BRANCHES OF FOREIGN BANKS

Enquiry: Few years ago Institute's attention was drawn to inconsistent treatment of head office expenses by branches of foreign banks. It was noted that some of the branches have been recording the head office expenses in their books and some branches have not been recording and their audit reports have been qualified in this respect. There have also been some branches who have not been recording these head office expenses and their audit reports have not been qualified.

I understand that the Institute clarified this matter by issuing a selected opinion wherein it was stated that head office expenses should be recognized as a liability in the balance sheet as "the outflow of resources is certain". In Committee's considered view, the non-recognition of the expenses in the financial statements impaired the "true and fair view" of the financial statements and, therefore, called for qualified audit report.

However, it has been noted that even in December 2003 financial statements this inconsistent treatment has continued and auditors have neither quantified the amount of liability nor recorded or qualified their reports.

It would be appreciated if the Committee looks into the matter and issue necessary clarification so that some comparability can be achieved. Also, perhaps it would be in order to also clarify the status of selected opinions i.e. whether they are binding on the members of the Institute or not.

Opinion:

In order to respond to the question raised by you the Committee considered it appropriate to ponder on the issue in the light of certain fundamental principles. Accordingly, paragraph 49(b) and paragraph 70(b) of the "Framework for the Preparation and Presentation of Financial Statements" wherein the expressions "liability" and "expenses" have been defined were discussed. These definitions are reproduced below for reference.

"49(b) A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits."

"70(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."

In the light of the definitions reproduced above, the Committee agreed that if the head office makes a claim in respect of certain expenses that it had incurred for the Pakistan Branch, such claim being usually evidenced by a debit note, the claim in such event will require recognition as an expense and a corresponding liability otherwise the "true and fair view" of the financial statement is likely to be impaired. However, in the absence of a claim from the head office and \ or in case where the head office confirms, either explicitly or implicitly, that expenses, if any, incurred by the head office and attributable to the branch will not be claimed, there is neither any liability capable of being booked nor an expense is incurred which would need to be recorded in the books of account of the Pakistan Branch. The fact that a branch is entitled to resort to the provision of tax permitting deductibility of a claim representing "Head Office expenses" on the basis of "attribution" supported by a certificate from the head office's auditors and a confirmation from the Head Office to the effect that such attribution to the Pakistan operation is proper and reasonable for the limited purpose of determining Pakistan Branch's taxable profits does not in itself mean that a claim has been made by the head office on the branch or the branch has incurred such expense or by the same token, a liability. You would appreciate that in view of the decision of the Supreme Court of Pakistan, the allowance of "head office expenses" is not negated by the fact that such expenses have not been recognized in the financial statements of the branch. The deliberation of the Committee is thus summed up as under:

1. If there is a claim on the branch by the head office, of certain expenses paid on behalf of the Pakistan Branch, evidenced by a debit note, such claim will require recognition as expenses and liability in the financial statements of the Pakistan Branch.
2. If there is no claim from the head office or the head office confirms either explicitly or implicitly that expenses, if any, incurred by the head office and attributable to the branch will not be claimed, there can obviously be no basis or cause for recognition of expenses or liability as any determination purported to be "head office expenses" is merely an internal attribution to

enable Pakistan Branch to determine its taxable profit for the purposes of Pakistan taxation.

3. The deductibility of “head office expenses” therefore, for the purposes of computation of income of the branch for purposes of Pakistan taxation does not amount to a claim by the head office on the branch and has to be seen and equated with other permissible statutory allowances or deductions permitted by the tax law which are not and do not require to be accounted for in the financial statements of the Pakistan Branch.

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

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

(August 13, 2005)

1.13

PRESENTATION OF INVESTMENTS IN ASSOCIATES IN ACCORDANCE WITH THE REVISED IAS

Enquiry:

You must be aware that seventeen IASs were recently revised and became applicable in Pakistan with effect from January 01, 2005 and July 01, 2005 depending on whether the year end of the company is December 31, or June 30. As these are being applied for the first time in Pakistan, some issues regarding their interpretation are arising in the application of the same. We would like to bring to your kind notice certain matters with regard to IAS 28 in respect of which we require your guidance, as it affects companies that have investments in associates only.

Paragraph 13 of the revised IAS 28 Investment in Associates requires that investment in an associate should be accounted for using the equity method. Paragraph 35 of the said IAS also states that investment in an associate shall be accounted for in the investors’ separate financial statements in accordance with the requirements of paragraph 37 to 42 of IAS 27 – Consolidated and Separate Financial Statements, which states that associates that are not classified as held for sale should be accounted for at cost or in accordance with IAS 39. However, paragraph 35 does not mandate which entities are required to produce separate financial statements.

Paragraph 3 of IAS 28 states that financial statements in which the equity method is applied are not separate financial statements. Further, paragraph 4 of the said IAS states that separate financial statements may or may not be appended to, or accompany the financial statements. Therefore, it appears that it is not mandatory for a company only with investment in associates to prepare separate financial statements.

We, however, believe that preparation of separate financial statements in which the equity method is not applied is very important from a company’s point of view. Under the equity method, the investment in an associate is initially recorded at cost and the carrying amount of the investment is increased or decreased to recognize the investor’s share of the profit or loss of the associate after acquisition. The investor’s share of the profit or loss of the associate is reflected in the investor’s profit and loss account. Distributions received from the associate reduce the carrying amount of the investment. In our opinion,

a company can only pay dividends out of its own profit. The profit for this purpose is accurately reflected in separate financial statements rather than the financial statements based on equity accounting as the proportionate share of the associate's profit is included in its financial statements, but it may not have received this profit as the same is paid through dividends by the associate. Hence, financial statements prepared only on the basis of the equity method would give the impression to the shareholders that both company's own profit and the share of the associate's profit are available for payment of dividend, which is clearly not the case.

Moreover, a company presenting financial statements only under the equity method may face adverse income tax application as its pre-tax profit would increase by its share of the associate's pre-tax profit. This would unfairly prejudice the company as the accounting and payment of taxation of the associate is already considered in the associate's individual financial statements.

Section 237 of the Companies Ordinance 1984 requires that a holding company which has subsidiaries should attach to its own financial statements, consolidated financial statements of the group presented as a single enterprise. Therefore, Pakistani law is clear about the requirements for companies with subsidiaries. However, the same is not clear with regard to companies which only have investments in associates.

In order to remove any confusion arising in the shareholder's mind regarding distributable profits, we have shown investment in associates at cost as we have been doing for many decades, to ensure continuity, but however we seek your clarification and guidance in the matter.

Opinion:

Your attention is drawn towards the following introductory paragraph of IAS 28:-

IN8. The Standard clarifies that investments in associates over which the investor has significant influence must be accounted for using the equity method whether or not the investor also has investments in subsidiaries and prepares consolidated financial statements. However, the investor does not apply the equity method when presenting separate financial statements prepared in accordance with IAS 27.

Further the following paragraph of the same IAS defines what separate financial statements are:-

4. Separate financial statements are those presented in addition to consolidated financial statements, financial statements in which investments are accounted for using the equity method and financial statements in which venturers' interests in joint ventures are proportionately consolidated. Separate financial statements may or may not be appended to, or accompany, those financial statements.
5. Entities that are exempted in accordance with paragraph 10 of IAS 27 *Consolidated and Separate Financial Statements* from consolidation, paragraph 2 of IAS 31 *Interests in Joint Ventures* from applying proportionate consolidation or paragraph 13(c) of this Standard from applying the equity method may present separate financial statements as their only financial statements.

However, there are certain exemptions to the application of the equity method which are given in the following paragraph of IAS 28:

13. An investment in an associate shall be accounted for using

the equity method except when:

- (a) the investment is classified as held for sale in accordance with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*;
- (b) the exception in paragraph 10 of IAS 27, allowing a parent that also has an investment in an associate not to present consolidated financial statements, applies; or
- (c) all of the following apply:
 - (i) the investor is a wholly-owned subsidiary, or is a partially-owned subsidiary of another entity and its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the investor not applying the equity method;
 - (ii) the investor's debt or equity instruments are not traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets);
 - (iii) the investor did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organisation, for the purpose of issuing any class of instruments in a public market; and
 - (iv) the ultimate or any intermediate parent of the investor produces consolidated financial statements available for public use that comply with International Financial Reporting Standards.

In view of the above the Committee is of the opinion that a company having investment in associate (as per IAS 28) only would be required to account for such investment in its financial statements using the equity method except for the exemption stated in paragraph 13 above. The said company may or may not enclose separate financial statements along with these financial statements. However, if it decides to do so the requirements of paragraph 37 to 42 of IAS 27 must be followed in letter and spirit.

(February 4, 2006)

1.14 RESIDUAL VALUE OF ASSETS – IAS 16

Enquiry: The revised International Accounting Standard (IAS) 16 is applicable for annual periods beginning on or after January 01, 2005. In case of our and many other companies having financial year as the accounting year, the standard will apply to financial statements for the year ended 30 June 2006 for the first time.

The standard includes an important amendment to its paragraph 51, which provides for review of the residual value of each and every asset at each financial year-end. Companies having large assets base like ours and with assets scattered all over the country at different locations would find it extremely difficult to get the residual value of all the assets reviewed at each year, more specifically the first year of application of the amended IAS i.e. the year ending 30 June 2006.

The exercise is going to be a lengthy and time-consuming one depending upon the number and location of the assets, and will prove quite cumbersome for many companies to carry out at each year-end. There will also be cost attached to this exercise.

We feel that the Institute should give some guidelines to the members as to what should be done to handle this developing situation due to the above change, particularly for the first year of application.

Opinion: First of all your attention is drawn towards the following paragraphs of IAS 16 'Property, Plant and Equipment'

51 The residual value and the useful life of an asset shall be reviewed at least at each financial year-end and, if expectations differ from previous estimates, the change(s) shall be accounted for as a change in an accounting estimate in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors.

53 The depreciable amount of an asset is determined after deducting its residual value. In practice, the residual value of an asset is often insignificant and therefore immaterial in the calculation of the depreciable amount.

In view of the above the Committee is of the opinion that usually the residual value is insignificant therefore in most of the cases the issues highlighted in the above enquiry would not appear to arise. However, if an entity feels that the residual value is material / significant then it is required to estimate the same and for this purpose there is no requirement of an independent valuer and in the opinion of the Committee the entity, on the basis of its past experience, can do this exercise.

(June 3, 2006)

1.15 REVALUATION OF FIXED ASSETS AND TREATMENT OF PAGREE

Enquiry: Your attention is drawn to the following matters:

Revaluation of Fixed Assets:

At inception, the Company had only one unit, which asset was revalued with the passage of time. After few years the company has installed more units in different provinces and locations all over Pakistan. The assets that were revalued have been disposed off and surplus on revaluation on these assets has also been adjusted accordingly except land and remaining assets.

If the Company gets its assets revalued by a valuer again to meet the requirements of International Accounting Standard 16 Property, Plant and Equipment as reproduced below:

As per Paragraph no. 31:

"Revaluations shall be made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the balance sheet date", and;

As per Paragraph No. 34

"The frequency of revaluations depends upon the changes in fair values of the items of property, plant and equipment being revalued. When the fair value of a revalued asset differs materially from its carrying amount, a further revaluation is required. Some items of property, plant and equipment experience significant and volatile changes in fair value, thus necessitating annual revaluation. Such frequent revaluations are unnecessary for items of property, plant and equipment with only insignificant changes in fair value. Instead, it may be necessary to revalue the item only every three or five years".

Based on above paragraphs reference and keeping in view the fact of first unit's revaluation, your opinion is sought for the following:

- Q.1 Either related class of assets of all units needs to be revalued or that particular unit's assets that were previously revalued should be revalued?
- Q.2 What is meant by significant variation, is there any percentage of book value?
- Q.3 Except land almost all of the prior revalued assets were sold. Is it necessary to revalue the replaced assets?

As per Para No. 36

"If an item of property, plant and equipment is revalued, the entire class of property, plant and equipment to which that asset belongs shall be revalued"

- Q.4 Is there any provision in company law and International Accounting Standards available by which we could make reversal of revaluation of fixed assets and state revalued assets at cost or carrying amount in balance sheet after considering any possible depreciation or impairment if required?

Treatment of Pagree

- Q. 5 We intend to purchase a corporate office at one of the premier locations of the city but the space available over there is under PAGREE scheme. As nothing is available in IAS 38 Intangible Assets, however in Income Tax Ordinance, 2001 the treatment of un-adjustable amount is mentioned. According to the matching principle, matching cost should be amortized accordingly. Therefore your opinion is sought about the proper treatment and disclosure of PAGREE in the financial statements.

Opinion: Answer 1.

Apart from the paragraphs reproduced in the above enquiry your attention is also drawn to the following paragraphs of IAS 16:

- 37 A class of property, plant and equipment is a grouping of assets of a similar nature and use in an entity's operations. The following are examples of separate classes:
 - (a) land;
 - (b) land and buildings;
 - (c) machinery;
 - (d) ships;
 - (e) aircraft;
 - (f) motor vehicles;

- (g) furniture and fixtures; and
- (h) office equipment.

38 The items within a class of property, plant and equipment are revalued simultaneously to avoid selective revaluation of assets and the reporting of amounts in the financial statements that are a mixture of costs and values as at different dates. However, a class of assets may be revalued on a rolling basis provided revaluation of the class of assets is completed within a short period and provided the revaluations are kept up to date.

In view of the above the Committee is of the view that the entire class of assets of all the units should be revalued.

Answer 2.

As far as interpretation of term "significant" is concerned, IAS has neither defined it nor enunciated any criterion for it; rather it is up to the management to decide whether change in fair value of assets is material and important after taking into account the circumstances of the entity and nature and value of asset.

Answer 3

Once an accounting policy regarding the revaluation of assets and frequency thereof has been adopted by an entity, it should be applied consistently to all assets in that class of assets.

Answer 4

In reply to question 4 your attention is drawn to the following paragraph 31 of IAS-16, Property, Plant and Equipment

31. After recognition as an asset, an item of property, plant and equipment whose fair value can be measured reliably shall be carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses. Revaluations shall be made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the balance sheet date.

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

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

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

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

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

It may be pertinent to note that IAS 16 does not prohibit companies from changing accounting policies i.e. from allowed alternative treatment to benchmark treatment or vice versa. However, the condition precedent remains there.

From the above it can also be inferred that once the revaluation surplus is recognized in the financial statements, Section 235 of the Companies Ordinance, 1984 does not appear to allow its reversal or its use for any other purpose other than the purpose described in the above sub-section.

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

Answer 5

The system of pagree is more prevalent in Pakistan and India. Pagree, in common parlance, is an amount given to landlord by the pagree-tenant. Payment of such amount gives an entitlement to the pagree-tenant to the reduced or nominal rental amounts but also gives a right to receive a major portion of pagree at the time of the change of tenant from the successor tenant.

As far as form and documentation of pagree is concerned, usually it is undocumented and has no legal cover; however, the customary practices result in emanation of aforesaid rights in vogue. Analysis of nature of the rights associated with the payment of pagree exhibits that it entitles the payer to enjoy all the benefits of the property for an unascertainable period of time.

Though there is no treatment given in any IAS/IFR with regard to pagree, the Committee is of the view that it may be appropriate to disclose it as an intangible asset if the criterion given in paragraphs 107 and 108 of IAS 38 is met.

(December 10, 2005)

1.16 SECTION 226 OF THE COMPANIES ORDINANCE, 1984 'SECURITIES AND DEPOSITS'

Enquiry: We write with reference to the caption subject pertaining to the area of Security Deposits received by a corporate under section 226 of the Companies Ordinance, 1984.

Section 226 Securities and deposits, etc.

No company, and no officer or agent of a company, shall receive or utilize any money received as security or deposit, except in accordance with a contract in writing; and all moneys so received shall be kept or deposited by the company or the officer or agent concerned, as the case may be, in a special account with a scheduled bank;

Provided that this section shall not apply where the money received is in the nature of an advance payment for goods to be delivered or sold to an agent, dealer or sub-agent in accordance with a contract in writing.

We request for your attention and clarification to certain queries on the subject matter which are as follows:

- (i) What kinds of Security Deposits come under this section and should they be treated as short-term or long-term?
- (ii) Is it necessary to deposit the amount in a current account or a savings account? Is there any mandatory requirement?
- (iii) If the amount is deposited in a current account then can a company make a lien on that security deposit against its loan? And if it is allowed can the company return the charge amount?

We would greatly appreciate your views on the above queries.

Opinion: The securities or deposits other than those in the nature of advance payment for goods received in accordance with a contract in writing may fall under the purview of this section. These securities and deposits may be treated as either short-term or long-term depending upon the terms of the contract. The statute has not explicitly stipulated the type of account in which these securities or deposits are required to be kept. The only mandatory statutory requirement pertaining to these securities or deposits stipulated in the Companies Ordinance, 1984 is that they are required to be kept in a special account with a scheduled bank.

However it has been observed that usually prior to receipt of securities or deposits, parties to the contract unequivocally provide for in the contracts that the security or deposit is not required to be kept in a special account according to the provisions of Section 226 of the Companies Ordinance, 1984. These contracts also usually grant permission to the recipient of such kind of securities or deposits for utilization thereof either with or without compliance of conditions precedent.

With regard to your third query relating to lien on securities deposits, the Committee is of the view that the question of lien does not arise if the amount is to be kept in a separate bank account unless there is a specific approval in writing.

(October 8, 2005)

1.17 THE CONTINUOUS FUNDING SYSTEMS

Enquiry: With effect from August 22, 2005, the Karachi Stock Exchange (Guarantee) Limited has introduced "The Continuous Funding Systems (CFS) Regulations, 2005. The said Regulations have replaced the previously applicable "Carry Over Transactions (COT) Regulations, 1993". The transaction mechanism under the new Regulations is the same as was under the previous COT Regulations.

In this regard we would like to have the ICAP's opinion whether its ruling under TR-29 will continue to be applicable in case of CFS transactions i.e. whether CFS transactions should be treated as "Rev Repo Transactions" in our books of account. If yes, then whether it should be disclosed under the head "Lending to Financial and Other Institutions" or under the head "Advances"?

Opinion: Preamble of Continuous Funding System provides that the system is introduced to improve market liquidity and would replace the existing Carry Over Regulations.

Review of the Rules reveals that though CFS Rules are different in form from the Carry Over Regulations, the essence of both the Regulations is to provide liquidity to the buyer of the shares by providing finance against shares following the mechanism given under the respective Regulations.

Paragraph 35 of the '*Framework for the Preparation and Presentation of Financial Statements*' issued by IASB provides that transaction should be recorded on the basis of substance and not on form. As substance of both the Regulations is provision of liquidity through financing, therefore, the Committee is of the opinion that TR 29 should be followed in accounting transactions executed under CFS.

With regard to the disclosure, as the financing is done through Karachi Automated System, which can only be operated by the authorized members of the Stock Exchange who execute the transaction normally on behalf of their clients following the pooling of funds concept with subsequent allocation on required basis. As such, categorization of clients according to their operational status is not possible. In view of the above, it may be appropriate to generalize the disclosure and disclose the transaction as financing against shares.

(January 7, 2006)

1.18 TREATMENT OF PREFERENCE SHARES / REDEEMABLE / CONVERTIBLE IN THE FINANCIAL STATEMENTS

Enquiry: Due to the amendment in the 4th Schedule to the Companies Ordinance, 1984 which, has made the application of International Accounting Standards mandatory. This includes IAS-32 prescribing the treatment of Preference Shares, which is in contradiction to treatment and classification implied by the Companies Ordinance, 1984.

Whereas Preference Shares / Redeemable / Convertible or otherwise are classified as part of equity if they meet certain criteria in accordance with IAS-32, if the criteria is not met the same are required to be classified as liabilities. The provisions of the Companies Ordinance, 1984 are indicative of the fact that the same are part of the equity.

Some of the facts have been examined below:

1. Although the 4th Schedule requires adherence to all IASs including IAS-32 there are contradictory provisions in the 4th Schedule itself in this context. Part II-6 pertains to disclosure of requirements of Share Capital and also requires Paid-up Capital to be grouped under Share Capital and Reserves.
2. In accordance with section 90 of the Companies Ordinance, 1984 different classes of shares as provided by the memorandum and articles of association of the company are categorized as share capital i.e. equity. Return of allotment of shares filed under section 73(1) group both ordinary / preference shares of each class in Paid-up Capital.
3. Various other provisions of the Companies Ordinance, 1984 and 'Companies' Share Capital, (Variation in Rights and Privileges) Rules, 2000' are indicative of the fact that Preference Shares redeemable, convertible or otherwise are part of Share Capital.
4. The normal terms of issue of the Redeemable Preference Shares provides options for redemption and conversion into Ordinary Shares. On redemption it will fall within purview of Section 85 of the Companies Ordinance, which requires creation of Capital Redemption Reserves and

the latter is part of equity. On conversion it will be converted into class of Ordinary Shares, which is again equity.

5. Further Schedules are sub-ordinate to the Ordinance; accordingly provisions of the Ordinance take precedence.
6. It is further observed that IAS-32 does not cater for the situation where redemption reserve is created.
7. It is also observed that dividend on preference shares are appropriations of profits both from the perspective of the Companies Ordinance and under the tax laws.

Irrespective of the requirements of IAS 32, the Companies Ordinance, 1984 will take precedence. This is similar to the treatment of revaluation surplus under S235 of the Companies Ordinance, 1984 which differs from the requirements of IAS 16.

A number of our clients have already issued Preference Shares / Redeemable / Convertible or otherwise or are in the process of issuing the same. We shall be grateful if you could confirm in this context, taking into consideration the above stated facts that it is appropriate to classify such shares as part of equity.

Alternatively till the resolution of the matter, the companies be allowed to treat and classify them equity for the interim period involving the current audited financial statements in process.

Opinion: The appropriate Committee of the Institute has examined the above enquiry, regarding the treatment of preference shares and its comments are as under: -

1. It is important to note that while Section 234 of the Companies Ordinance, 1984 (the Companies Ordinance) makes it obligatory for listed companies to observe IASs as are notified from time to time, the repealed Fourth Schedule to the Ordinance did not bear any direct reference to the mandatory observance of such IASs.

It is significant to note that paragraph 1 of Part-I of the revised fourth schedule carries an overriding stipulation as under:

“The listed companies and their subsidiaries shall follow all the International Accounting standards in regard to accounts and preparation of balance sheet and profit and loss account as are notified for the purpose in the official Gazette by the Commission, under sub-section (3) of section 234 of the companies Ordinance, 1984 (XLVII of 1984)”.

From the aforesaid, it is the Committee's view that IASs would override anything to the contrary contained in the Fourth Schedule of the Ordinance vis-à-vis accounting treatment and disclosure. Indeed the very revision of the Fourth Schedule, in the Committee's view, would seem to be premised on the fact that the accounts shall be prepared and disclosed pursuant to IASs read with the said schedule.

2. Section 90 of the Companies Ordinance read with the Companies' Share Capital, (Variation in Rights and Privileges) Rules, 2000 and the 4th Schedule to the Companies Ordinance provides for issuance and disclosure of different kinds of share capital and classes therein. If the memorandum and articles of a company so provide, it may issue any class of its share on terms that they shall be redeemed at a fixed date, or over a fixed period of time, or on the occurrence of

one or more specified contingencies, or that the shares may be redeemed at the option of the company or the holders of the shares on a fixed date or at any time.

3. In this regard, Clause 6 of Part II of the 4th Schedule to the Companies Ordinance provides that:

“Share capital and reserves shall be classified under the following sub-heads, namely:-

- a. Issued, subscribed and paid up capital, **distinguishing in respect of each class** between, -
 - i. shares allotted for consideration paid in cash;
 - ii. shares allotted for consideration other than cash, showing separately shares issued against property and others (to be specified); and
 - iii. shares allotted as bonus shares.
- b. Reserves, distinguishing between capital reserves and revenue reserves.”

4. On the other hand, Section 85 of the Companies Ordinance deals with redemption of preference share. The gist of the provisions of this section is that the amount required to redeem the redeemable shares may be found out of the profits of the company available for distribution or out of the proceeds of a fresh issue of shares. If shares are redeemed out of the proceeds of a fresh issue of shares, the capital issued or paid up on those shares will replace the redeemed capital. If alternatively, redeemable shares are redeemed out of assets representing a company's distributable profits, the amount by which its issued share capital is thereby reduced must be transferred from profits or revenue reserves to a special capital reserve known as “the capital redemption reserve fund”, which can itself be reduced only in the same way as paid up share capital. In effect, the amount credited to the capital redemption reserve fund replaces the aggregate nominal values of the redeemed shares, and the transfer from profits or revenue reserves make the amount transferred unavailable for distribution as dividend.

5. In this regard, the following paragraph of IAS 32 state that:

18 The substance of a financial instrument, rather than its legal form, governs its classification on the entity's balance sheet. Substance and legal form are commonly consistent, but not always. Some financial instruments take the legal form of equity but are liabilities in substance and others may combine features associated with equity instruments and features associated with financial liabilities. For example:

- (a) a preference share that provides for mandatory redemption by the issuer for a fixed or determinable amount at a fixed or determinable future date, or gives the holder the right to require the issuer to redeem the instrument at or after a particular date for a fixed or determinable amount, is a financial liability.

20 A financial instrument that does not explicitly establish a contractual obligation to deliver cash or another financial asset may establish an obligation indirectly through its terms and conditions. For example:

- (a) a financial instrument may contain a non-financial obligation that must be settled if, and only if, the entity fails to make distributions

or to redeem the instrument. If the entity can avoid a transfer of cash or another financial asset only by settling the non-financial obligation, the financial instrument is a financial liability.

- (b) a financial instrument is a financial liability if it provides that on settlement the entity will deliver either:
 - (i) cash or another financial asset; or
 - (ii) its own shares whose value is determined to exceed substantially the value of the cash or other financial asset.

Although the entity does not have an explicit contractual obligation to deliver cash or another financial asset, the value of the share settlement alternative is such that the entity will settle in cash. In any event, the holder has in substance been guaranteed receipt of an amount that is at least equal to the cash settlement option.

- 6. Hence, in view of above, the Committee is of the opinion that the Securities and Exchange Commission of Pakistan (the SECP), in order to remove the above inconsistencies between the Companies Ordinance and IAS 32, should amend section 85 of the Companies Ordinance by adding a proviso to the effect that for companies which are required to adopt 4th Schedule to the Companies Ordinance in the preparation of their financial statements, the provisions contained in the said schedule relating to redemption shall not apply. This will result in clarifying the circumstances when preference shares should be classified as equity or otherwise to conform to the requirements of the said IAS.

Once this amendment is made to the Companies Ordinance, then the ambiguity regarding the treatment and/or disclosure of preference shares as either equity or debt will be resolved. Accordingly, dividend paid on such preference shares will also be classified as either an appropriation or a charge to the profit and loss account, as the case may be, depending upon the forms governing the issue of preference shares.

- 7. However, recognizing that the amendment to the Companies Ordinance could take some time, the SECP, in the meantime, is requested to issue **a notification** with regard to the treatment and disclosure of preference shares in the financial statements of listed companies.

(January 7, 2006)

2. AUDITING

2.1 STOCK TAKING OBSERVANCE WITHOUT OBTAINING PRIOR CLEARANCE OF PREVIOUS AUDITORS

Enquiry: We have been appointed auditors of two partnership concerns, in the partners' meeting held on 20 June 2005. We have been informed of our appointment through letters of 27 June 2005 forwarding copies of resolution, received by us on 28 June 2005.

Through separate letters we have also been requested to observe the annual stock taking to take place on 30 June 2005.

The question is, in absence of and without receiving professional clearance from retiring auditors (which we have yet to seek) can we observe the stock taking?

Your immediate response shall be highly appreciated.

Opinion: Your attention is drawn towards the following sections of the Code of Ethics for Chartered Accountants:

13.21 Before accepting an appointment involving recurring professional services hitherto carried out by another chartered accountant in practice, the proposed chartered accountant in practice should: -

- (a) Ascertain if the prospective client has advised the existing accountant of the proposed change and has given permission, preferably in writing, to discuss the client's affairs fully and freely with the proposed chartered accountant in practice.
- (b) When satisfied with the reply received from prospective client, request permission to communicate with the existing chartered accountant. If such permission is refused or the permission referred to in (a) above is not given, the proposed chartered accountant in practice should, in the absence of exceptional circumstances of which there is full knowledge, and unless there is satisfaction as to necessary facts by other means, decline the appointment.
- (c) On receipt of permission, asks the existing accountant, preferably in writing: -
 - (i) to provide information on any professional reasons which should be known before deciding whether or not to accept the appointment and, if there are such matters; and
 - (ii) to provide all the necessary details to be able to come to a decision.

13.23 If the proposed chartered accountant in practice does not receive, within a reasonable time, a reply from the existing accountant and there is no reason to believe that there are any exceptional circumstances surrounding the proposed change, the proposed chartered accountant in practice should endeavour to communicate with the existing accountant by some other means. If unable to obtain a satisfactory outcome in this way, the proposed

chartered accountant in practice should send a further letter, stating that there is an assumption that there is no professional reason why the appointment should not be accepted and that there is an intention to do so.

In view of the above, the Committee is of the opinion that you should not commence the audit without fulfilling the requirements of the Code of Ethics.

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