SELECTED OPINIONS

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COMPILED BY

TECHNICAL SERVICES DIRECTORATE

OF

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF PAKISTAN

INTRODUCTION

This report is the twelfth compilation of Selected Opinions issued by the Technical Advisory Committee on inquiries raised by the members and other agencies during the period from July 2006 to June 2007 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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1. ACCOUNTING

1.1 ACCOUNTING FOR PROJECT DEVELOPMENT EXPENDITURE AND COSTS RELATED THERETO

Enquiry We would like to draw your attention to the capitalization of "Project Development Expenditure", which is covered under IAS 16 Property, Plant and Equipment. This standard does not deal specifically with Project Development Expenditure as TR 20 did and has very narrow application compared with any infrastructure Project Development activity, especially Power Projects (hydro or thermal) which normally takes a number of years to develop.

Power Generation project are developed under the specific concessions given by the Government in accordance the Power Policy of the Government. The concession/licenses are either under Build-Own and Operate (BOO) or under Build own operate and transfer (BOOT) concept. Such projects are being developed under a Special Purpose Company whose Sole Purpose is to develop, design, construct, own, finance, operate and maintain specific facility, hence all the development expenditure being incurred by the Company is for the sole purpose to develop, design, construct, finance and bring the power generating facility to operation for which it is intended, therefore all the expenditure is directly attributable to preparing the assets for its intended use.

The Project Development Costs are well defined and identified for infrastructure projects, normally these are based on estimates and budgets which comprise of all such elements of cost and expenditure as given in Para 16 and 17 of IAS and also include administrative and general overhead costs which are incurred prior to Commercial Operation Date (COD) and are necessary to achieve the purpose for which the company is set up. These administrative and general overhead costs include office rent, utility bills, motor vehicle running costs, traveling, salaries of driver, secretaries, accountants etc.

Para 19 of IAS 16 gives examples that are not costs of an item of property, plant and equipment, which includes administration and other general overhead costs. This may be applicable for the acquisition or construction of plant and equipment by an existing or ongoing company already in operation but for Special Purpose Company whose sole purpose is to construct a facility all costs including the administrative costs are directly attributable to such facility as development costs and has to be Capitalized as the benefits relating to such costs arise after the commercial operation date.

If these costs are not development cost then the question arises how can a Special Purpose Company operate without an office, its related facilities and office staff to fulfill its Sole Purpose of setting up a specific project. Obviously, there are costs related to such administrative functions e.g. office rent, utility bills, staff salaries, traveling etc. and such costs are incurred directly as a consequence of the project development. The revenue and economic benefit of which are derived upon commercial operation of the project complex.

Furthermore, in case of infrastructure projects the project development costs are recognized as part of the total project cost for the purposes of computing DSCR, IRR and fixation of tariff therefore it can not be expensed/ charged to profit & loss account.

In light of the above facts, we believe that the administrative and general costs incurred by the "Infrastructure Projects" are directly attributable to the "Project Development Expenditure" and should be capitalized. Previously, it was not the issue as it was covered under TR 20, upon withdrawal of TR 20 by the Institute on August 24, 2006, this has left a big question mark which needs to be resolved. Hence a clarification is required from the technical committee on this particular issue.

We look forward to your views on this matter.

Opinion First the Committee would like to apprise that the reason for withdrawing TR-20 by the Council of the Institute through Circular No. 07/2006 dated August 24, 2006 was the revision in IAS 16 since treatment of indirect costs referred to in the TR was not in compliance with the revised version of IAS 16.

Now your attention is drawn to the following paragraphs of IAS 16:-

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…….

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.

19 Examples of costs that are not costs of an item of property, plant and equipment are:

(a) costs of opening a new facility;
(b) costs of introducing a new product or service (including costs of advertising and promotional activities);

(c) costs of conducting business in a new location or with a new class of customer (including costs of staff training); and
(d) administration and other general overhead costs.

21 Some operations occur in connection with the construction or development of an item of property, plant and equipment, but are not necessary to bring the item to the location and condition necessary for it to be capable of operating in the manner intended by management. These incidental operations may occur before or during the construction or development activities. For example, income may be earned through using a building site as a car park until construction starts. Because incidental operations are not necessary to

> bring an item to the location and condition necessary for it to be capable of operating in the manner intended by management, the income and related expenses of incidental operations are recognised in profit or loss and included in their respective classifications of income and expense.

In view of the above, the Committee is of the opinion that any cost which is directly attributable to the project should be capitalized and the administration, other general overhead costs or any other expense which can not be directly attributed to the property, plant and equipment should be charged to profit and loss since they do not meet the definition of assets

For further clarification your attention is drawn to the following paragraph of the Framework of IFRS which is self explanatory:

> 95 Expenses are recognised in the income statement on the basis of a direct association between the costs incurred and the earning of specific items of income. This process, commonly referred to as the matching of costs with revenues, involves the simultaneous or combined recognition of revenues and expenses that result directly and jointly from the same transactions or other events; for example, the various components of expense making up the cost of goods sold are recognised at the same time as the income derived from the sale of the goods. However, the application of the matching concept under this *Framework* does not allow the recognition of items in the balance sheet which do not meet the definition of assets or liabilities.

The Committee appreciates your concerns that earlier TR-20 used to allow charging of indirect cost to property, plant and equipment but as you are well aware that accounting framework for corporate entities in Pakistan is IFRS therefore it would not be appropriate to deviate from the accounting principles which have been laid down in IFRS.

Further, the Committee appreciates that there are costs that are necessary to incur to achieve the objectives of the company and these cost may not necessarily relate to revenue generating activities. However, in the light of Paragraph 95 of the framework these cost would need to be charged to profit and loss as these do not meet the criteria set for recognition of these as either intangibles or property plant and equipment or any other asset.

(January 5, 2007)

1.2 ACCOUNTING FOR LEASES - IAS 17

Enquiry I would like to draw the attention of the Committee to a problem which being faced by many organizations these days in accounting for lease transactions. Leasing companies and financial institutions have adopted the practice of leasing the asset on a floating rate basis rather than on fixed rate. The floating rate is based on KIBOR. Due to floating rate of interest, the lease rentals in future years are subject to revision and I have seen many cases where the lease rentals have been revised upward or downward by the leasing company consequent to change in their base rate. Now the questions arise as follows:

a) Whether the transactions of acquiring an asset on a floating rate basis will be classified as a lease transaction. The agreement contains the bargain purchase option and all other things are the same except that the IRR is not constant. IAS 17 defines the interest rate implicit in the lease as the discount rate that, at the inception of the lease, causes the aggregate present value of a) the minimum lease payments and b) the unguaranteed residual value to be equal to the sum of the fair value of the leased asset and any initial direct costs of the lessor. As is apparent from the definition, the implicit interest rate of lease will be a constant rate that will equal the sum of the aggregate present value of MLP and unguaranteed residual value to the sum of fair value of leased assets and initial direct cost. The question is still the same whether the transaction involving a floating rate of interest will be classified as a lease transaction.

b) If the transaction is classified as a lease transaction, what will be the treatment of a change in lease rental due to a change in interest rate? The rentals were revised after 12 months and I have treated the problem by using two approaches. In treatment 1, I have used a constant periodic rate in spite of change in lease rental due to change in IRR. This has resulted in difference in opening balance. In treatment 2, I have treated the present value of MLP at the time of revision as a new finance and recomputed the IRR once again on the remaining period of lease. This will only affect the future periods. Now, my question is that which of the treatment adopted is correct. If there is any other treatment to be adopted for this case, please mention that treatment in your opinion.

Opinion Your attention is drawn to the following paragraph 4 of definition of IAS 17 'Leases':

A *lease* **is an agreement whereby the lessor conveys to the lessee in return for a payment or a series of payments the right to use an asset for an agreed period of time.**

A *finance lease* **is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or may not eventually be transferred.**

An *operating lease* **is a lease other than a finance lease**

The Committee is of the opinion that if a transaction fulfills the above criteria then it should be classified as either finance / operating lease.

Further with regard to your view *'the implicit interest rate of lease will be a constant rate'* the Committee likes to draw your attention to following paragraph of IAS 17

25 Minimum lease payments shall be apportioned between the finance charge and the reduction of the outstanding liability. The finance charge shall be allocated to each period during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability. Contingent rentals shall be charged as an expense in the periods in which they are incurred.

From the above paragraph it appears that the term *'constant'* referred to above does not mean that lease rental can not be changed. Instead it requires that allocation of finance charge is to be made on the basis of a constant **periodic** rate of interest on the remaining balance of minimum lease payment which may change if the future rentals are to be calculated on the basis of floating interest rate as per the lease agreement.

With regard to your second enquiry the Committee is of the opinion that at each repricing date the revised rentals are to be worked out for the remaining period of the lease term which may also result in change in Minimum Lease Payments.

(January 5, 2007)

1.3 ACCOUNTING TREATMENT OF TOOLS AND PARTS

Enquiry I work in the automotive sector where we are involved in automotive assembly/manufacturing. Our cost of components for assembly operation is built up of two main areas:

- Cost of imported parts
- Cost of local parts

As far as imported parts are concerned, the case is very simple. We import parts from our principal and include the same in our cost of inventory by adding C&F value, all taxes, insurance and related costs.

As far as local parts are concerned, we need to clarify the proceedings and one typical issue.

In Pakistan, automotive companies are required to follow a compulsory deletion program (the same has been dispensed with in the new budget of 2006-07 and replaced by Tariff Based System-TBS but there has been heavy investment in this regard by automotive companies) in which companies need to compulsory localize 59% of their total parts at the time of initiation of assembly operation. If such local parts are not procured and produced locally and instead imported, there is a penalty duty of extra 15% imposed on their import from outside Pakistan. These local parts development is based on certain processes. I will explain this through an example:

Under the deletion program, we need to compulsorily localize (or produce locally) **car bumpers** which cannot be imported without the imposition of penalty. We need to approach a local vendor who is a producer of car bumpers to build the part for our car. Now the vendor says that the bumper for our XYZ car is a specific one and requires special tools and moulds to prepare it for our specifications and quality standards. Every car has its own specifications and our car would require a specific mould and tool. To prepare such a mould, the vendor requires a specific amount of money which in this example we can take as PKR 3 million. Now there are three scenarios in which this amount could be provided to the vendor:

1. Vendor makes his/her own investment and prepares the mould and tool for development of our car bumper
2. Our company makes full investment and provides the PKR 3 million to the vendor for development of tool and mould
3. Both the parties i.e. vendor and us share the cost of investment in a pre-agreed ratio. In this example we take it as 50% each.

It should also be remembered that there is a separate cost of the bumper on which the same is provided to our company by the vendor. We take the cost to be PKR 2,000 in this case.

In first and third scenarios, there is a threshold that is set for the advance amount to be amortized. It is usually on a quantity of that particular part produced for that tool/mould, in this case, a quantity of 15,000 units is taken over a period of three years. This would come up to PKR 200 per unit produced.

In the first scenario, the vendor will charge the amount of PKR 200/unit tooling advance in their bill of parts cost issued. For 100 units of bumpers supplied they will charge an amount of PKR 220,000 (cost + amortization of tooling advance). This tooling advance will be included in the bill till such time the 15,000 agreed volume of amortization is not reached.

In the second scenario, there would be no impact in the bill of vendor and we would be amortizing the amount of PKR 3 million in our own books based on the number of units supplied.

In the third scenario, a mixture of the above two treatments would take place and we would be amortizing our own commitment of PKR 1.5 million over the number of units and vendor would be charging us PKR 100 for each bumper unit provided.

Please also note that in all these cases, the mould would be our company's property (in case of second scenario, it will always be our property) but in cases 1 and 3, it will become our company's property after the completion of the amortization period.

Accounting Treatment:

Now comes the problem of accounting treatment. The cost of the part is simple. It will be charged to the cost of sales, but we need a clarification of the tooling advance paid to the vendor in all cases. Please note that the life of the mould/tool is much more than the amortization period. We can take the advance paid by us as a CWIP for the advance period and capitalize this as an asset after the completion of the advance period or should we charge it to the P&L account. We take jigs & fixtures which are used to assemble the car as fixed assets and if we look in substance, these tools and moulds are also used to produce parts for car assembly, therefore it might not be the case to take the cost of building these tools and moulds to profit & loss account. Please advise on this issue.

Opinion The enquiry raised has three aspects:

- Recognition of moulds and tools as assets
- Amount of cost to be recognized
- Depreciation charge and period

Recognition of moulds and tools as assets

Since moulds and tools developed are tangible assets and the ownership of the same will remain with the automotive company in all cases, guidance from IAS 16 should be sought on all the issues involved.

IAS 16 paragraph 7 states:

> **The cost of an item of property, plant and equipment shall be recognised as an asset if, and only if:**
>
> **(a) it is probable that future economic benefits associated with the item will flow to the entity; and**
>
> **(b) the cost of the item can be measured reliably.**

In your case both conditions appear to be met and the moulds and tools qualify for recognition as an item of property, plant and equipment.

Further, in accordance with the requirements of IAS-16, an item of property, plant and equipment should be recognized and the depreciation charge should commence from the date when it is available for use, i.e. when it is in the location and condition necessary for it to be capable of operating in the manner intended by management.

Accordingly, in scenarios 1 and 3, it appears to be appropriate to capitalize the moulds and tools even before the advance amortization period by recording a corresponding liability for the cost of asset towards the vendor at the time the asset is ready for use. The subsequent payments made for the asset referred to in your letter as amortization charge included in the cost of parts should be applied to reduce the aforesaid liability.

In scenario 2, the payments made for the development of moulds and tools should be treated as advance until the moulds and tools are ready for use at which the same should be capitalized as operating fixed asset.

Amount of cost to be recognized

As per IAS 16 paragraph 23:

> The cost of an item of property, plant and equipment is the cash price equivalent at the recognition date.

Under scenario 2 it is clear that all the investment would be made outright by the company, therefore, the cash price equivalent is Rs 3,000,000. However, under scenarios 1 and 3, the local vendor may have some hidden cost of financing involved over and above the cash price. In such a situation, guidance should be sought from IAS 39 for allocation of the amounts between principal and interest.

Depreciation charge and period

Depreciation charge for any item of property, plant and equipment is based on its useful life to the entity. If the useful life of these moulds and tools, to your entity, extends beyond the three year period, the useful life should be used as a base for charging depreciation rather than the three year period. Also the difference between useful life and economic life should be considered before making any decision.

(December 9, 2006)

1.4 APPLICATION OF INTERNATIONAL ACCOUNTING STANDARD (IAS) – 39

Enquiry Our company operates in a monopoly environment in the Gas sector in the provinces of Punjab and N.W.F.P. and obtaining finance on favorable terms from the Government and consumers is a regular feature in our case.

We have obtained concessional loans from the Federal Government, Government of Punjab, Government of N.W.F.P. and various industrial consumers with the mark up rate ranging from 1.5% to 5% respectively. We also maintain interest/non-interest bearing security deposit from consumers which carry interest below the market rates. We also have interest relating to the period from 1995 to June 2001) with zero interest charge (interest on interest is not applicable in Pakistan) payable to the Federal Government appearing under the head of other long term liabilities, the repayment of which was staggered over a period of 10 years in the year 2001.

In addition to the above, financial assets in the form of concessional loans have been given to our employees as part of our company policy and general industry practice.

All the above stated facts are a regular feature of our business and it is deemed that such assets and liabilities do not fall, within the scope of the IAS-39, it may not be possible for us to recalculate and restate these assets and liabilities through amortization in our accounts as the number of these transactions are in multiples of thousands. The basis of valuation of our assets / liabilities is being regularly disclosed in our Accounting Policy.

We have now been asked by our auditors to incorporate the impact of paragraph 46 and 47 of the revised version of IAS-39 Financial Instruments: Recognition and Measurement applicable to annual periods beginning on or after 1 January 2005 in the current financial year, requiring certain financial assets / liabilities to be carried at their amortized cost using the effective interest rate method. The effective interest rate is further subject to interpretation.

We would like to point out that the previous version of the standard which was applicable from 1 January 2001, also required the same treatment for financial assets and liabilities, but our accounts never reflected these changes due to limitations stated above.

It is pointed out that none of the financial statements of quoted companies have so far incorporated the impact of IAS-39 in their accounts.

In the light of the above circumstances, it may not be possible to incorporate the changes in our Annual Accounts as stated in IAS-39. Owing to the nature of our business and the volume of work involved it is not practicable.

Please let us have your opinion on the above matter.

Opinion Financial Instruments are defined in paragraph 11 of IAS 32 *'Financial Instruments: Presentation'* as follows:

> A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.
>
> A financial asset is any asset that is:
>
> (a) cash;
> (b) an equity instrument of another entity;
> (c) a contractual right:
>
> (i) to receive cash or another financial asset from another entity; or
> (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or
>
> (d) ………………….
>
> A financial liability is any liability that is:
>
> (a) a contractual obligation:
>
> (i) to deliver cash or another financial asset to another entity; or
> (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or
>
> (b) ………………..

Further for measurement of financial instruments your attention is drawn to the following paragraphs 46 and 47 of IAS 39 *'Financial Instruments: Recognition and Measurement':*

> **46 After initial recognition, an entity shall measure financial assets, including derivatives that are assets, at their fair values, without any deduction for transaction costs it may incur on sale or other disposal, except for the following financial assets:**
>
> **(a) loans and receivables as defined in paragraph 9, which shall be measured at amortised cost using the effective interest method;**

(b) held-to-maturity investments as defined in paragraph 9, which shall be measured at amortised cost using the effective interest method; and

(c) investments in equity instruments that do not have a quoted market price …………………

Subsequent measurement of financial liabilities

47 After initial recognition, an entity shall measure all financial liabilities at amortised cost using the effective interest method, except for:

(a) financial liabilities at fair value through profit or loss. Such liabilities, including derivatives that are liabilities, shall be measured at fair value except for a derivative liability that is linked to and must be settled by delivery of an unquoted equity instrument whose fair value cannot be reliably measured, which shall be measured at cost.

(b) financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or when the continuing involvement approach applies. Paragraphs 29 and 31 apply to the measurement of such financial liabilities.

(c) financial guarantee contracts ………………

CONCLUSION

In view of the above paragraphs the Committee is of the opinion that loans from the Federal/ provincial governments, security deposit from consumers and loans to staff fall under the definition of financial assets/ liabilities, therefore, they should be dealt with as per the requirements of paragraphs 46 and 47 of IAS 39.

With regard to your statement that '*The basis of valuation of our assets / liabilities is being regularly disclosed in our Accounting Policy*' the Committee would like to draw your attention to the following paragraph of IAS 1 which is self explanatory:

16 Inappropriate accounting policies are not rectified either by disclosure of the accounting policies used or by notes or explanatory material.

Further the Committee is also of the view that reasons for non-compliance with paragraphs 46 and 47 mentioned in your enquiry do not appear to be such which causes you to depart from the said requirement of the standards. For further detail you may refer to paragraphs 17 to 21 of IAS 1 *Presentation of Financial Statements*' which refers to circumstances where you are allowed to depart from a requirement of Standard or an Interpretation.

(November 4, 2006)

1.5 DEFERRED TAX

Enquiry A company has unused tax losses amounting to Rs.100 million but deferred tax asset has not been recognized due to non-availability of future taxable profits. However, the company had recorded a surplus on revaluation of fixed assets amounting to Rs. 40 million, but the resultant deferred tax liability was not recorded on the basis of availability of above mentioned tax losses. We would like to seek your guidance whether the deferred tax would be calculated on:

a) net basis, i.e. deferred tax asset of Rs. 60 million or
b) gross basis, i.e. deferred tax liability on surplus to be separately charged to equity.

Opinion Your attention is drawn to the following paragraphs of IAS 12 "Income Taxes" that deals with recognition of deferred tax liabilities on taxable temporary differences

"15. A deferred tax liability shall be recognised for all taxable temporary differences, except to the extent that the deferred tax liability arises from:

(a) the initial recognition of goodwill; or

(b) the initial recognition of an asset or liability in a transaction which:

(i) is not a business combination; and

(ii) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss)."

The above paragraph requires that <u>all taxable temporary differences</u> (except as stated in (a) and (b) above) should be considered while calculating deferred tax liabilities.

Taxable temporary differences include incremental value of those assets which are revalued and for that no equivalent adjustment is made for tax purposes. (IAS 12.18(b)).

The difference between the carrying amount of a revalued asset and its tax base is a temporary difference and gives rise to a deferred tax liability or asset. (IAS 12.20)

"16. It is inherent in the recognition of an asset that its carrying amount will be recovered in the form of economic benefits that flow to the entity in future periods. When the carrying amount of the asset exceeds its tax base, the amount of taxable economic benefits will exceed the amount that will be allowed as a deduction for tax purposes. This difference is a taxable temporary difference and the obligation to pay the resulting income taxes in future periods is a deferred tax liability. As the entity recovers the carrying amount of the asset, the taxable temporary difference will reverse and the entity will have taxable profit. This makes it probable that economic benefits will flow from the entity in the form of tax payments. Therefore, this Standard requires the recognition of all deferred tax liabilities, except in certain circumstances described in paragraphs 15 and 39".

"25. It is inherent in the recognition of a liability that the carrying amount will be settled in future periods through an outflow from the entity of resources embodying economic benefits. When resources flow from the entity, part or all of their amounts may be deductible in determining taxable profit of a period later than the period in which the liability is recognised. In such cases, a temporary difference exists between the carrying amount of the liability and its tax base. Accordingly, a deferred tax asset arises in respect of the income taxes that will be recoverable in the future periods when that part of the liability is allowed as a deduction in determining taxable profit. Similarly, if the carrying amount of an asset is less than its tax base, the difference gives rise to a deferred tax asset in respect of the income taxes that will be recoverable in future periods".

Paragraph 34 of IAS 12 lays down the criteria for recognition of deferred tax asset resulting from unused tax losses which are as under;

"34. A deferred tax asset shall be recognised for the carryforward of unused tax losses and unused tax credits to the extent that it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilised.

35. The criteria for recognising deferred tax assets arising from the carryforward of unused tax losses and tax credits are the same as the criteria for recognising deferred tax assets arising from deductible temporary differences. However, the existence of unused tax losses is strong evidence that future taxable profit may not be available. <u>Therefore, when an entity has a history of recent losses, the entity recognises a deferred tax asset arising from unused tax losses or tax credits only to the extent that the entity has sufficient taxable temporary differences or there is convincing other evidence that sufficient taxable profit will be available against which the unused tax losses or unused tax credits can be utilised by the entity.</u> In such circumstances, paragraph 82 requires disclosure of the amount of the deferred tax asset and the nature of the evidence supporting its recognition". (Underlining is ours)

Paragraphs 74 and 75 of IAS 12 include presentation of deferred tax assets and deferred tax liabilities that are as follows:

74. An entity shall offset deferred tax assets and deferred tax liabilities if, and only if:

(a) the entity has a legally enforceable right to set off current tax assets against current tax liabilities; and

(b) the deferred tax assets and the deferred tax liabilities relate to income taxes levied by the same taxation authority on either:

(i) the same taxable entity; or

(ii) different taxable entities which intend either to settle current tax liabilities and assets on a net basis, or to realise the assets and settle the liabilities simultaneously, in each future period in which significant amounts of deferred tax liabilities or assets are expected to be settled or recovered.

75. To avoid the need for detailed scheduling of the timing of the reversal of each temporary difference, this Standard requires an entity to set off a deferred tax asset against a deferred tax liability of the same taxable entity if, and only if, they relate to income taxes levied by the same taxation authority and the entity has a legally enforceable right to set off current tax assets against current tax liabilities.

Example 2 in Appendix B that accompanies to IAS 12 has shown calculation of net deferred tax liability and illustrative disclosure of its major components.

In view of the above, the Committee is of the opinion that the entity should recognize deferred tax including revaluation surplus only to the extent that the entity has sufficient taxable temporary differences or there is convincing other evidence that sufficient taxable profit will be available against which the unused tax losses or unused tax credits can be utilised by the entity and net it against deferred tax liability in accordance with paragraphs 74 and 75 of IAS 12 Income Taxes.

(March 9, 2007)

1.6 IMPACT OF WITHDRAWAL OF TR-20

Enquiry

One of our clients is facing problem in applying requirements of IAS -16 which have become effective due to withdrawal of TR-20. The client has not yet commenced its business activities and has not earned any income. All expenses incurred are classified as pre-commencement expenditure and shown as an asset in the financial statements. Prior to withdrawal of TR - 20, it was being understood that direct attributable expenses shall be allocated to the respective asset and indirect expenses shall be allocated to land and building proportionately according to their respective costs.

Now as a result of withdrawal of TR - 20, paragraph 19 of IAS 16, Property, Plant and Equipment becomes effective. This paragraph requires recognition of indirect pre-commencement expenses as expense in the period in which these are incurred rather than allocating these expenses to the cost of land and building.

Now the questions arise as follows:

a) Since the company has not commenced its operations and there is no income against which these indirect expenses will be matched. So whether preparing profit and loss account without income is necessary as a fundamental matching concept will not be complied with if we decide to prepare profit and loss account?

b) if profit and loss account is prepared, what will be its presentation since all expenses indirect expenses are in the nature of administrative expenses?

c) What would happen if the company has not commenced its business activities but is earning income through other sources e.g. interest income on deposit accounts? Can the indirect pre-commencement expenses be matched with the other income earned in a period?

d) Whether adopting para 19 of IAS - 16 and foregoing the application of TR - 20 constitutes a change in accounting policy.

Opinion

First the Committee would like to apprise that the reason for withdrawing TR-20 by the Council of the Institute through Circular No. 07/2006 dated August 24, 2006 was the revision in IAS 16 since treatment of indirect costs referred to in the TR was not in compliance with the revised version of IAS 16.

With regard to your first concern on matching principle, the Committee would like to draw your attention to the following paragraph of the Framework of IFRS which is self explanatory:

95 Expenses are recognised in the income statement on the basis of a direct association between the costs incurred and the earning of specific items of income. This process, commonly referred to as the matching of costs with revenues, involves the simultaneous or combined recognition of revenues and expenses that result directly and jointly from the same transactions or other events; for example, the various components of expense making up the cost of goods sold are recognised at the same time as the income derived from the sale of the goods. However, <u>the application of the matching concept under this *Framework* does not allow the recognition of items in the balance sheet which do not meet the definition of assets or liabilities.</u> (underlining is ours)

With regard to your queries (b) and (c) the Committee wishes to draw your attention to the following paragraph of IAS 16:

21 Some operations occur in connection with the construction or development of an item of property, plant and equipment, but are not necessary to bring the item to the location and condition necessary for it to be capable of operating in the manner intended by management. These incidental operations may occur before or during the construction or development activities. For example, income may be earned through using a building site as a car park until construction starts. Because incidental operations are not necessary to bring an item to the location and condition necessary for it to be capable of operating in the manner intended by management, the income and related expenses of incidental operations are recognised in profit or loss and included in their respective classifications of income and expense.

(underlining is ours)

In view of the above paragraphs the Committee is of the opinion that though there would not be any revenue or turnover until the commercial production is started or business is commenced, the profit and loss account would have to be prepared as IAS/IFRS do not exempt any entity from preparing profit and loss account. The income e.g. interest income and expenses which are not directly attributable to property plant and equipment should be recognised in the profit or loss account in their relevant heads.

However, while recognizing the interest income you are advised to take cognizance of the following paragraphs of IAS 23 'Borrowing Cost':

15 To the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation on that asset shall be determined as the actual borrowing costs incurred on that borrowing during the period less any investment income on the temporary investment of those borrowings.

16 The financing arrangements for a qualifying asset may result in an entity obtaining borrowed funds and incurring associated borrowing costs before some or all of the funds are used for expenditures on the qualifying asset. In such circumstances, the funds are often temporarily invested pending their expenditure on the qualifying asset. In determining the amount of borrowing costs eligible for capitalisation during a period, any investment income earned on such funds is deducted from the borrowing costs incurred.

As previously TR-20 used to allow charging of indirect expenses to property, plant and equipment therefore the Committee is of the opinion that subsequent to withdrawal of TR-20 the change in the treatment of indirect expenses would be considered as change in accounting policies and dealt with as per IAS 8 *'Accounting policies, Changes in Accounting Estimates and Errors'*

(January 5, 2007)

1.7 INCORPORATION OF NIT DIVIDEND AS INCOME

Enquiry We would like to seek opinion of the Committee on the captioned subject. .We would like to inform you that National Investment Trust had declared dividend at the rate of Rs.5.80 per unit on July 8, 2006 and they have incorporated dividend as liability in their financial statements for the year ended June 30, 2006.

In light of the above, we have incorporated dividend as income in the half yearly financial statements. This matter is under discussion with the external auditors and pending for decision.

IAS-10 describes in paragraph 12 that "If an entity declares dividend to holders of equity instrument (as defined in IAS 32) after the Balance Sheet date, the entity shall not recognize those dividends as a liability at the balance sheet date".

International Accounting Standard 10 explicitly prohibits the recognition of dividend as liability in the financial statements if declared after the balance sheet instead should be presented as non adjusting event after the balance sheet date in light of IAS 37 and IAS 1. On the other hand, if dividend is declared and the company declaring the dividend is incorporated in the financial statements as liability then the receiving party can take dividend as income in view of the policy which is stated as under:

> "Dividend income is recognized when Bank's right to receive the income is established"

As discussed earlier, right to receive is automatically established once the declaring party declares a dividend and shown as liability in their annual accounts.

Further, we would like to inform you that some of the Banks are taking dividend as income in their half yearly financial statements and we request you to please treat this matter as very urgent and guide us in this regard so that our financial statements can be finalized soon.

Opinion Your attention is drawn towards following paragraph 29 of IAS 18 Revenue:

> **Revenue arising from the use by others of entity assets yielding interest, royalties and dividends shall be recognized on the bases set out in paragraph 30 when:**
>
> **a) it is probable that the economic benefits associated with the transaction will flow to the entity; and**
> **b) the amount of revenue can be measured reliably."**

Both conditions are to be satisfied before revenue can be recognized i.e. probability and reliable measurement at the time of recognition.

Paragraph 30 of IAS 18 states that income shall be recognized when right to receive payment is established. Accordingly, in all circumstances, including specific situation identified and discussed below, the holders of instruments are entitled to recognize distribution as income only as and when declared.

There is no specific situation conceived in the International Financial Reporting Standards (IFRS) and the framework on accounting standards strongly prohibits premature recognition of income. In our country, in certain institutions, a practice of deemed obligation and correspondingly right to receive dividend has been perceived to be present. This has resulted in the present situation, where more than one accounting treatment is in practice and each is being advocated with certain reasonable bases for the validity of such treatments.

The Committee has examined all relevant aspects of the issue in depth, past practices and nature and character of obligation, if any, and is of the opinion that, in future, notwithstanding the obligation or the right to receive, in all circumstances, actual declaration of dividend by an entity should be the sole basis for recognizing income in the accounts of the investor/holder of investment.

(March 9, 2007)

1.8 INTERPRETATION / IMPLEMENTATION OF INTERNATIONAL ACCOUNTING STANDARD (IAS 39)

Enquiry It is informed that scheduled commercial banks granted long term loan to industrial unit repayable at fixed rate of mark up per annum in 20 half yearly equal installments.

Industrial unit due to financial crises could not pay installments of loan on due dates including accrued mark up. As per the decision of Baig Committee appointed by Government of Pakistan rescheduled all stuck up loans for revival of textile industry.

During rescheduling the accrued mark up was also included as part and parcel of the amount of loan rescheduled and as per BPD (Banking Policy Department) Circular No. 37 dated November 7, 1995 of the State Bank of Pakistan and subsequent circulars issued in this connection, the charging of mark up on accrued mark up capitalized was forbidden.

Accordingly, the scheduled bank to rectify the mistake segregated the rescheduled amount of loan in the following three categories.

a) The balance outstanding principal amount of loan was rescheduled to be repayable in 20 half yearly equal installments of Rs.0.953 million w.e.f September 1, 1999 to August 31, 2009 @ fixed mark up rate of 14% per annum.

b) The balance amount of accrued mark up inadvertently included in rescheduled amount was classified as deferred mark up repayable in 20 half yearly equal installments of Rs.0.623 million w.e.f. September 1, 2009 to August 31, 2019 @ zero % mark up rate per annum.

c) The amount of mark up charged on mark up capitalized amounting to Rs.4.192 million shall be waived.

In view of the above, we seek your clarification regarding the following questions:

a) Should the original loan amount repayable in 20 half yearly equal installments payable @ 10% per annum (reduced from 14% per annum) be shown at its present value in terms of IAS-39?

b) Should the amount of Accrued mark up freezed and repayable in 20 half yearly equal installments w.e.f. September 1, 2009 to August 31, 2019 be classified as a loan in term of IAS-39 and how to work out its present value @ zero % mark up rate?

Opinion The Committee first would like to draw your attention towards the following paragraphs of IAS 39:

“Derecognition of a financial liability

39 An entity shall remove a financial liability (or a part of a financial liability) from its balance sheet when, and only when, it is <u>extinguished-</u> i.e. when the obligation specified in the contract is discharged or cancelled or expires. (Underlining is ours).

40 An exchange between an existing borrower and lender of debt instruments with substantially different terms shall be accounted for as an <u>extinguishment</u> of the original financial liability and the recognition of a new financial liability. Similarly, a substantial modification of the terms of an existing financial liability or a part

of it (whether or not attributable to the financial difficulty of the debtor) shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. (Underlining is ours).

AG57 A financial liability (or part of it) is extinguished when the debtor either:

a. discharges the liability (or part of it) by paying the creditor, normally with cash, other financial assets, goods or services; or

b. is legally released from primary responsibility for the liability (or part of it) either by process of law or by the creditor. (If the debtor has given a guarantee this condition may still be met). (Underlining is ours).

AG62 For the purpose of paragraph 40, the terms are substantially different if the discounted present value of the cash flows under the new terms, including any fees paid net of any fees received and discounted using the original effective interest rate, is at least 10 per cent different from the discounted present value of the remaining cash flows of the original financial liability. If an exchange of debt instruments or modification of terms is accounted for as an extinguishment, any costs or fees incurred are recognised as part of the gain or loss on the extinguishment. If the exchange or modification is not accounted for as an extinguishment, any costs or fees incurred adjust the carrying amount of the liability and are amortised over the remaining term of the modified liability. (Underlining is ours)"

It follows from the above that if the rescheduling arrangement meets the above criteria of "substantial modification of terms", the accounting treatment would be as follows:

a) The carrying amount of original loan should be derecognized;
b) The new or rescheduled loan should be recognized which has to be initially measured at fair value (for further guidance, you may refer to the following paragraphs of IAS 39 and its application guidance); and
c) The difference between (a) and (b) above should be taken to the profit and loss account.

"Initial measurement of financial assets and financial liabilities

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

Initial measurement of financial assets and financial liabilities (paragraph 43)

AG64 The fair value of a financial instrument on initial recognition is normally the transaction price (i.e. the fair value of the consideration given or received, see also paragraph AG76). However, if part of the consideration given or received is for something other than the financial instrument, the fair value of the financial instrument is estimated using a valuation technique (see paragraphs AG74–AG79). For example, the fair value of a long-term loan or receivable that carries no interest can be estimated as the present value of all future cash receipts discounted using the prevailing market rate(s) of interest for a similar instrument (similar as to currency, term, type of interest rate and other factors) with a similar credit rating. Any additional amount lent is an expense or a reduction of income unless it qualifies for recognition as some other type of asset.

AG65 If an entity originates a loan that bears an off-market interest rate (e.g. 5 per cent when the market rate for similar loans is 8 per cent), and receives an up-front fee as compensation, the entity recognises the loan at its fair value, i.e. net of the fee it receives. The entity accretes the discount to profit or loss using the effective interest rate method."

Where the financial liability is not extinguished and does not qualify for derecognition in accordance with the criteria as referred to in the above paragraphs, the modification to the financial liability consequent to renegotiation with the banks may be accounted for under one of two treatments for which support can be found in IAS 39. However, the chosen treatment should be the most appropriate treatment in the particular facts and circumstances of the transaction being accounted for. These treatments are as follows:

1) the difference between the previous carrying amount and the present value of the new cash flows discounted at the original effective interest rate is recognised immediately as a gain or loss in the profit and loss account; or

2) the effective interest rate of the liability is adjusted for the difference between the previous carrying amount and the present value of the new cash flows discounted at the original effective interest rate and accordingly this difference is recognised in the income statement over the remaining life of the liability.

(March 9, 2007)

1.9 MEASUREMENT OF INTEREST FREE (LOW INTEREST RATE LOANS RECEIVED / ADVANCED BY COMPANIES

Enquiry Many companies have received from / advanced loan to related parties mainly associated companies, which are long term in nature and carry low interest rate or bear no mark up.

As per paragraph 43 of IAS 39 "when a financial asset or financial liability is recognized initially, an entity shall measure it at its fair value"

Further as per example given in AG 64 "the fair value of a long-term loan or receivable that carries no interest can be estimated as the present value of all future cash receipts discounted using the prevailing market rate(s) of interest for a similar instrument"

Query

1. Should all the companies who have received interest free loan from associated company, record the loan at its fair value and account for any resultant gain in income for the year?

2. What will be the consequences of deferred taxation (if any) to be recognized (under para 15(c)(ii) of IAS 12), on this transaction?

Opinion Financial Instruments are defined in paragraph 11 of IAS 32 as follows:

A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

A financial asset is any asset that is:

(a) cash;
(b) an equity instrument of another entity;

(c) a contractual right:

(i) to receive cash or another financial asset from another entity; or
(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or

………………….

A financial liability is any liability that is:

(a) a contractual obligation:

(i) to deliver cash or another financial asset to another entity; or
(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or

(b) ………………..

<u>CONCLUSION</u>

In view of the above the Committee is of the opinion that loans/advances to or from related parties fall under the definition of financial instruments and should be dealt with as per the requirements of paragraphs 45 to 47 and AG64 to AG66 of IAS 39. As per the requirements of the aforesaid paragraphs loan received or given to a related party that carries no interest or bears an off-market interest rate should be measured at fair value which would be the present value of all future cash receipts and payments discounted using the prevailing market rate(s) of interest for a similar instrument. Any resultant gain or loss should be charged to profit and loss account.

However while measuring the fair value of financial assets or financial liabilities you are advised to take cognizance of the following paragraph of IAS 39:

49 The fair value of a financial liability with a demand feature (e.g. a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid.

With regard to your second, the Committee is of the opinion that deferred tax liability or asset may appear to arise.

(January 5, 2007)

1.10 RE-CLASSIFICATION OF THE SHARES

Enquiry PQR Corporation Limited (PQR) acquired the rights to manage two closed-end funds i.e. The Growth Fund (TGF) and The Investment Fund (TIF) in the privatization process from XYZ Corporation of Pakistan (XYZ) on December 13, 2002 and May 3, 2003 respectively.

The above mentioned dates represent the signing of the Management Rights Transfer Agreement (MRTA) amongst XYZ, PQR and Privatization Commission. Pursuant to these agreements the status of shares of A, B, C and D held in these two funds were ascertained from XYZ through our two correspondences. In reply we were informed that these shares form a part of strategic shareholding under control of Government of Pakistan, thus implying that they are not to be sold and be treated as frozen.

Subsequently, D being a private entity was removed from the list and consents agreements were executed for 'C' and 'A' shares. Furthermore, privatization of 'C' led to reduction in the frozen holdings and at present only two frozen entities are left with Funds i.e. 'A' and 'B'.

As a matter of prudent investment policy these shares were Held for Trading (HFT), marking them to market every year. These frozen holdings constitute almost 50% portfolio of TGF and 25% portfolio of TIF. It has been consistently observed that our performance in non frozen holdings gets overshadowed by the dispositions of these mammoth frozen chunks.

Unfortunately, the International Accounting Standard – 39 (IAS 39) in its paragraphs 50 to 54 does not permit reclassification of shares once classified as HFT. Since the concept of IAS 39 revolves around the notion of realizable price and these shares are not for sale therefore we seek your opinion whether we can reclassify these shares as Long term strategic.

The core benefit of transferring these holdings into AFS is rationalization of Profit & Loss Account through lower volatility. Moreover, the concept of keeping a security in HFT is valid only if it is tradeable which is not the case as these securities are not tradeable by their very nature and provide a misleading picture to the certificate holders.

Opinion Your attention is drawn to the following paragraphs of the revised International Accounting Standard (IAS) 39; "Financial Instruments: Recognition and Measurement", which is applicable to financial statements covering annual periods beginning on or after January 1, 2005:

"Definitions of four categories of financial instruments (paragraph 9 of IAS 39)

A *financial asset or financial liability at fair value through profit or loss* **is a financial asset or financial liability that meets either of the following conditions.**

(a) It is classified as held for trading. A financial asset or financial liability is classified as held for trading if it is:

(i) acquired or incurred principally for the purpose of selling or repurchasing it in the near term;

(ii) part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or

(iii) a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).

(b) Upon initial recognition it is designated by the entity as at fair value through profit or loss. An entity may use this designation only when permitted by paragraph 11A, or when doing so results in more relevant information, because either

(i) it eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as 'an accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases; or

(ii) a group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity's key management personnel (as defined in IAS 24 *Related Party Disclosures* (as revised in 2003)), for example the entity's board of directors and chief executive officer."

"**Reclassifications**

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

It follows from the above that almost any financial asset within the scope of IAS 39 may be classified as a financial asset at fair value through profit or loss if it is either (i) classified as held for trading; or (ii) specifically designated as such by the entity at the time of initial recognition. In addition, once a financial asset has been classified as a financial asset at fair value through profit or loss, it can not be subsequently reclassified into any other category. Accordingly, even if the investments made by TIF and TGF do not meet the criteria of held for trading given above, these investments may still be classified under the revised IAS 39 as a financial asset at fair value through profit or loss if these are designated as such by the entity.

You would be aware that the revised IAS 39 which became applicable to financial statements covering annual periods beginning on or after January 1, 2005 provided the following transitional provision to an entity to re-designate previously recognized financial assets as either "financial assets at fair value through profit or loss" or as "available for sale", as per the definition given in the revised IAS 39:

"**105 When this Standard is first applied, an entity is permitted to designate a previously recognised financial asset as available for sale. For any such financial asset the entity shall recognise all cumulative changes in fair value in a separate component of equity until subsequent derecognition or impairment, when the entity shall transfer that cumulative gain or loss to profit or loss. The entity shall also:**

(a) restate the financial asset using the new designation in the comparative financial statements; and

(b) disclose the fair value of the financial assets at the date of designation and their classification and carrying amount in the previous financial statements."

However, the Committee understands that the above transitional provisions of revised IAS 39 was not taken into account at the time of preparation of these financial statements and the investments were inadvertently continued to be classified as "Held for Trading".

In this specific case, the Committee would like to draw your attention to the following paragraphs of International Accounting Standard (IAS) 8, "Accounting Policies, Changes in Accounting Estimates and Errors":

"Definitions (paragraph 5 of IAS 8)

Prior period errors **are omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that:**

(a) was available when financial statements for those periods were authorised for issue; and

(b) could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.

Such errors include the effects of mathematical mistakes, mistakes in applying accounting policies, <u>oversights</u> or misinterpretations of facts, and fraud". (Underlining is ours)

"42 Subject to paragraph 43, an entity shall correct material prior period errors retrospectively in the first set of financial statements authorised for issue after their discovery by:

(a) restating the comparative amounts for the prior period(s) presented in which the error occurred; or

(b) if the error occurred before the earliest prior period presented, restating the opening balances of assets, liabilities and equity for the earliest prior period presented."

"Limitations on retrospective restatement

43 A prior period error shall be corrected by retrospective restatement except to the extent that it is impracticable to determine either the period-specific effects or the cumulative effect of the error.

44 When it is impracticable to determine the period-specific effects of an error on comparative information for one or more prior periods presented, the entity shall restate the opening balances of assets, liabilities and equity for the earliest period for which retrospective restatement is practicable (which may be the current period).

45 When it is impracticable to determine the cumulative effect, at the beginning of the current period, of an error on all prior periods, the entity shall restate the comparative information to correct the error prospectively from the earliest date practicable."

Accordingly, the Committee is of the view that if at the time of initial recognition the restrictions on disposal of these investments in the frozen shares of 'A' and 'B' was in place, the classification as held for trading at the time of initial recognition did not meet the criteria for held for trading financial assets as allowed under the revised IAS 39. Therefore, such classification may be treated as a prior period error and the Funds may rectify the error though the application of above referred provisions of IAS 8.

However, it should be clearly understood that financial assets and liabilities once classified can not be reclassified. This exemption through the use of IAS 8 is only available where despite availability of all material information at the time of initial recognition due to an error or omission the instruments are wrongly classified. Therefore, use of this procedure to correct or rectify any situation which comes to light after the initial recognition of any instruments will not be appropriate.

(February 9, 2007)

1.11 RECOGNITION OF INCOME BY LEASING COMPANIES

Enquiry I request the kind advice/opinion of the Technical Committee on the recognition of finance income by Leasing Companies in compliance with revised IAS 17. I hereby give some brief facts that may be helpful for the Committee in forming the opinion.

1.<u>HISTORY</u>

<u>IAS 17 (reformatted 1994)</u>

Reference: Para 30

Subject to the consideration of prudence, the recognition of finance income should be based on a pattern reflecting a constant periodic rate of return on either the lessor's **net investment outstanding** or the **net cash investment outstanding** in respect of the finance lease. The method used should be applied consistently to leases of similar financial character.

<u>ICAP CIRCULAR JAN 11, 1997 REGARDING CLARIFICATION TO IAS-17</u>

<u>SELECTED OPINION (LEASES- ACCOUNTING FOR –FURTHER CLARIFICATION REGARDING IAS-17) BY ICAP</u>

OPINION

REFERENCE: Para 2

It may also be noted that IAS 17 states that income included in monthly rentals should be allocated either on the basis of **Net Investment Outstanding** or **Net Cash Investment Outstanding** in the leases. You may also note that former method assumes recovery of guaranteed residual value and payment of lease key money at end of a lease term contrary to the latter method, which assumes the same at the time of lease execution. You will appreciate that as majority of leasing companies in Pakistan follow the former method of income allocation therefore, to make income allocation basis in conformity with the industry practice Markup in both schedules is allocated on the basis of **Net Investment Outstanding** in the Lease.

<u>IAS 17 REVISED (EFFECTIVE FROM 01 JAN 1999)</u>

Reference: Para 6 of Introduction of revised IAS 17

IAS 17 (revised) requires that the recognition of finance income should be based reflecting a constant periodic rate of return basing on one method, namely the lessor's **net investment outstanding** in respect of the finance lease.

<u>IAS 17 LEASES (EFFECTIVE FROM 01 JAN 2005)</u>

IAS 17 Leases replaced IAS 17 leases (revised in 1997) with the same criteria of recognition of finance income as in revised IAS 17.

<u>UK SSAP 21</u>

UK SSAP 21 requires that total income receivable be allocated over the period of the lease to give a constant rate of interest on the **net cash investment**. (Present status of SSAP is not known)

2. PRACTICAL CASE

Lease Amount	292,000,000
Down Payment / Lease Key Money @ 30%	87,600,000
Residual Value	87,600,000
IRR	14% P.A
Monthly Rental in Advance	6,905,345
No of Months	36
Implicit rate of return (as per IAS 17 Leases)	8.32% P.A
Spread (IRR-Borrowing Cost) (14-12)	2% P.A

Assumptions

1. The Company recognizes finance income based on pattern reflecting a constant periodic rate of return on the lessor's net investment in the finance lease.
2. The Company borrows fund for lease with fixed rate of return of 12%.
3. The Company pays off its borrowing by payment of KLM and First rent received in advance.

Net profit in Financial Statement after one year

YEARS	PROFIT AT IMPLICIT RATE IN FINANCIAL STATEMENTS	ACTUAL PROFIT
01	(375,370)	3,423,547
02	2,058,763	2,166,955
03	4,629,810	722,701
TOTAL	**6,313,204**	**6,313,204**

3. ENQUIRY

As per my understanding recognition of finance income by Leasing Companies based on pattern reflecting a constant periodic rate of return on the lessor's net investment :

- reflects loss in the financial statements of the Company in first year despite of spread of 2% and enhanced profit in subsequent years which impair qualitative characteristics and the objective of the Financial Statements that is to provide information about the financial position of an entity that is useful to a wide range of users in making economic decisions.
- does not present true and fair view of financial position and performance of Leasing Companies.
- recognition of borrowing cost in Financial Statement of Leasing Companies, impairs the concept of matching cost with revenue as borrowing cost is recorded on the outstanding principal based on IRR and income is recognized on implicit rate of return.

In view of the above you are requested to confirm my understanding regarding recognition of income and its impact on the Financial Statements of Leasing Companies and if Committee agrees with my understanding please suggest whether IAS 17 requires any amendment to recognition criteria of Finance Income or whether there is any other remedy available to Leasing Company in this regard.

Opinion Based on the background of the above query raised, the committee draws attention to some paragraphs of the International Accounting Standard 17 'Leases' (IAS 17), which in the Committee's opinion are pertinent to this transaction.

As per paragraph 4 of IAS 17 the minimum lease payments (MLP) and gross investment in lease are:

> *Minimum lease payments* **are the payments over the lease term that the lessee is or can be required to make, excluding contingent rent, costs for services and taxes to be paid by and reimbursed to the lessor, together with:**
>
> **(a) for a lessee, any amounts guaranteed by the lessee or by a party related to the lessee; or**
>
> **(b) for a lessor, any residual value guaranteed to the lessor by:**
>
> **(i) the lessee;**
> **(ii) a party related to the lessee; or**
> **(iii) a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee.**
>
> (underlining is ours)
>
> *Gross investment in the lease* ***is the aggregate of:***
>
> *(a)* ***the minimum lease payments receivable by the lessor under a finance lease, and*** (underlining is ours)
>
> ***(b) any unguaranteed residual value accruing to the lessor.***

Based on the above definition, the MLP in the above query is the sum of the 36 monthly rentals of Rs. 6,905,345/month and Rs. 87,600,000 guaranteed residual value, which has been paid in advance by the lessee in the form of a security deposit.

Since there is no unguaranteed residual value in the given example gross investment in lease would be the same as the MLP calculated above.

Leasing companies disclose the residual value as asset in their financial statements under the caption "Net Investment in Lease Finance". Lease Key Money / Security Deposit is disclosed in the financial statements of the lessor as Liability till the lease maturity. It may be noted that the provision with regard to the utilization of Lease Key Money and recovery of Residual Value is generally contained in the lease documents.

Now in order to address the query regarding the pattern of income recognition in the example given above, refer to the lease finance income recognition criteria provided in paragraph 39 of IAS 17. This paragraph requires that:

> **The recognition of finance income shall be based on a pattern reflecting a constant periodic rate of return on the lessor's net investment in the finance lease.** (underlining is ours)

Based on the requirements of the above paragraph a constant rate of return on the lessor's net investment in finance lease needs to be calculated. This rate has been defined as the 'interest rate implicit in lease' in paragraph 4 of IAS 17 as follows:

> **The** *interest rate implicit in the lease* **is the discount rate that, at the inception of the lease, causes the aggregate present value of (a) the minimum lease payments and (b) the unguaranteed residual value to be equal to the sum of (i) the fair value of the leased asset and (ii) any initial direct costs of the lessor.**

As per the requirements of the above paragraph, implicit rate in lease is calculated based on MLP, which as described above includes monthly rentals and any guaranteed residual value (i.e. the security deposit). This should be calculated keeping in view the methodology for working out discounted present value which requires that cash inflows and outflows are discounted based on the timing of the receipts and for payment.

The example forming part of the query comprises the following two different rates for income recognition:

a) Implicit rate of return of 8.32% per annum under 'net investment outstanding method'
b) IRR of 14% per annum under 'net cash investment method'.

The difference between the workings in deriving the two rates calculated in the given example is the treatment accorded to the guaranteed residual value (i.e. the security deposit received in advance), where in (a) above the guaranteed residual value has been discounted at the end of the lease term and in (b) it has been discounted at the beginning.

The Committee is of the opinion that the guaranteed residual value (being the security deposit received in advance) should be discounted upfront (in accordance with the timing of its receipt) in (a) above for calculating the implicit rate of return to make it in accordance with the methodology for working out the discounted present values as discussed above. In this manner, the anomaly pointed out in the above query would cease to occur.

(November 4, 2006)

1.12 RESERVES ON AMALGAMATION

Enquiry ABC Limited entered into a Scheme of Arrangement for Amalgamation (the Scheme) with DEF, then a 77.77% subsidiary of ABC as at July 1, 2004, the effective date of amalgamation. The Scheme was sanctioned by the Securities and Exchange Commission of Pakistan (SECP) on February 11, 2005.

The amalgamation was accounted for in the financial statements of ABC as a Uniting of Interests and accordingly all assets and liabilities of DEF were recorded at their pre-merger carrying values in accordance with the guidance specified in International Accounting Standard (IAS) 22: Business Combinations relating to the "pooling of interests" method. Under the Scheme, ABC Limited issued 700,000 fully paid-up ordinary shares of Rs.10 each to the registered shareholders of DEF (other than ABC) on the basis of a swap ratio of 1.4:1 i.e. 140 shares of ABC for every 100 shares held by these shareholders in DEF as consideration for the acquisition of shares of DEF. Consequent to issue of shares in accordance with the above swap ratio and under the "pooling of interests" method, a negative reserve of Rs. 2 million arose, representing the difference between the share capital issued to DEF, shareholders (other amalgamation, and the share capital of DEF, acquired under the scheme of amalgamation, and this negative reserve was separately classified in the statement of changes in equity as reserve on amalgamation.

Now we wish to remove this negative reserve from our books. We understand that paragraph 79 of IAS 22: Business Combinations permits the set off of any difference between the amount recorded as share capital issued plus any additional consideration in the form of cash or other assets and the amount recorded for the share capital in the equity. The equity is defined in the "Framework for the Preparation and Presentation of Financial Statements" as the residual interest in the assets of an entity after deducting all its liabilities. This residual interest may be sub-classified in the balance sheet as paid-up capital retained earnings and reserves which are created through appropriations of retained earnings etc.

On the contrary, the Fifth Schedule to the Companies Ordinance, 1984 which is applicable to financial statements of unlisted companies such as ABC, requires reserves to be classified separately as capital reserves and revenue reserves. Capital reserves specified in this Schedule include capital redemption reserve, share premium account, profit prior to incorporation or any reserve not regarded free for distribution by way of dividend while revenue reserve specified in this Schedule include general reserve dividend equalization reserve and other reserves created out of profit. In that respect this reserve appears to be a capital reserve, hence not available for distribution / adjustment.

Having considered the above, we are looking for two options to remove the negative reserve on amalgamation from our books. Firstly, to set off the negative reserve from the accumulated profits available for distribution as permitted by IAS 22. Finally, the board of directors may appropriate Rs. 2 million from accumulated profits to the negatives reserve on amalgamation as we consider that there is no binding on appropriation from revenue reserve to capital reserve, for example appropriations from accumulated profits to reserve for issue of bonus share.

We trust the above explains the matter in detail enabling the Institute to issue an opinion on the appropriate treatment of negative reserve on amalgamation.

Opinion

Your attention is drawn to the following paragraphs of Fourth and Fifth Schedules of the Companies Ordinance, 1984 relating to Capital Reserve:-

Clause 2 (ii) of Part I of Fourth Schedule:

> “capital reserve” includes capital redemption reserve, capital repurchase reserve account, share premium account, profit prior to incorporation or any reserve not regarded free for distribution by way of dividend.

Clause 6 of Part II of the Fourth Schedule:

> Share capital and reserves shall be classified under the following sub-heads namely:-
>
> (i) ………
> (ii) Reserves, distinguishing between capital reserves and revenue reserves.

Clause 7(A) of Part II of the Fifth Schedule:

> (i) ………………….
>
> (ii) Reserves, distinguishing between capital reserves and revenue reserves, capital reserves shall include capital redemption reserve, share premium account, profit prior to incorporation or any reserve not regarded free for distribution, by way of dividend (to be specified), while revenue reserves shall include general reserve, dividend equalization reserve, other reserves created out of profit (to be specified), and unappropriated profit (i.e. credit balance of profit and loss account after appropriations for the period to the date of balance sheet). Additions to and deductions from each item of reserves shall be shown in the balance-sheet under the respective items unless they are disclosed in the profit and loss account or a statement or a report annexed thereto.

Accumulated loss-adverse balance of profit and loss account shall be shown as deduction from the capital and reserves.

Though the above clauses of the Fourth and Fifth Schedules of the Companies Ordinance require reserves to be classified either as capital reserves or revenue reserves, no disclosure has been prescribed anywhere in the Companies Ordinance, 1984 where there is a negative reserve. In view of this the Committee is of the opinion that it would be appropriate to charge the negative reserves to retained earning as required by the following paragraph of IAS 22, *Business Combinations.*

79. Any difference between the amount recorded as share capital issued plus any additional consideration in the form of cash or other assets and the amount recorded for the share capital acquired should be adjusted against equity.

(November 4, 2006)

1.13 REVALUATION OF LEASEHOLD LAND

Enquiry: A reference to the annual accounts of some listed companies has revealed that these companies have revalued leasehold land as part of their fixed assets and have recognized revaluation surplus in their balance sheet. This treatment reflects positively on the Companies' state of affairs, as overall equity position is improved. Moreover, the revalued leasehold land is not being amortized, as a result of which the balance sheet footing is inflated and the companies' profits are overstated.

International Accounting Standard 17 on Leases provides guidance on accounting treatment of leasehold assets. Para 14 of the said IAS specifically deals with recognition and amortization of leasehold land and state as under:-

"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."

On the other hand, para (1)(a) part II of Fourth Schedule to the Companies Ordinance, 1984 requires that leasehold land should be reported under fixed assets. ICAP had given a Selected Opinion (Opinion 1.8 of Volume III) regarding this apparent conflict in which it is stated that:

"In the case of leasehold land the risks and rewards are not transferred to the lessee, the leasehold land as per International Accounting Standard 17, Accounting for Leases, is classified as an operating lease. However, in Pakistan, paragraph 1 (i)(a) of Part II of the Fourth Schedule to the Companies Ordinance, 1984, requires that the leasehold land should be classified under fixed assets and as the Companies Ordinance, 1984 prevails over International Accounting Standards, the leasehold land is accounted for as part of fixed assets and not as an operating lease. It is to be noted that in majority of leases, the lease costs, where the government is lessor, are immaterial. The published accounts of different companies show that where the lease costs are considered to be material by the Management, these are being amortized and in the opinion of the Committee these should be amortized".

Although the question of recognition of leasehold land and charge of amortization thereon has been somewhat dealt with in the above opinion of ICAP, the following points still need to be considered and clarified:

a) Whether leasehold land can be revalued with particular reference to the fact that the company does not hold title of the land, but in substance on its treatment as finance lease it is recognized as an asset like other assets of the Company.

b) If yes, whether the value of land and revaluation surplus which so arises should be depreciated/amortized as provided in Section 235 of the Ordinance read with SRO 45(I) /2003 .

The matters have been examined and we are of the opinion that:-

i) There is no divergence between IAS 17 and Fourth Schedule. Fourth Schedule requires "freehold land" and "leasehold land" to be separately disclosed. Obviously this is intended to warn the reader of financial statements as to the ownership of land. IAS 17 goes a step further and requires "leasehold land" to be differentiated between "finance lease" and "operating lease".

ii) Methods for depreciation or amortization of lease payments in either of the two cases are discussed in IAS 17. The charge for depreciation in case of revaluation are discussed and provided in paragraphs 31 to 42 of IAS 16.

iii) A reference to paragraph 35 of Framework for Preparation and Presentation of Financial Statements is required at this stage. This paragraph provides that information and transactions should be accounted for and presented in accordance with their substance and economic reality and not merely their legal form. This paragraph also gives an example which further elaborates how substance of a transaction can be different from its apparent form. Drawing on this principle we have to look at the "finance lease" and "operating lease" according to the nature and substance of these two leases.

iv) IAS 17 after analysis of different factors has categorized "finance lease" to consist of two elements. First, the expense that is to be depreciated and, second, the expense which is to be charged as finance expense. Naturally the portion of the finance lease which can at all be considered for revaluation is the depreciable part. Operating lease, in any case, is different and is to be charged or amortized somewhat differently although the underlying idea in determination of the treatment is the same.

v) In the aforesaid background from the point of recognition of "substance" of a transaction rather than its "form" it has been determined by the IAS 16 and IAS 17 that leased assets are the assets where the risks and rewards relating to its ownership remain with the lessor and are not passed on to the lessee.

vi) In both the cases of "finance lease" and "operating lease" the risks and rewards of ownership do not pass to the lessee at lease till a future date. This being so, the substance of the arrangement of leases (more particularly finance leases) is that the lessee is not an owner in "substance" but in "form" only and consequently should not have the right to avail the attendant reward or be burdened with the attendant risk. Accordingly, the lesee should not have a right to claim that his financial interest in that lease has increased in value and recognize the same as revaluation. This right is attached to the real owner of the property. Therefore, there is no ground to recognize revaluation of leasehold and whether it is further categorized as “finance lease” or “operating lease”.

It is requested that ICAP may reconsider the issue and circulate an appropriate opinion for the guidance of its members.

Opinion: As per paragraph 14 of IAS 17 quoted by you in the above enquiry, the lessee should not record the leasehold land in its books as an asset unless title is expected to pass to the lessee by the end of the lease term. On the other hand the treatment prescribed in Clause 1 (i)(a) of Part II of the Fourth Schedule to the Companies Ordinance, 1984 is somewhat different than that required by IAS 17 and leasehold land is required to be shown as fixed asset irrespective of transfer of title.

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 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 because of the peculiar nature of leasehold land the treatment prescribed in the Fourth Schedule is appropriate for the following reasons:-

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 time factor does not have a material impact on the fair value of the property on a year to year basis (unless the expiry period is short);

(v) the lessee can transfer his interest and obligations to others without any restrictions;

(vi) further the legal structure governing the convincing 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. A lessee can receive risk and rewards in two ways. 1) by using the land itself or by renting it out 2) it can assign the remaining lease to a sub-lessee and make a gain or loss.

A lease of long leasehold interests differs very little from buying a property outright. It may also be noted here that majority of lands are leasehold land.

In view of the above reasons and particularly owing to the transfer of risks and rewards to the lessee which are incidental to the leasehold land, the Committee is of the view that leasehold land may be carried in the balance sheet at revalued amount.

The Committee is also of the view that since long-term leasehold land is in commercial substance owned by the lessee and since the lessee has the right to continue to indefinitely extend the lease by payment of a token amount (when compared to the market value of the lease) of lease renewal charges every 99 years, the useful life of this asset becomes infinite. On the other hand, the theoretical residual value estimated for the land would not be less than the purchase cost. This would result in zero depreciation. Hence, in the opinion of the Committee the question of charging any amortization or depreciation to surplus on revaluation cannot arise.

(July 27, 2006)

1.14 VALUATION OF UNQUOTED INVESTMENT

Enquiry After the applicability of IAS 32 and IAS 39 in Pakistan, the concept of valuation of financial assets and financial liabilities at fair value is broadly followed. Consequently, equity investment in an unquoted company by a listed company, in most of cases, is measured at fair value being the break up value of the shares held, based on the latest financial statements of the investee.

Ours is a listed company which has short term investment in an unquoted insurance company XYZ Limited, a group company of MND Group. We hold approximately 9% of the equity of XYZ and have intentions to sell this investment within next few months. XYZ has significant investments in different listed companies including its own group companies. The accounting policy adopted for the valuation of these investments by XYZ and as stated in its audited financial statements for the year ended December 31, 2005 is setout below:

"Paragraph 4.6

Investments

The investments made by the company are classified for the purpose of measurement into the following categories:

a) **Held to Maturity** – Investments with fixed maturity that the management has the intent and ability to hold to maturity are classified as held to maturity and are initially recognized at cost being the fair value of consideration given and include transaction costs. At subsequent reporting dates these are measured at amortized costs using the yield method. Any premium paid or discounts availed on acquisition of such investments is deferred and included in income for the period on straight line basis over the term of investments.

b) **Available for Sale -** Investments classified as available for sale are initially measured at cost, being the fair value of consideration given and include transaction costs. Subsequent to the initial recognition at cost, these are stated at the lower of cost and market value, (market value being taken as lower if the fall is other than temporary), in accordance with the requirements of SRO 938 issued by the SECP in December 2002. The Company uses latest stock exchange quotations in an active market to determine the market value of its listed investments. The investment for which quoted market price is not available is measured at cost as it is not possible to apply any other valuation methodology.

At the subsequent reporting dates, the company reviews the carrying amounts of the investments to assess whether there is any indication that such investments have suffered an impairment loss. If any such indication exists the recoverable amount is estimated in order to determine the extent of the impairment loss, if any. Impairment losses are recognized as expenses.

This policy of stating available for sale investments at lower of cost and market value is not in compliance with IAS 39, which states that investments available for sale at subsequent reporting dates should be measured at fair value. The market value of available for sale investments as at December 31, 2005 is Rs. 4,061,132,654. Had the company complied with IAS 39, the carrying value of investments as at December 31, 2005 would have been higher by Rs.3,395,790,251"

The above non-conformity of compliance with IAS 39 is disclosed in audited financial statements of XYZ for the year ended December 31, 2005.

Our accounting policy for the valuation of investments available for sale is setout below:

These are stated at fair value and changes in carrying value are recognized as separate component of equity until investments are sold, disposed or until investments is determined to be impaired, at which the accumulated gain / loss previously reported in equity is included in income. For unquoted securities, fair value is determined considering the break up value of the securities.

You would appreciate that the break up value of XYZ is substantially understated as XYZ has not valued their investments in accordance with the measurement criteria provided by IAS 39 and accordingly is understating its available for sale investments and equity. Consequently the fair value of our investment in XYZ will not be stated at fair value in our books of account, if we adopt conventional method of valuing XYZ share at the break up value disclosed in its accounts.

Had XYZ valued its investments in accordance with the measurement criteria given in IAS 39, the carrying value of investments and equity of XYZ as at December 31, 2005 would have been higher by Rs. 3,395,790,251. Accordingly break up value used for the valuation of these investments in our company would also have been higher by the amount with which its equity would have increased. Our view in this regard is that while determining the fair value of our investment in XYZ, it is appropriate to adjust the equity of XYZ by the amount with which it is understated as at December 31, 2005.

You are requested to please let us have your comments on the above matter.

Opinion Your attention is drawn to the following paragraph 46 of IAS 39:-

46 After initial recognition, an entity shall measure financial assets, including derivatives that are assets, at their fair values, without any deduction for transaction costs it may incur on sale or other disposal, except for the following financial assets:

(a) ……………………….;
(b) ……………………….; and

(c) investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured and derivatives that are linked to and must be settled by delivery of such unquoted equity instruments, which shall be measured at cost (see Appendix A paragraphs AG80 and AG81).

Further your attention is also drawn to the paragraphs AG74 to AG75 and AG 80 to AG82 of IAS 39:-

No active market: valuation technique

AG74 If the market for a financial instrument is not active, an entity establishes fair value by using a valuation technique. Valuation techniques include using recent arm's length market transactions between knowledgeable, willing parties, if available, reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis and option pricing models. If there is a valuation technique commonly used by market participants to price the instrument and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transactions, the entity uses that technique.

AG75 The objective of using a valuation technique is to establish what the transaction price would have been on the measurement date in an arm's length exchange motivated by normal business considerations. Fair value is estimated on the basis of the results of a valuation technique that makes maximum use of market inputs, and relies as little as possible on entity-specific inputs. A valuation technique would be expected to arrive at a realistic estimate of the fair value if (a) it reasonably reflects how the market could be expected to price the instrument and (b) the inputs to the valuation technique reasonably represent market expectations and measures of the risk-return factors inherent in the financial instrument.

AG80 The fair value of investments in equity instruments that do not have a quoted market price in an active market and derivatives that are linked to and must be settled by delivery of such an unquoted equity instrument (see paragraphs 46(c) and 47) is reliably measurable if (a) the variability in the range of reasonable fair value estimates is not significant for that instrument or (b) the probabilities of the various estimates within the range can be reasonably assessed and used in estimating fair value.

AG81 There are many situations in which the variability in the range of reasonable fair value estimates of investments in equity instruments that do not have a quoted market price and derivatives that are linked to and must be settled by delivery of such an unquoted equity instrument (see paragraphs 46(c) and 47) is likely not to be significant. Normally it is possible to estimate the fair value of a financial asset that an entity has acquired from an outside party. However, if the range of reasonable fair value estimates is significant and the probabilities of the various estimates cannot be reasonably assessed, an entity is precluded from measuring the instrument at fair value.

In view of the above the Committee is of the opinion that instead of adjusting the equity of the Insurance Company in which you have an investment it would be appropriate to measure such investment at fair value by using the valuation technique referred to in paragraph AG 74 provided it can be measured reliably.

(November 4, 2006)