
SELECTED OPINIONS

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COMPILED BY

TECHNICAL SERVICES DIRECTORATE

OF

**THE INSTITUTE OF CHARTERED
ACCOUNTANTS OF PAKISTAN**

INTRODUCTION

This report is the fourteenth compilation of Selected Opinions issued by the Technical Advisory Committee on inquiries raised by the members and other agencies during the period from July 2008 to June 2009 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 ACCOUNTING TREATMENT FOR INCOME EARNED ON EQUITY RAISED SPECIFICALLY FOR QUALIFYING ASSET

Enquiry: BACKGROUND

The Company is expanding its production capacity by adding a new cement line. The financing arrangement of this expansion project (qualifying asset) has been mix of debt and equity. The project has been kicked off and Equity (through right issue) has been raised up front and been utilized for the project payments. The equity funds are in the bank accounts and company is earning income on these funds.

QUERY

What will be accounting treatment of the income earned on equity raised specifically for the qualifying asset (If company had taken decision not to expand then the company would not have raised this equity). Can it be capitalized in the CWIP or it will be charged to Profit and Loss account.

Opinion: We would like to reproduce the following paragraphs from IAS-16 Property, Plant and Equipment:

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 recognized 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 interest income earned on the temporary investment of funds raised through equity are in the nature of earnings from incidental operations as referred to in the above paragraph of IAS-16 and hence should be recognized in the profit and loss account in the period in which such income is earned

(August 9, 2008)

1.2 ACCOUNTING TREATMENT OF POST DATED CHEQUES

Enquiry: Please advise us accounting treatment for post dated cheques issued for guarantee purposes. Normally, these cheques are issued to customs authorities and are returned upon completion of certain formalities and payments into government treasury after certain period.

I think TR-9 used to refer treatment for the above issue which has been withdrawn subsequently. Also please advise which IAS/IFRS includes such a treatment.

Opinion: The Committee noted that withdrawn TR-9 referred to in your enquiry did not address the question raised by you.

The issuance of post dated cheques signifies an entity's commitment to meet the future legal or contractual liability which is not recognized at the balance sheet date in accordance with the requirements of IAS 37. Such commitments, therefore, should be disclosed in the notes to the financial statements as required under the provisions of clause 10 (iii) of Part II of the fourth and fifth schedule to the Companies Ordinance, 1984

(April 10, 2009)

1.3 CAPITALISATION OF BORROWING COST

Enquiry: We are conducting an internal audit of a Public sector medium size company operating a hospital. The facts are as under.

- During the year, the company undertook to construct another hospital with a Grant received from Government of Punjab.
- During the year, the company constructed a boundary wall and stopped the construction at this stage due to some disputes with Government departments not related to this project.
- The company invested the Grant received from Government with a bank on short term basis and earned a profit during the year and the same amount was capitalized in CWIP, resulting in CWIP amount in negative.
- The company got prepared the technical drawings and other workings for the construction of hospital at that place.
- The company could not start construction of hospital building due to those disputes and due to current political havoc it is not possible that the project will be started within next 4 to 5 months.

QUESTION?

1. Can company capitalize the interest earned?

Upto June 30, 2008

After and up to February 28, 2008

2. Can CWIP be presented as negative figure in balance sheet?

Opinion: We would like to reproduce the following paragraphs from IAS-16 Property, Plant and Equipment:

- 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 recognized 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 interest income earned on the temporary investment of funds received through government grant are in the nature of earnings from incidental operations as referred to in the above paragraph of IAS-16 and hence should be recognized in the profit and loss account in the period in which such income is earned.

(March 13, 2009)

1.4 CONSOLIDATION AS PER SECTION 237 OF THE COMPANIES ORDINANCE 1984

Enquiry: One of our clients, an unlisted public limited company, has recently acquired a private limited liability Company as a Subsidiary. Section 237 of the Companies Ordinance, 1984 requires consolidation of the financial statements of the two entities. The client is reluctant for consolidation of the subsidiary accounts with the holding company.

Opinion: Your attention is drawn to the following paragraph of the Companies Ordinance 1984:

237. Consolidated financial statements. (1) There shall be attached to the financial statements of a holding company having a subsidiary or subsidiaries, at the end of the financial year at which the holding company's financial statements are made out, consolidated financial statements of the group presented as those of a single enterprise and such consolidated financial statements shall comply with the disclosure requirements of the Fourth schedule and International Accounting Standards notified under sub-section (3) of section 234. (underlining is ours)

It may be noted that in the above section the term 'holding company' has been used which includes all companies irrespective of status, based on which it appears that unlisted public company would also be required to prepare consolidated financial statements if it is a holding company.

(March 13, 2009)

1.5 DEFERRED TAXATION ON INVESTMENT PROPERTY

Enquiry: The Company (public unlisted) is engaged in the Real Estate business that includes but not limited to development and sale of properties such as shopping malls, apartments, commercial building, hotels etc. The properties are also rented out and management of above referred properties is under the control of the Company. The background and reasons of our views are stated hereunder for your consideration.

Background

In the recent economic turmoil being experienced all across the world the Real Estate sector has also been affected which had resulted in lowering the prices of the land at different vicinities. During the year 2007-08, the Company identified a location of land (the "Land") and acquired it at a reasonable price. Due to the economic turmoil the management had decided to only undertake those projects which are currently being developed for sale and not to over-burden the Company with new initiatives, hence the Company has not determined yet that it will use the land as owner-occupied property or for short-term sale in ordinary course of business or for development and sale in accordance with its business plan. The Company is in no position to determine the exact use of the Land, based on the market/economic conditions which in the near future does not seem to correct itself. Therefore, at the year end, in line with para 8 of IAS 40, the Company classified the Land as "Investment Property". The extract of para 8 of IAS 40 is reproduced hereunder:

Para 8 of IAS 40 provides example that land held for a currently undetermined future use. (If an entity has not determined that it will use the land as owner-occupied property or for short-term sale in the ordinary course of business, the land is regarded as held for capital appreciation.)

It may be noted that as per para 35 of IAS 40, on re-measurement of Investment property, any gain or loss arising from a change in the fair value of investment property shall be recognized in profit or loss for the period in which it arises.

It may further be noted that para 20 of IAS 12 provides that IFRS permit or require certain assets to be carried at fair value or to be revalued. For example, IAS 16: (Property, Plant and Equipment), IAS 38: Intangible Assets, IAS 39: Financial Instruments: Recognition and Measurement) and IAS 40: Investment Property.

It is also stated in para 20 of IAS 12 that “In some jurisdictions, the revaluation or other restatement of an asset to fair value affects taxable profit (tax loss) for the current period. As a result, the tax base of the asset is adjusted and no temporary difference arises”

Provisions of Income Tax Ordinance, 2001

Though the term “Investment Property” is not defined in the Income Tax Ordinance, 2001 however, Section 22(13)(d) of the Income Tax Ordinance, 2001 states that “where the consideration received on the disposal of immovable property exceeds the cost of the property, the consideration received shall be treated as the cost of the property”.

SIC 21 Income taxes- Recovery of revalued non depreciable assets

SIC 21 provides that the deferred tax liability or asset that arises from the revaluation of a non-depreciable asset in accordance with IAS 16.31, shall be measured on the basis of the tax consequences that would follow from recovery of the carrying amount of that asset through sale, regardless of the basis of measuring the carrying amount of that asset.

Accordingly, if the tax law specifies a tax rate applicable to the taxable amount derived from the sale of an asset that differs from the tax rate applicable to the taxable amount derived from using an asset, the former rate is applied in measuring the deferred tax liability or asset related to a non-depreciable asset.

SIC-21 also applies to investment properties that are carried at revalued amounts under IAS 40.33 but would be considered non-depreciable if IAS 16 were to be applied.

Our View

From the understanding of the provisions of the Income Tax Ordinance, 2001, related paragraphs (as mentioned above) of International Accounting Standards and SIC 21 it seems to be very much clear that in case consideration received exceeds the cost of immovable property, consideration received will be treated as cost of immovable property for the purpose of tax, therefore there would be a permanent difference. Resultantly no deferred tax liability or asset would be arisen in this case.

Issue/clarification required

The auditors of the Company are of the view that “Deferred Tax” would arise on the changes in fair value gain on Investment Property, whereas the Company is of the view (based on its discussions with its tax consultants/legal advisors) that in the light of the

provisions stated in the Income Tax Ordinance, 2001 and International Accounting Standards/IFRS deferred tax does not arise.

Hence guidance based on the facts of the case is requested.

Opinion: The Committee deliberated on the question raised in your enquiry and would like to explain that the amount of tax payable on the profits of a particular period often bears little relationship with the profits as disclosed by the financial statement of the same period. This results from the different basis on which profits are computed for tax purposes and that arrived at in the financial statements. These differences are of two types. Firstly, certain income may be tax exempt or certain expenditure is disallowable giving rise to "other than temporary differences" between taxable and book profits. Secondly, there are items included in the financial statements of a period which may be dealt with differently for taxation purposes giving rise to "temporary differences". As other than temporary differences are differences that originate in the current period and do not reverse in subsequent periods, the question of "deferred tax" on such differences does not arise. The question, therefore, is to determine whether the gain/loss in a particular case is the subject matter of taxation under the Income Tax Ordinance, 2001, if the answer is in the negative, no deferred tax would arise on such gain/loss.

(December 26, 2008)

1.6 DISCLOSURE & REPORTING REQUIREMENTS FOR DELISTED COMPANIES

Enquiry: One of our audit clients was a listed company as at 30-6-2007 and was de-listed subsequently from Karachi and Lahore Stock Exchanges.

Financial statements' disclosures for the financial year ended 30-6-2007 have been made in accordance with the requirements of Listing Regulations and the Fourth Schedule to the Companies Ordinance, 1984 and accordingly Audit Report has been issued by our predecessor.

Now we have to report for the financial year ended 30-6-2008 which includes 4 months of listed period and 8 months of unlisted period as the company stands as an unlisted company as at 30-6-2008. Therefore, in order to issue audit report for the financial year ended 30-6-2008, we need to have your valuable opinion on the following issues:

1. Which of the Fourth & Fifth Schedule (the Companies Ordinance, 1984) would be applicable?
2. Whether the financial statements should comply with listing regulations of Stock Exchanges? If so, whether to whole year or to 4 months only.
3. Whether the Code of Corporate Governance incorporated in Listed Regulations would apply to the company? If so, whether to whole year or 4 months only.
4. Whether the Directors' report should include discussion & statements with reference to Listing Regulations? If so, whether for whole year or covering 4 months only.
5. Whether the Auditors' Review Report to the Members on Statement of Compliance needs to be issued? If so, whether for whole year or covering 4 months only.
6. Whether the following statements as applicable to listed companies should be issued with the financial statements? If so, whether for whole year or covering 4 months only:

- (a) Vision & mission statements
- (b) Statement to ethics & business practices
- (c) Statement of Compliance with the Code of Corporate Governance

7. Whether the company should continue to follow complete set of IASs or it should follow Accounting Standard for SSEs or MSEs, whichever applicable.

Opinion: The Committee is of the view that as of June 30, 2008 the company you referred to in your above enquiry was not listed therefore you would be required to comply with the requirements of Fifth Schedule and MSE or SSE standards whichever is applicable, provided such company is not a subsidiary of a listed company.

Further in the above case compliance with the Code of Corporate Governance which is a part of Listing Regulation of the three Stock Exchanges of the country is also not mandatory.

(October 18, 2008)

1.7 ELUCIDATION REQUIRED REGARDING ACCOUNTING AND FINANCIAL REPORTING STANDARDS FOR MEDIUM SIZED ENTITIES (MSEs) ISSUED BY ICAP

Enquiry: With reference to the above mentioned subject, we need your professional advice regarding definition of Medium Sized Entities (MSE) clause (c) as compared with definition of Economically Significant Entities (ESE). Clause (c) specifies that:

“An entity shall not be classified as Medium sized entity if it holds assets in a Fiduciary capacity for a broad group of outsiders, such as a bank, insurance company, securities broker/dealer, pension fund, mutual fund or investment banking entity”

Further definition of Economically Significant Entity (ESE) is as follows:

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

- **Turnover in excess of Rs.1 billion, excluding other income;**
- **Number of employees in excess of 750;**
- **Total borrowings (excluding trade creditors and accrued liabilities) in excess of Rs.500 million.**

In order to be treated as economically significant any two of the criterion mentioned in 1, 2 and 3 above have to met. The criterion followed will be based on the previous year’s audited financial statements. Entities can be delisted from this category where they do not fall under the aforementioned criteria for two consecutive years.”

Professional advice required:

Comparing the preceding paragraphs, what is the appropriate classification of an entity if it falls under the clause (c) of **“Medium Sized Entities”** definition, and also does not fulfill the conditions for eligibility as an **“Economically Significant Entity”**.

Opinion: Your attention is drawn to the following paragraphs of Technical Release 5 (Revised 2006) issued by ICAP:

2.5 The Institute further directs its members that while expressing an opinion on financial statements of entities that do not qualify to be treated as MSE or SSE

as per the definition given in paragraphs 2.4.3 above (except for public utility entities or similar entities that provide an essential public service or regulatory agencies that do not fall under the jurisdiction of Securities and Exchange Commission of Pakistan (SECP), they shall ensure compliance with the International Accounting Standards (IASs)/ International Financial Reporting Standards (IFRSs) as adopted by the Council and notified by the SECP under section 234(3) of the Companies Ordinance, 1984.

In view of the above the entity will be required to comply with the requirements of IFRS while preparing their financial statements.

(June 5, 2009)

1.8 OPINION ON VALUATION OF BIOLOGICAL ASSETS APPLYING IAS 41

Enquiry: Our client (the Company), a subsidiary of a Limited Company, is engaged in the business of manufacturing, processing and selling dairy food products. The Company is to import dairy cattle from Australia and has also planted fodder/crops mainly as feedstock for the dairy cattle.

The dairy cattle as well the crops fall under the definition of biological assets, the recognition and measurement (valuation) thereof for accounting purposes have been discussed in International Accounting Standard 41 – Agriculture.

However, as there is no active market (formal/organized) for dairy cattle in Pakistan, even of local breed let alone that of Australian, the Company would like to confirm the accounting policy that it has formulated in the light of IAS – 41 for adoption.

An analysis of the options/alternatives discussed in the IAS – 41 is as follows:

Options available to an entity in the absence of an active market

The following methods for determination of fair value, as an approximation thereof in the absence of an active market, has been prescribed in paragraph 18 of IAS 41, if such data is available:

- a) *the most recent market transaction price, provided that there has not been a significant change in economic circumstances between the date of that transaction and the balance sheet date;*
- b) *market prices for similar assets with adjustment to reflect differences; and*
- c) *sector benchmarks such as the value of an orchard expressed per export tray, bushel, or hectare, and the value of cattle expressed per kilogram of meat.*

In addition to the above, paragraph 20 and 21 of IAS - 41, in certain circumstances, also allows the discounted cash flow method:

Para 20:

In some circumstances, market-determined prices or values may not be available for a biological asset in its present condition. In these circumstances, an entity uses the present value of expected net cash flows from the asset discounted at a current market-determined pre-tax rate in determining fair value.

Para 21:

The objective of a calculation of the present value of expected net cash flows is to determine the fair value of a biological asset in its present location and condition. An

entity considers this in determining an appropriate discount rate to be used and in estimating expected net cash flows. The present condition of a biological asset excludes any increases in value from additional biological transformation and future activities of the entity, such as those related to enhancing the future biological transformation, harvesting, and selling.

ASSESSMENT OF EACH OPTION

a) use of the most recent market transaction price

The Company is of the view that this option is not suitable, as currently there are very limited willing buyers locally, if any, of the Australian breed and the fact that the data for such transactions are not readily available, not to mention the reliability thereof. Further, the Company believes that no one will sell its biological assets, imported by it, under the normal circumstances i.e. when the asset is in good healthy condition and is producing milk as per the required / expected standards. In these circumstances, it would be difficult to substantiate or accept the transaction price which could well be that of 'unwanted' assets, as a basis to determine fair value of assets held by the Company in good condition.

b) market prices for similar assets adjusted to reflect differences

Keeping in view the Company's specific situation and the dairy cattle market in Pakistan, this method seems more appropriate than others. With some modifications as more fully explained in the following paragraph, this is our recommended method.

c) sector benchmarks such as the value of cattle expressed per kilogram of meat

We consider that this option is not an appropriate method for determination of fair value of biological assets being maintained by the Company to produce milk. This method is appropriate for consumable assets (e.g. beef cattle or crops for harvest say wheat), as opposed to bearer assets (e.g. dairy cattle or fruit trees).

d) discounted cash flow method

This method, however, is not mentioned in IAS 41 – para 18 but only in para 20 as a method only to be used to determine a fair value if there is no market at all which can be used as a point of reference. In other words, IAS - 41 makes it clear that it is preferable to use one of the methods in para 18 before defaulting to the last available valuation method i.e. DCF.

Given that there are considerable active markets for dairy cattle/biological assets across the globe, we believe it would not be appropriate to estimate a fair value solely on the basis of a discounted cash flow calculation. However, a discounted cash flow calculation may prove a useful tool to support any fair value estimated using alternative valuation methods described earlier.

Our recommended method

Based on the discussion/analysis of the various methods available considering that there is no active market in Pakistan, in our view a modified method, as explained below, which would basically falls with the boundaries of one of the preferred method stated in para 18(b), Market prices for similar assets adjusted for differences, would be appropriate.

IAS - 41 prefers that the fair values be representative of an active market as much as possible, if not the actual market price itself. Therefore, as there is an active market of the Company's cattle in Australia, it would be appropriate for the Company to use the price quoted in those markets as a reference point which then can be adjusted for factors such

as difference in expected milk yield, fertility, estimated residual value etc, of any, for maintaining these assets in Pakistan.

However, in this connection management should ensure that the appropriate number of independent quotations (say 3 to 5 quotations) is obtained from the active markets in Australia. Further, the quotations should be specific and cater to the individual class of each category of biological asset, showing values based on breed, age, number of lactations and other material specifications.

The Company's management is of the opinion that once the Australian breed settles in Pakistan there are no material differential factors i.e. the cattle is expected to perform in the local environment (milk yield and fertility) as they would in Australia, given that the right environment (management thereof) is provided to them.

Further, until such time as there is an active market in Pakistan, it may be reasonable to include the cost (transportation etc.) of bringing the asset to Pakistan in the fair value of the asset. This is because to give a reasonable approximation of what a market price in Pakistan might be. In other words one needs to consider at what price, the Company might sell the asset to another party in Pakistan, as there is a restriction on re-export out of Pakistan, so the only parties to whom the Company can sell the biological asset will be other parties within Pakistan. The Company should consider whether, if they made such a sale, they would charge on the costs of bringing the asset to Pakistan to their customer by increasing the sales price. Therefore, it may be reasonable to include the cost of bringing the asset to Pakistan in the fair value of the asset. This is supported by the fact that, until there is an active market in Pakistan, any other entity in Pakistan wishing to purchase cattle would have to either purchase it from entities currently operating (inclusive of transportation costs) or would have to incur the cost of purchasing cattle from the market in Australia plus the cost of transporting that cattle to Pakistan.

However, if an active market develops in Pakistan over the time, the valuation method should be changed to the prices quoted in that market.

VALUATION OF FODDER (CROPS / FEED STOCK)

IAS – 41 is applicable to biological assets (which includes trees, plants, bushes etc.) and to agriculture produce, which is the harvested product of the entity's biological assets. However, IAS – 41 does not apply to agriculture produce after the point of harvest and it is most likely that such agriculture produce which has been harvested will be inventory under the scope of IAS – 2 'Inventories'.

Para 17 of IAS - 41 requires that, 'If an active market exists for a biological asset or agricultural produce, the quoted price in that market is the appropriate basis for determining the fair value of that asset. If an entity has access to different active markets, the entity uses the most relevant one. For example, if an entity has access to two active markets, it would use the price existing in the market expected to be used.'

Further para 32 of IAS – 41 requires, 'In all cases, an entity measures agricultural produce at the point of harvest at its fair value less estimated point-of-sale costs. This Standard reflects the view that the fair value of agricultural produce at the point of harvest can always be measured reliably.'

As evident from the above, the agriculture produce at the point of harvest should be measured at the fair value, because there is a presumption in IAS – 41 that fair value of agriculture produce at the point of harvest can always be measured reliably. This can be done by the Company by obtaining quotes from the market for such fodder/feed stock at the point of harvest, which we understand are readily available, and valuing these accordingly.

However, there may be a case that there is a lack of an active market for partly grown fodder / feed stock and very few sales of part-grown fodder/feed stock i.e. there is no market based fair value available. In such cases, the Company should follow the discounted cash flow method for such partly grown fodder / feed stock. The crops / fodder being planted by the Company are mostly for use as cattle feed (internal consumption), and have a very short biological transformation and consumption cycle. Therefore these can be carried at cost rather than using the discounted cash flow method.

As stated earlier, once harvested, the crops fall outside the scope of IAS - 41 and are dealt with by IAS 2 - 'Inventories'. This means that the crops harvested and in hand as at year end would be measured at the lower of cost and net realizable value. The cost being the fair value less estimated point-of-sale costs at the point of harvest, as stated in para 13 of IAS -14 which states, 'Agricultural produce harvested from an entity's biological assets shall be measured at its fair value less estimated point-of-sale costs at the point of harvest. Such measurement is the cost at that date when applying IAS 2 Inventories or another applicable Standard.'

Opinion: Your attention is drawn to the following paragraph of IAS 41:

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

Fair value versus cost

- B13 The Standard requires an entity to use a fair value approach in measuring its biological assets related to agricultural activity as proposed in the DSOP and E65, except for cases where the fair value cannot be measured reliably on initial recognition.**

From the above paragraphs it is clear that IAS 41 requires all the biological assets to be measured at fair value except in the circumstances where neither does active market exist nor the alternative estimates of fair value is reliable as referred to in the above paragraph 30 of IAS 41.

In view of the above the Committee is of the opinion that the method recommended in your enquiry for determination of fair value of dairy cattle may be considered as appropriate provided the fair value measured under the aforesaid method is not unreliable.

(December 26, 2008)

1.9 PARTICULAR METHOD FOR PROVIDING DEPRECIATION IN THE ACCOUNTS

Enquiry: Reference is made to para 62 of IAS 16 which is reproduced hereunder:

62 *A variety of depreciation methods can be used to allocate the depreciable amount of an asset on a systematic basis over its useful life. These methods **include** the straight-line method, the diminishing balance method and the units of production method. Straight-line depreciation results in a constant charge over the useful life if the asset's residual value does not change. The diminishing balance method results in a decreasing charge over the useful life. The units of production method results in a charge based on the expected use or output. The entity selects the method that most closely reflects the expected pattern of consumption of the future economic benefits embodied in the asset. That method is applied consistently from period to period unless there is a change in the expected pattern of consumption of those future economic benefits.*

In the light of above, it can be validly concluded that there is no binding as regards to application of any particular method for providing depreciation in the accounts. In the hotel industry depreciation in respect of "crockery, cutlery and linen" is being provided on replacement cost method whereby initially an asset is recorded at cost and subsequent purchases thereof is charged to profit and loss account however, an exercise is carried out every year in order to assess that whether the amount recoded at historical cost without providing any depreciation should not be materially differ as compared to inventory of crockery, cutlery and linen in hand.

We, therefore, request you to please advice us as regards to allowability of above method especially for hotel industry in relation to assets classified under crockery, cutlery and Linen in the light of IAS and related guidelines.

Opinion: At the outset, the Committee would like to draw your attention to the following requirements of IAS-16 "Property, Plant and Equipment"

50 - The depreciable amount of an asset shall be allocated on a systematic basis over its useful life

60 - The depreciation method should reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity. (underline is ours)

The Committee has considered that replacement cost method does not result in systematic allocation of depreciable amount of an asset over its useful life and hence is not a proper method of depreciation. Therefore, for the purpose of charging depreciation in respect of assets in the hotel industry such as crockery, cutlery and Linen, an appropriate depreciation method should be selected that reflects the expected pattern of consumption of future economic benefits embodied in such assets through their usage.

The Committee also recognizes that in view of the nature of the above referred assets, the estimation of their useful life may involve a significant amount of judgment. However, in this regard the management should consider factors such as physical wear and tear, commercial obsolescence, asset management policy of an entity that may involve replacement of such assets after a specified period etc. Accordingly, the useful life of each item should be estimated separately. While determining the useful life of an asset the factors that have been given in paragraph 56 of IAS 16 should be taken into account.

The depreciation charge as determined above, should be recognized in profit and loss account on a systematic basis over the useful life of the asset.

(July 4, 2008)

1.10 TREATMENT OF START-UP COSTS IN THE CASE OF MEDIUM-SIZED ENTITIES

Enquiry: I am concerned with the accounting treatment of start-up costs in the case of medium-sized companies, in view of the newly issued "Accounting and Financial Reporting Standards for Medium-sized Entities" and the amendments in the fifth Schedule to the Companies Ordinance, 1984.

The revised fifth schedule does not contain any heading for "Deferred Cost" under the umbrella of which start-up cost can be capitalized and shown on the balance sheet. Section 5 of the "Accounting and Financial Reporting Standards for Medium-Sized Entities", that is "Intangible Assets", also clearly states in paragraph 5.11, that expenditure on start-up activities is recognized as expense when incurred, ***unless this expenditure is included in the cost of an item of property, plant and equipment.*** This section of the standard includes establishment cost (i.e. preliminary expenses) and pre-operating expenses, which obviously includes certain operating and overhead expenses, in the definition of start-up costs. But section 5 does not lay down any criteria for the inclusion of start up expenditure in the cost of an asset.

However if we go through section 3 "Property, Plant and Equipment", paragraph 3.5 clearly mentions that administrative and general overhead costs are not costs of an item of property, plant and equipment.

These provisions create confusion, kindly elaborate whether general administrative and overhead costs can be capitalized under any circumstances and if so, what is the criteria.

Please also note that the Income Tax Ordinance, 2001 allows capitalization of pre-business commencement expenses. Therefore if a company expenses out start-up costs because the accounting standards do not allow that, so how it will be able to take advantage of tax laws. Kindly provide some guideline.

Opinion: For ready reference we would like to reproduce the following paragraphs of Section 3 of Accounting and Financial Reporting Standards for Medium-Sized Entities (MSEs) and Small Sized Entities (SSEs).

Measurement at Initial Recognition

3.3 An item of *property, plant and equipment* that qualifies for recognition as an asset shall initially be measured at its cost.

- (a) The cost of an item of *property, plant and equipment* comprises its purchase price, including import duties and non-refundable purchase taxes after deducting trade discounts and rebates;
- (b) any directly attributable costs of bringing the asset to working condition for its intended use the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce *inventories* during that period.

- 3.4 Examples of directly attributable costs include the following:
- (a) costs of *employee benefits* (as defined in Section 17 *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 .
- 3.5 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.

Further your attention is also drawn to the following paragraph of IAS 16 which is not part of MSE Standard:

- 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 or overhead which is directly attributable to any asset 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.

With regard to your concern on amortization of pre-commencement expenditure as allowed in section 25 of the Income Tax Ordinance, 2001, the Committee is of the view

that charging of whole amount of start-up cost to profit and loss account would not put a company at disadvantage while calculating tax profit.

(August 9, 2008)

1.11 TREATMENT OF INCREMENTAL DEPRECIATION ARISING OUT OF REVALUATION OF FIXED ASSETS

Enquiry: Suppose if a Company in its financial statements has disclosed that it has revalued its fixed assets 3 months before the year end. The said revaluation has resulted in surplus amounting to Rs.900 million in certain items of plant and machinery and deficit of amounting to Rs.600 million in case of certain other items leading to net surplus of Rs.300 million which was reported in the balance sheet as net Surplus on Revaluation of Fixed Assets Account.

Depreciation rates for plant and machinery items were in the range of 6% to 20%. While computing incremental depreciation on plant and machinery items it was noticed that those items which have resulted in deficit were charged with higher rate of depreciation and thus resulted in reduction in depreciation charge for the year amounted to Rs. 9 million.

If we assume following results:

	<u>Rs. in million</u>	<u>Applicable Dep. Rate</u>	<u>Incremental Depreciation Rs. in millions</u>
Plant A – Surplus on revaluation	900	9% Avg	81
Plant B – Deficit on revaluation	(600)	15% Avg	(90)
	-----		-----
Net result (Surplus)	300		(9)
	-----		-----

It can also be understood as following:

	<u>Cost</u>	<u>Surplus/ deficit</u>	<u>Revalued Amount</u>	<u>Dep Rate</u>	<u>Depreciation</u>		<u>Incremental Depreciation</u>
					<u>Before Revalue</u>	<u>After Revalue</u>	
Plant A	1000	900	1900	9%	90	171	81
Plant B	1000	(600)	400	15%	150	60	(90)

							(9)

Accounting Treatment adopted by the Company:

The depreciation charge for the current year was reduced by Rs.9 million due to major impact of depreciation on deficit items and no adjustment has been made to the value of surplus on revaluation of fixed assets.

In pursuance of section 235 of the Companies Ordinance, 1984 which provides that

Quote “(1) Where a company revalues its fixed assets, the increase in, or sums added by writing up of, the value of such assets as appearing in the books of accounts of the company shall be transferred to an account to be called “Surplus on revaluation of Fixed Assets Account” and shown in the balance-sheet of the company after Capital and Reserves.

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

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

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

Items which have resulted in deficit on revaluation, had an impact of reduction in the depreciation charge for the year in Profit and Loss Accounts and thus increased the amount of profit made available for distribution to the shareholders just because of revaluation of fixed assets.

The accounting treatment adopted by the Company appears to be in violation of the requirement of the Ordinance and IAS-16 as no adjustment with surplus on revaluation of fixed assets has been accounted for. We shall be grateful for your valuation comments on the accounting treatment adopted by the said Company.

Opinion:

The Committee noted that the issue has arisen because Section 235 of the Companies Ordinance allows companies to set-off revaluation of surplus of fixed assets against the deficit of any other fixed assets (which may have different useful life/depreciation rate) which IAS 16 does not permit. Paragraph 40 of IAS 16 states that:

If an asset's carrying amount is decreased as a result of a revaluation, the decrease shall be recognized in profit or loss. However, the decrease shall be recognized in other comprehensive income to the extent of any credit balance existing in the revaluation surplus in respect of that asset. The decrease recognized in other comprehensive income reduces the amount accumulated in equity under the heading of revaluation surplus (underlining is ours).

However, notwithstanding the above the Committee deliberated the matter and is of the view that the accounting treatment adopted by the company is in accordance with Section 235 of the Companies Ordinance, 1984 read with SRO 45(I)/2003 dated January 13, 2003 except that the company should also transfer each year an amount, equal to the decrease in depreciation charge, from the retained earnings/unappropriate profit to the surplus on revaluation account. .

(October 18, 2008)

2. AUDITING

2.1 APPOINTMENT OF ONE AUDITOR IN PLACE OF TWO RETIRING AUDITORS

Enquiry: A brief description of the situation is that our company has appointed one external auditor in place of two joint auditors in the Annual General Meeting. The objective of which was to reduce audit costs. Both the retiring auditors were working at a fee of say Rs. 100,000/= each. My question now is that whether the incoming auditor can accept the engagement at a fee less than Rs. 200,000/=. The companies management is of the view that the incoming auditor is not appointed at a fee lower than the audit remuneration of the single predecessor auditor i.e Rs. 100,000/=. Whereas the incoming auditor is of the view that this may provoke the provisions of under cutting.

Opinion: The committee has examined your inquiry and would like to comment and opine as follows:

Audit fee is a composite figure and it is presumed to have been fixed keeping in view the scope and quantum of work of a particular audit engagement. In the case cited by you, the Committee is given to understand that the audit fee for the year is Rs.200,000/= that it is being shared by two auditors.

The Committee further observed that the term 'undercutting' itself has not been precisely defined in International Standards of Auditing or Code of Ethics prescribed by the Institute of Chartered Accountants of Pakistan. Literal meaning of the verb 'undercut' means "to sell or work at lower price than". To Stretch the term, Undercutting may also mean to gain out of an event, transaction or appointment at the cost of another. Accordingly, if the incoming auditor takes up an audit appointment at lower fees to the detriment of the existing auditor whether directly or indirectly, it would amount to undercutting. To put it plainly, the Committee observed that charging a smaller fee in itself is not a conclusive proof of undercutting since there may be good reasons for it to prove otherwise. Undercutting is, therefore, always a question of fact dependent on the circumstances of each case. For example in the case of a philanthropic organization, the incoming auditor may decide not to charge any fee, despite the fact that the outgoing auditor used to charge the fee for the same assignment.

In the case cited by you the reason conveyed to us for lowering the fee does not appear to be in line with section 240.1 of the Revised (May 2008) Code of Ethics for Chartered Accountants which is reproduced below for your ready reference.

Section 240 Fees and Other Types of Remuneration

"240.1 When entering into negotiations regarding professional services, a chartered accountant in practice may quote whatever fee deemed to be appropriate commensurate with the nature and service to be rendered. However, in such cases, chartered accountants in practice should be careful not to quote fee lower than that charged by the chartered accountants in practice previously carrying out the audit unless scope and quantum of work materially differs from the scope and quantum of work carried out by the previous auditor, as it could then be regarded as undercutting."

In view of the above the committee concurs with the view of the incoming auditor that lowering the fee in this case would amount to under cutting.

May we remind you that our opinion is based on the particular information supplied to us and in the nature of a guidance only. As stated earlier It is solely, the responsibility of the incoming auditor to display in each case that his appointment did not amount to undercutting.

(June 5, 2009)

2.2 MAINTENANCE OF REGISTER OF MORTGAGES U/S 135 OF THE COMPANIES ORD., 1984 & MAINTENANCE OF FIXED ASSETS REGISTER AS PER ICAP – TR-6

Enquiry: We seek your guidance relating to the Auditors responsibilities for non-maintenance of the above registers by the client.

Background

We qualified the Auditors report relating to Deferred Tax Liability. We mentioned in the Management Letter for the non-maintenance of Mortgages register and Fixed Assets register.

The SECP issued a Show cause notice to us for not qualifying the Auditors report for non-maintenance of those two registers and imposed a fine on us.

We provided a detailed reply stating that our responsibility is limited to ML unless Materiality is affected. We mentioned in this letter to SECP that all the documents and evidences relating to Mortgage and charges and fixed assets were verified by us. We also provided a copy ATR – 20 of ICAP which provides ICAP guidance on Auditors responsibilities.

Our Request for ICAP Guidance

We request you to kindly provide ICAP guidance on the above case, as SECP appears to have different interpretations than ICAP on the above subject.

Opinion: We would like to draw your attention to the following paragraphs of ISA 500, *Audit Evidence*:-

1. The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. In order to form an opinion on the financial statements, the auditor performs the audit procedures in accordance with the International Standards on Auditing (ISA). We would like to draw your attention towards the following paragraphs of ISA 500 “Audit Evidence”:
2. The auditor should obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion.
3. “Audit evidence” is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based, and includes the information contained in the accounting records underlying the financial statements and other information. Auditors are not expected to address all information that may exist. Audit evidence, which is cumulative in nature, includes audit evidence obtained from audit procedures performed during the course of the audit and may include audit evidence obtained from other sources such as previous audits and a firm’s quality control procedures for client acceptance and continuance.
4. Accounting records generally include the records of initial entries and supporting records, such as checks and records of electronic fund transfers; invoices; contracts; the general and subsidiary ledgers, journal entries and other adjustments to the financial statements that are not reflected in formal journal entries; and records such as work sheets and spreadsheets supporting cost allocations, computations, reconciliations and disclosures. The entries in the accounting records are often initiated, recorded, processed and reported in electronic form. In addition, the accounting records may be part of integrated

systems that share data and support all aspects of the entity's financial reporting, operations and compliance objectives.

5. Management is responsible for the preparation of the financial statements based upon the accounting records of the entity. The auditor obtains some audit evidence by testing the accounting records, for example, through analysis and review, reperforming procedures followed in the financial reporting process, and reconciling related types and applications of the same information. Through the performance of such audit procedures, the auditor may determine that the accounting records are internally consistent and agree to the financial statements. However, because accounting records alone do not provide sufficient audit evidence on which to base an audit opinion on the financial statements, the auditor obtains other audit evidence.

By applying the audit procedures, the auditor comes to a conclusion whether or not:

- a) All assets, liabilities and equity reported in the financial statements exist;
- b) The entity holds or controls the rights to all assets and liabilities are the obligations of the entity.
- c) All assets, liabilities and equity that should have been recorded have been recorded.
- d) All assets, liabilities, and equity are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

A Fixed Assets Register (FAR) is kept by a company for internal control purposes, as it allows a company to keep track of details of each fixed asset, ensuring control and preventing misappropriation of assets. It also keeps track of the correct value of assets, which allows for computation of depreciation and for tax and insurance purposes. The FAR generates accurate, complete, and customized reports that suit the needs of management.

As per Section 2 (5) of the Companies Ordinance 1984 "**books of account**" include accounts, deeds, vouchers, writings and documents, maintained on paper or computer network, floppy, diskette, magnetic cartridge tape, CD-Rom or any other computer readable media.

A company normally maintains various documents as "books of account" like general ledger, voucher, cash book, good received note, party ledger, purchase book, FAR etc. FAR is one of the secondary accounting records which may be maintained by a company as its books of account. Thus, FAR may be considered to be one of the sources to verify fixed assets but not the only source.

Section 255 requires an auditor to give an opinion whether or not proper books of account as required by this Ordinance have been kept by the company. Section 230 requires a company to maintain proper books of account with regard to its assets, liabilities, sales, purchases, receipts, payments and production.

If a company does not maintain its "books of account" in a manner that the auditor is not able to obtain sufficient appropriate audit evidence for material account balances, the auditor would be required to modify the audit report appropriately.

In the absence of FAR, if the auditor is able to satisfactorily verify fixed assets from other accounting records, modification of audit report does not seem to be necessary. Conversely, the audit report would be modified if the auditor is not able to obtain sufficient appropriate audit evidence for material fixed asset balance(s).

Further, the responsibility of maintaining records under section 135 of the Companies Ordinance, 1984 (Company's register of mortgages) is that of the Company. The auditor cannot be held responsible for the noncompliance.

ATR-20 Auditor's Reporting Responsibilities in respect of Non- Compliances with Laws or Regulations, clarifies as follows:

5. It should also be noted that it is not the purpose of the audit nor the responsibility of the auditor to highlight the contraventions of corporate and other laws.
7. Additionally, in case of non compliance with laws and regulations, the ISA 250 also requires the auditor to report the same to members of management charged with governance.
8. Hence it is concluded that an infraction of laws or regulations, the financial implication of which is not material to the financial statement do not require the modification of the auditors opinion. The auditor should follow the guidance given in paragraphs 6 and 7 above

The auditor is not necessarily required to modify the audit report if he is able obtain sufficient appropriate audit evidence through alternative sources such as Form 10 and 17, bank letters etc., in the absence of Register of Mortgages under section 135 of the Companies Ordinance, 1984.

(June 5, 2009)