
SELECTED OPINIONS

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COMPILED BY

TECHNICAL SERVICES DIRECTORATE

OF

**THE INSTITUTE OF CHARTERED
ACCOUNTANTS OF PAKISTAN**

INTRODUCTION

This report is the thirteenth compilation of selected opinions issued by the Technical Advisory Committee on inquiries raised by the members and other agencies during the period from July 2007 to June 2008 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.

Muhammad Asif Iqbal
Director Technical Services

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1. ACCOUNTING

1.1 RECOGNITION OF GOODWILL OF COMPANY'S BRANDS

Enquiry: The examination of annual accounts of a Company for the year ended June 30, 2007 revealed that the company has recognized Goodwill of its Brands of Rs.100,000,000 as intangible assets vide the valuation report given by the valuer on June 25, 2005. Perusal of the annual accounts of the Company for the previous years revealed that the aforesaid amount is appearing in the accounts of the Company since 2005 which is in contravention to Para 48 of International Accounting Standard (IAS) 38 (Intangible Assets) which states that Internally generated Goodwill shall not be recognized as an asset.

On enquiry, the Company has submitted to this Commission that the Goodwill for its brand recognized in the accounts is not internally generated. Its brand is a well renowned brand on which the company has incurred substantial advertisement expenses. The company has recognized the asset on the basis of the report of the valuer because the following criteria are met:

- The asset meets the definition of an intangible asset i.e. it is identifiable and controlled by the entity.
- It is probable that future economic benefits that are attributable to the asset will flow to the entity;
- The cost of the asset can be measured reliably.

Moreover, if the brand name is sold in the market, it would fetch the value not below the amount on which the asset has been recognized.

In view of the above, please comment on the appropriateness of the above accounting policy for recognition of goodwill in light of IAS 38. As with the aforesaid treatment the company has inflated the profits of the company by the said amount in the year 2005.

Opinion: The Committee would like to draw your attention to paragraph 9 and paragraphs 57-67 of IAS 38 '*Intangible Assets*' whereby the standard does not prohibit recognition of internally generated "intangible assets". However, paragraph 63 and 64 (reproduced below) of the Standard specifically prohibits recognition of internally generated "brands" as Intangible assets.

63 Internally generated brands, mastheads, publishing titles, customer lists and items similar in substance shall not be recognised as intangible assets

64 Expenditure on internally generated brands, mastheads, publishing titles, customer lists and items similar in substance cannot be distinguished from the cost of developing the business as a whole. Therefore, such items are not recognised as intangible assets.

In view of the above the Committee reached a conclusion that the value of internally generated "brand" should not have been recognized as intangible asset.

(February 8, 2008)

1.2 APPLICABILITY OF SSE STANDARD

Enquiry: Accounting and financial reporting Standard for SSEs requires the lease payments, either operating or finance, should be recognized as an expense and should not be shown either as an asset or liability in the balance sheet. Please suggest for the following; If in the previous years the finance lease is shown as an asset and liability. In the current year, as the SMEs standard applies, should the previous years figure be restated; or else.

Opinion: Your attention is drawn to the following paragraph of Accounting and financial reporting standards for SSEs:

41 Lease payments, deriving from an *operating or finance lease*, shall be recognized as an expense (on an accrual basis). If the payments are material, the expense should be shown under a specific lease payment heading in the income statement.

As there is no transitional provision available in SSE Standard with regard to the above requirement therefore the Committee is of the opinion that the above requirement should be applied retrospectively. For further guidance you may refer to IAS 8 '*Accounting Policies, Changes in Accounting Estimates and Errors*'

(January 11, 2008)

1.3 REVALUATION OF LEASED ASSETS

Enquiry: We will be highly obliged if you would provide your professional opinion whether a company is permitted to revalue its leased fixed assets, recognized as fixed assets in its financial statements?

We are detailing below brief facts of our case for your consideration and professional opinion:

1. We are a public company listed on the Karachi Stock Exchange (Guarantee) Limited
2. In compliance with the requirements of IAS 17 we have recognized the assets subject to finance lease as leased fixed assets in our financial statements (statutory auditors agree with this accounting treatment).
3. We are following the revaluation model for measurement after initial recognition for all our material fixed assets.
4. In accordance with our accounting policy we have revalued all our material fixed assets including leased fixed assets during the year ended 30 June, 2007.
5. Depreciation is being charged on leased fixed assets in accordance with the requirements of IAS 16 and is consistent with that for depreciable assets of same class that are owned.
6. The depreciation rates applicable on depreciable assets have been revised during the year ended 30 June, 2007. Depreciation rates on leased fixed assets and owned fixed assets of the same class were found excessive and therefore have been reduced.
7. The external auditors have referred to the contents of following note to the account in their report to the members:

“In the opinion of the Auditors, revaluation of leased assets has not been in compliance with the Generally Accepted Accounting Principles”

8. We are of the view that revaluation of leased fixed assets was necessary for stating them at their fair value and this accounting policy is in compliance with the provisions of IAS summarized below:
- IAS 16 clearly states that it is applicable to those aspects of accounting treatment for recognition of property, plant and equipment for which any other IAS does not require a different approach. Hence IAS 16 is applicable to measurement after recognition of leased assets.
 - IAS 16 further specifies that where an item of property plant and equipment is revalued, the entire class of property, plant and equipment to which that asset belongs shall be revalued. It would have been a selective revaluation of our fixed assets had we revalued owned property, plant and equipment and stated the same class of leased property, plant and equipment at historical cost.

We understand that the selected opinion referred in your letter was issued from July 1997 to June 2000, subsequent to which a number of changes have taken place in the International Accounting Standards. We request you to please refer our original query to the appropriate Committee of the Institute with the following additional submissions:

- IAS 17 specifies the accounting treatment for initial recognition of property, plant and equipment subject to finance lease.
- IAS 16 states that it is applicable to those aspects of accounting treatment for recognition of property, plant and equipment for which any other IAS does not require a different approach. Hence IAS 16 is applicable to measurement after initial recognition of leased assets.

We request you to please give your professional opinion on the basis of above facts and any other rules, law, stipulations, etc. which might have been omitted in this letter.

Opinion:

The Committee considered its earlier opinion which has been reproduced in volume V of the “Selected Opinions” (Opinion 1.16) wherein it has been stated that *“The IAS does not provide for any revaluation after initial recognition during the pendency of the lease”*. This conclusion is based on paragraph 11 (now paragraph 20) of IAS 17. After a debate on the issue, the members of the Committee came to the conclusion that basing the opinion primarily on the grounds that IAS 17 does not mandate a revaluation of assets held under finance lease would be wrong. What needs to be appreciated is the fact that IAS 8 provides that if in any IAS something is not specifically allowed or mentioned, reference can be made to other IASs for eliciting an accounting treatment.

Reference to paragraph 4 and 27 of IAS 16 shows that it includes finance leased assets as part of its scope and specifically refers to other accounting for a finance lease asset, after initial recognition. The Committee feels that treating finance leased assets the same as owned assets under IAS 16, including revaluation, is consistent with the economic substance of finance leases in that “substantially all the risks and rewards incidental to ownership of an asset” are transferred to the lessee.

Accordingly, assets that are recognized under a finance lease by a lessee may be revalued using the revaluation option under IAS 16.

(January 11, 2008)

1.4

SCOPE OF ACCOUNTING TERM

Enquiry:

Our Company exports 'Naphtha' but is in principle a bye-product in this line of business. The company wants clarification regarding the 'accounting' aspects as used in the Income Tax Rules 2002. We reproduce two rules as follow:

1. Income Tax Rules 2002

1.1 Rule 32 provides as follows

32 General form of books of accounts, documents and records:-

- (a) The books of accounts, records and other documents required to be maintained by a taxpayer in accordance with this Chapter may be kept on electronic media, provided sufficient steps have been taken to ensure the sanctity and safe keeping of such accounts, documents and records.
- (b) The books of accounts, documents and records required to be maintained by a company in accordance with this Chapter shall be maintained in accordance with International Accounting Standards and as required under the Companies Ordinance 1984

1.2. Rule 231 provides as follows

231 Computation of export profits and tax attributable to export sales:-

- (1) Where a taxpayer exports any goods manufactured in Pakistan, the taxpayer's profits attributable to export sales of such goods shall be computed in the manner specified hereunder:-
 - (a) where a taxpayer **maintains separate accounts** of the business of export of goods manufactured in Pakistan, the profits of the export business shall be taken to be such amount as may be determined by the Commissioner in accordance with the provisions of Ordinance on the basis of such accounts; or
 - (b) in other cases, the profits of such business shall be taken to be an amount which bears to the total profits of the business of the assessee from the sale of goods, the same proportion as the export sales of goods manufactured in Pakistan bear to the total sales of goods.
- (2) Where the total income of a taxpayer includes any profit from the export of goods manufactured in Pakistan, the tax attributable to such profits shall be an amount which bears to the tax payable on the income the same proportion as such profits bear to the total income.
- (3) In this rule, unless there is anything repugnant in the subject or context:-
 - (a) "export sales" means the fob price of the goods exported;
 - (b) "total profits" means:-
 - (i) the aggregate of export sales as determined under clause (a); and
 - (ii) the ex-factory price of goods sold in Pakistan, where the goods exported out of Pakistan were manufactured by the exporter; or
 - (iii) the ex-godown price of goods sold in Pakistan, in other cases.

2. We need your opinion as to the scope of the terms used in Rule 231 (1)(a)" where a tax payer maintains separate accounts of the business of export of goods manufactured in Pakistan"
3. We seek Institute's assistance in identifying the professional and practical meaning of 'separate accounts of the business of export' in the light of various accounting pronouncements and the Institute's expertise.

Opinion:

The Committee is of the opinion that the term "separate accounts of the business of export of goods manufactured in Pakistan" used in the rule 231 of Income Tax Rules 2002 refers to maintenance of separate books of accounts, records and documents relating to the export business in such a manner that the Commissioner may determine / verify the following:

- a) all exports and purchase of goods relating to export business
- b) directly allocated manufacturing expenses relating to exports
- c) indirectly allocated manufacturing expenses relating to exports
- d) all sums of money received and expended by the taxpayer and the matters in respect of which the receipt and expenditure takes place in export business
- e) all assets relating to export business
- f) all liabilities relating to export business

Beside this, the Company is required to maintain books of accounts, documents and records in accordance with International Accounting Standards and as required under the Companies Ordinance, 1984.

(February 8, 2008)

1.5

ACCOUNTING TREATMENT RESULTING FROM AMENDMENT IN PRUDENTIAL REGULATION R – 8, CLASSIFICATION AND PROVISIONING OF ASSETS.

Enquiry:

We seek the committee's opinion on whether to account the effects of the amendment introduced in R- 8 of not considering the benefit of Forced Sale Value (FSV) as a change in Accounting Policy or a Change in Estimate after consideration of the following.

A. Definitions and Elaboration of certain relevant terms.

1. The term **Accounting Policy** has been defined in Para 5 of IAS 8 as *Accounting policies are the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements.*
2. Elaborating on the definition, an entity **adopts** Accounting Policies;
 - that are most appropriate to its particular circumstances for the purpose of giving a true and fair view,
 - they are reviewed regularly to ensure that they remain appropriate, and are changed when a new policy becomes more appropriate to the entity's particular circumstances; and
 - that sufficient information is disclosed in the financial statements to enable users to understand the accounting policies adopted and how they have been **applied**.
3. Similarly an entity **applies** accounting policies to **reflect the effects of transactions** and other events through recognizing, **selecting measurement bases for, and presenting assets, liabilities, gains, and losses and changes to shareholders funds.**

4. **Estimation Techniques.** Accounting policies do not include estimation techniques which are the **methods and estimates adopted by an entity to arrive at monetary values, corresponding to the measurement basis** selected, for assets, liabilities, gains, losses and changes to shareholders' funds. The estimation techniques for example include methods of depreciation, such as straight – line and reducing balance, applied in the context of a particular measurement basis, used to estimate the proportion of the economic benefits of a tangible fixed asset consumed in a period.
5. **Measurement** is defined in para 99 of the Framework, as the process of determining the monetary amounts at which the elements of the financial statements are to be recognized and carried in the balance sheet and income statement.
6. **Measurement basis** are those **monetary attributes** of the elements of financial statements (assets, liabilities, gains, losses, and changes to shareholders' funds) that are reflected in financial statements. Measurement basis are defined in para 100 of the Framework as **A number of different measurement basis are employed to different degrees and in varying combinations in financial statements. They include the (a) Historical Cost (b) Current Cost (c) Realisable (settlement) Value and (d) Present Value**
7. **Monetary Attributes** The different attributes or values of an element of a financial statement are monetary attributes. In other words the different measurement basis defined in para 100 of the framework are monetary attributes.
8. **Change in accounting estimate** is defined in para 5, Definition of IAS 8 as, Change in Accounting Estimate is an adjustment of the carrying amount of an asset or a liability, or the amount of the periodic consumption of an asset, that results from the assessment of the present status of, and expected future benefits and obligations associated with, asset and liabilities. Changes in accounting estimates results from new information or new developments and accordingly are not corrections of errors.

B. Discussion.

1. The determination, of whether a change is to be recognized as a change in accounting policy or estimate, will require carrying out an analysis of the effect of the change. This can be done by testing the effect on three general principles arising from the definition of accounting policy relating to preparation and presentation of financial statement being, the recognition (recognition criteria), presentation and the measurement basis. A change in any one of the general principles will have to be accounted for as a change in accounting policy.
2. The general understanding of the three principles is briefly summarized for clarity as follows;
 - Recognition Criteria. How to recognize elements of financial statements (assets, liabilities, gains or losses) as a result of the transaction,
 - Presentation. Where to present the elements in the financial statement i.e balance sheet or profit and loss account.
 - Measurement basis. How to attribute a monetary amount to the elements that are recognized.
3. R – 8 provides guidelines to Banks and DFIs in the matter of classification of their asset portfolio and provisioning there against.

4. Through SBP circular the application of IAS 39 has been deferred in the case of Banks and DFIs and therefore the classification of financial assets as well as the **provisioning** is according to SBP circulars and Regulations. In view of the principle that where compliance with a particular accounting standard is inconsistent with the requirements of legislature, entities are permitted to depart from the requirements of that standard and therefore the principles outlined in the circulars are effected to comply with the guidelines and therefore R- 8 is adopted for presentation of financial assets by Banks / DFIs. It is clarified that the word provisioning appearing in R – 8 is in the nature of impairment and not in the nature of ordinary provisions. (Reference para 7 of IAS 37).
5. Before amendment, R – 8 required Banks / DFI's to classify and determine, the category of classification using the time based criteria. The time based criteria requires a provision percentage (10 %, 25 %, 50 %, 100%) of the difference resulting from the outstanding balance of principle less the amount of liquid assets realizable without recourse to a court of law and adjusted forced sale value of mortgaged /pledged assets as valued by valuers fulfilling prescribed eligibility criteria. In other words by taking the benefit of FSV the future potential cash flows from securities is considered.
6. The carrying amounts of loans / advances after giving effect to the provisioning criteria prescribed in R – 8, somewhat resembles the concept of **present value**, defined for Assets in para 100 (d) as, **Assets are carried at the present discounted value of the future net cash inflows that the item is expected to generate in the normal course of business.**
7. After amendment in R – 8 the benefit of FSV is now not available while making provisions, resulting in a monetary attribute of the assets that will not meet the test of Present Value Definition. Instead the subject assets will now reflect a hybrid monetary basis resembling a combination value of Current cost and Realisable (Settlement) value thus due to this change in the **measurement basis criteria the same will result in a change of accounting policy in accordance with paragraph 35 of IAS 8.**
8. The amendment has also effectively taken the option (refer para 4 of R -8) available with the Banks / DFIs of availing the benefit of collateral held against loans / advances by considering the value determined by the valuers thus leaving only one measurement basis i.e. the hybrid basis and therefore the amendment will need to be accounted for as a change in accounting policy.
9. Argumentatively the change would have been considered as a change in estimate if the subject amendment provided a different basis of valuation for collateral / securities or alternately required estimation of impairment / provisioning by using a cash flow model in which case **the measurement basis remaining the same a change in the estimation technique would have occurred thus giving rise to recognition of the effects of amendment as a change in estimate.**
10. This finds further strength from the fact that the objectives against which an entity judges the appropriateness of accounting policies to its particular circumstances are;
 - Relevance;
 - Reliability ;
 - Comparability; and
 - Understandability

being the headings defining the qualitative characteristics of financial statements as set out in IAS 1, Presentation of Financial Statements.

11. The Change in Accounting Policy argument also finds strength from reading of paras 7 & 14
 - (a) of IAS 8. Para 14 (a) requires that **An entity shall change an accounting policy only if the change:**
 - (a) is required by a Standard or interpretation; or
 - (b)
12. This is due to the fact that the amendment in R – 8 has the effect of a change due to amendment in R – 8 which results in changing the measurement basis as it meets the test in the definition of **Measurement defined in para 99 of the Framework** for the reason that the amendment results in a change in the **monetary amount of the asset at which it is carried in the balance sheet** which is different in principle from the previous basis.
13. Therefore where an entity, based on the above considerations, adopts the R -8 criteria of provisioning as a change in accounting policy it should account for the current amendment in R – 8 on the same principle which will enable it to meet the objectives of financial statement comparability to provide a better understanding of the current period financial statements.

Opinion: Your attention is drawn to the following paragraph of IAS 8 'Accounting Policies, Changes in Accounting Estimates and Errors':

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

Accounting policies are the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements.

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

As the revised circular of SBP is not allowing banks to take any benefit of FSV against non-performing loans for calculating provision therefore the Committee is of the view that it is an adjustment of the carrying amount of liabilities for valuation of the non-performing loan for the purpose of provisioning. The Committee therefore is of the opinion that this change should be considered as change in accounting estimate rather than change in accounting policy.

However, if an entity treated the change in R – 8 as change in accounting policy instead of change in accounting estimate in the financial statements of previous year, the Committee is of the view that this should be considered as an error and should be dealt with as per paragraphs 41 to 49 of IAS 8.

(March 8, 2008)

1.6

MEMBERSHIP CARD

Enquiry: A limited liability company has part of its assets a seat (trading right membership) in one of the stock exchanges in Pakistan. Under what heading this asset shall come under IFRS for disclosure and valuation purpose in the balance sheet of the company. This asset after purchase at cost, can thereafter be shown at fair value representing the current market price of the seat.

Opinion: At the outset, the Committee would like to draw to your attention to the definition of intangible assets as provided in IAS-38 'Intangible Assets', which reads as under:

“An *intangible asset* is an identifiable non-monetary asset without physical substance”

Also, paragraph 12 of the said IAS states that:

- “12 An asset meets the identifiability criterion in the definition of an intangible asset when it:**
- (a) is separable, ie is capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, asset or liability; or**
 - (b) arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.”**

In view of the above, the Committee is of the opinion that trading rights arising from stock exchange membership fall under the definition of intangible asset and, therefore, should be classified as such in the financial statements

With regard to your second question, the Committee would like to make reference to the following paragraphs of IAS- 38:

- “72 An entity shall choose either the cost model in paragraph 74 or the revaluation model in paragraph 75 as its accounting policy. If an intangible asset is accounted for using the revaluation model, all the other assets in its class shall also be accounted for using the same model, unless there is no active market for those assets.**

Cost model

- 74 After initial recognition, an intangible asset shall be carried at its cost less any accumulated amortisation and any accumulated impairment losses.**

Revaluation model

- 75. After initial recognition, an intangible asset shall be carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated amortisation and any subsequent accumulated impairment losses. For the purpose of revaluations under this Standard, fair value shall be determined by reference to an active market. Revaluations shall be made with such regularity that at the balance sheet date the carrying amount of the asset does not differ materially from its fair value.”**

It follows from the above that an intangible asset can be carried after initial recognition at revalued amount subject, however, to the condition that an active market exist for such intangible asset. In this context the characteristics of an active market have also been laid down by the IAS-38 which are as under:

“An active market is a market in which all the following conditions exist:

- (a) the items traded in the market are homogeneous;**
- (b) willing buyers and sellers can normally be found at any time; and**
- (c) prices are available to the public”**

The Committee would therefore recommend that the management of the company should assess the existence of an active market in relation to the trading rights (arising from the stock exchange membership) by considering the above referred characteristics of an active market and choose the accounting policy accordingly. In this context the Committee is of the view that the management should also assess the useful life of the Intangible asset to determine whether the same is finite or indefinite in accordance with IAS 38

(March 8, 2008)

1.7 TREATMENT OF INVESTMENT IN ASSOCIATES IN SEPARATE FINANCIAL STATEMENTS

Enquiry: A listed Company, in its separate financial statements for the year ended June 30, 2007, has disclosed following accounting policy for investments in associates and subsidiaries:

“Investments in subsidiaries and associates are stated at cost and the carrying amount is adjusted for impairment, if any.

The Company has made an equity investment in its associated company and has recorded that investment, in its separate financial statements, at cost in accordance with its accounting policy. During the year 2006 the Company decided to dispose of a portion of its investment in associate and transferred that portion from the category *“Investment in associates”* to *“Available for sale Investment”* and stated it at its fair value. During the year 2007 the said portion of investment was transferred back to the category *“investment in associate”* at its fair value on the date of transfer. The said action has been recorded in the books of the Company in following manner:

	2007 (Rs)	2006 (Rs)
Investment in Associates		
Investment in associates 61,917,188 (2006: 49,533,750 shares) of Rs.10 each) Market value of Rs. 219.95 (2006:137.75 per share)	1,772,546,770	1,862,802,950
Less: transferred to available for sale investment - 2,400,000 shares of Rs 10 each		(90,256,180)
Add: transferred from available for sale investments on reclassification - 2,400,000 shares of Rs 10 each	527,880,000	
	2,300,426,770	1,772,546,770

This represents 7.65% share (2006: 7.65%) in the equity of 809.4 million shares of Rs. 10 each in the associated company. The Group as a whole controls 30.3% (2006: 25.5 %) equity in the associated company. Increase in number of shares represent bonus shares received.

Available for Sale Investment

Opening balance	90,256,180	-
Transferred from investment in associate (2,400,000 shares)	-	90,256,180
Surplus on re-measurement of available for sale investment to fair value as on July 01	240,343,820	-
Surplus on re-measurement of available for sale investment to fair value for the year	197,280,000	240,343,820
	437,623,820	240,343,820
Transferred to investment in associate on reclassification	(527,880,000)	-
	-	330,600,000

NOTE: Last year as per management intention 2,400,000 shares of associate were transferred to available for sale Investments. During the year, pursuant to change in intention, these shares have been transferred back to investment in associate.

The Committee is requested to consider whether the accounting treatment adopted by the Company is in violation of Company's accounting policy and the requirements of IASs.

Opinion:

The Committee has reviewed the above matter and its views are as under:

The accounting for investments in associates in the separate financial statements of an entity is dealt with under IAS-27 (read with paragraph 35 of IAS 28) which is effective for annual periods beginning on or after January 1, 2005. The said standards requires as under:

'37 When separate financial statements are prepared, investments in subsidiaries, jointly controlled entities and associates that are not classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with IFRS 5 shall be accounted for either:

- (a) at cost, or
- (b) in accordance with IAS 39.

The same accounting shall be applied for each category of investments. Investments in subsidiaries, jointly controlled entities and associates that are classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with IFRS 5 shall be accounted for in accordance with that IFRS' (underlining is ours)

It follows from the above that, in the context of separate financial statements, investments classified as associates should be accounted for either (a) at cost or (b) in accordance with IAS-39 depending on the accounting policy selected by a Company. In the case referred by you, the Company has chosen cost basis as its accounting policy for investment in associates. The accounting policy selected should have been applied to the entire category of investment on a consistent basis except in the following circumstances:

- (i) the investment ceases to meet the criteria for classification as associate; or
- (ii) the investee becomes a subsidiary or joint venture, in which cases it would expel out of the scope of IAS 28

In the above situations, the investment would need to be accounted for in accordance with other relevant standards i.e IAS 39, IAS 27 or IAS 31, as the case may be.

In the case under discussion neither of the above circumstances exist and as such, the entire category of investment needs to be valued on the basis of accounting policy initially selected i.e. "Cost Basis". As such, reclassification of part of investment from "Investment in Associates" to "Available for Sale" and vice versa and application of different accounting policies considering the parts as different category of investment was not in accordance with the provisions of the Accounting Standards.

(June 7, 2008)

1.8

CHANGE OF ACCOUNTING POLICY FROM COST MODEL TO REVALUATION

Enquiry:

While examining the annual accounts of different companies it has been noticed that some companies have changed their accounting policy for assets recognition from fair value model to cost model. The reason for this change has been stated as to comply with the requirements of revised IAS-16 which became applicable to financial statements covering annual periods beginning on or after January 01, 2005. Different accounting treatments have been adopted by the companies which change their accounting policy for assets recognition from fair value model to cost model.

	Effect on		
	Revaluation reserve	Asset	P/L
Case 1:	No change	No change	No effect
Case 2:	Reversed	decreased	No effect(except decrease in depreciation charge)

CASE ONE

The Company has disclosed that the value as at the date of the change in policy has been taken as deemed cost meaning thereby, that the change will only result in saving the Company from further revaluations as required by the IAS and the existing revaluation reserve will be realized as per Section 235 of the Companies Ordinance, 1984. However, the treatment is a violation of IAS 8 as well as IAS 16 and accounts do not appear to be fairly stated.

Relevant note of the company which adopted such accounting treatment is as follows:

Property, plant and equipment and depreciation

Freehold land, building on freehold land and plant & machinery were revalued during the years 1984, 1995, 2004 and 2005; latest revaluation carried out during the preceding period of nine months ended 30 June 2005 by independent valuers; these property, plant and equipment are shown at such revalued figures. To comply with the requirements of the revised IAS 16 (Property, plant and equipment), which became applicable to financial statements covering annual periods beginning on or after 01 January, 2005, the Company has adopted the cost models for its fixed assets. Consequently, the revalued figures of such assets as at 01 July, 2005 have been treated as deemed cost. The surplus on revaluation on these assets shall be held on the balance sheet till realization in accordance with the requirements of section 235 of the Companies Ordinance, 1984. This change has no impact on loss for the year.

CASE TWO

In case 2 the Company has complied with the requirements of IAS 8 and IAS 16 but is the reversal of revaluation reserve as such, legally correct keeping in view the strict requirements of Section 235 of the Ordinance (ICAP's selected opinion 1.2 of volume X and 1.15 of volume XI is also referred).

Relevant note of the company which adopted such accounting treatment is as follows:

During the current year, the company has changed its accounting policy regarding the measurement of value of building on freehold land, plant and machinery, electric and gas installations and factory equipments under revaluation model to cost model whereas freehold land is recognized at revaluation model.

As per new policy, except for freehold land, after initial recognition property, plant and equipment shall be carried at its cost less accumulated depreciation and any impairment losses. The measurement of freehold land after initial recognition will be made under revaluation model using fair value at the date of revaluation less any impairment losses.

In view of above our question is that:

What is the correct treatment in a case when a Company decides to change its accounting policy from revaluation to cost model under the present scheme of law.

Opinion: At the outset, the Committee would like to draw your attention to the requirements of IAS-8 "Accounting Policies, Changes in Accounting Estimates and Errors" in connection with a change in an accounting policy, as reproduced below:

- 14 An entity shall change an accounting policy only if the change:**
- (a) is required by a Standard or an Interpretation; or**
 - (b) results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows.**

The Committee considers that as the revised IAS-16 'Property, Plant and Equipment' which became effective for annual periods beginning on or after January 1, 2005 did not bring any significant change with regard to revaluation of assets, therefore, the change in the accounting policy from revaluation to cost model may only be made if it can be

demonstrated that the change would result in a more reliable and relevant information in the financial statements.

In this respect, the Committee has also reconsidered its earlier opinion i.e. Selected Opinion 1.2 of Volume X which now stands superseded by this opinion.

As regards the application of the change in accounting policy, the Committee would like to draw your attention to the following requirements of IAS-8:

19 Subject to paragraph 23:

- (a) an entity shall account for a change in accounting policy resulting from the initial application of a Standard or an Interpretation in accordance with the specific transitional provisions, if any, in that Standard or Interpretation; and**
- (b) when an entity changes an accounting policy upon initial application of a Standard or an Interpretation that does not include specific transitional provisions applying to that change, or changes an accounting policy voluntarily, it shall apply the change retrospectively (emphasis ours)**

Retrospective application

- 22 Subject to paragraph 23, when a change in accounting policy is applied retrospectively in accordance with paragraph 19(a) or (b), the entity shall adjust the opening balance of each affected component of equity for the earliest prior period presented and the other comparative amounts disclosed for each prior period presented as if the new accounting policy had always been applied.**

Limitations on retrospective application

- 23 When retrospective application is required by paragraph 19(a) or (b), a change in accounting policy shall be applied retrospectively except to the extent that it is impracticable to determine either the period-specific effects or the cumulative effect of the change.**

It follows from the above that in case of change in accounting policy from revaluation to cost model with regard to property, plant or equipment, the said change should be applied retrospectively and the comparative amounts for prior periods should also be restated. Accordingly, the treatment as referred by you (case one) whereby the revalued amount has been treated as deemed cost does not appear to be appropriate.

Further, you have also raised a question that whether Section 235 of the Companies Ordinance, 1984, which deals with the accounting treatment of surplus on revaluation of fixed assets be considered to have been violated because of the retrospective adjustment to give effect to the change in accounting policy. In this respect, the Committee is of the view that the provisions of Section 235 of the Companies Ordinance, 1984 primarily aims at restricting the distribution to the shareholders of capital appreciation in the value of fixed assets except to the extent of the incremental depreciation charged to the profit and loss account. The said section does not address a situation whereby a surplus on revaluation is required to be reversed as a consequence of retrospective application of a change in accounting policy and hence, in the opinion of the Committee, the reversal of surplus on revaluation for the purposes of retrospective application of the change in accounting policy should not be construed as a contravention of the provisions of Section 235 of the Companies Ordinance, 1984

(June 7, 2008)

2.1 AUDITOR'S CERTIFICATE FOR BONUS ISSUE BASED ON UN-AUDITED FINANCIAL STATEMENTS

Enquiry: I am working in a Company and the Company intends to issue bonus share based on un-audited third quarter financial statements of the Company. Clause (iii) of Rule 6 of the Companies (Issue of Capital) Rules, 1996 provides that "a listed company may issue bonus shares subject to the following conditions, namely:

(iii) a certificate from the auditors shall be obtained to the effect that the free reserves and surpluses retained after the issue of the bonus shares will not be less than twenty-five per cent of the increased capital; and

I would like to seek opinion from ICAP as to whether the Company may issue bonus shares on the basis of free reserve computed on un-audited financial statements of the Company. As per our understanding, Auditors may give certificate on free reserve based on un-audited financial statements as well as audited financial statements of the Company.

You are requested to please apprise us your valuable opinion/clarification in respect of the above underlined question.

Opinion: We refer to your email dated May 06, 2008 seeking clarification on the above subject.

The Committee considered your enquiry and is of the opinion that the certificate should be issued on the basis of audited or reviewed financial statements.

(June 7, 2008)