
SELECTED OPINIONS

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COMPILED BY

TECHNICAL SERVICES DIRECTORATE

OF

**THE INSTITUTE OF CHARTERED
ACCOUNTANTS OF PAKISTAN**

INTRODUCTION

This report is the fifteenth compilation of selected opinions issued by the Technical Advisory Committee on inquiries raised by the members and other agencies during the period from July 2009 to June 2010 for the general guidance of the members of the Institute.

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

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

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

Shahid Hussain
Director Technical Services

CONTENTS

1. ACCOUNTING

	<u>Page #</u>
1.1 Accounting for Sugar Sales by Sugar Industry	3
1.2 Business Combination Involving Common Control Transactions	5
1.3 Change in Accounting Policy or Prior Period Error	7
1.4 Deferred Tax Reserves	8
1.5 Desktop Revaluations in Terms of IAS 16 (Property, Plant and Equipment)	9
1.6 Guidance on Accounting for Specie Dividend Issue by a Subsidiary Company	11
1.7 Issue of Bonus Shares	13
1.8 Presentation / Disclosure Requirements (Investments – Held-to-Maturity)	14
1.9 Query Related to WPPF	16

2. AUDITING

2.1 Clarification Regarding Half Yearly Review	18
2.2 Opinion on Appointing an External Auditor Providing Non- Assurance Services	19
2.3 Requirement to obtain NOC from the Retiring Cost Auditor.....	22
2.4 Situation Where a Conflict of Interest Arises	24

1. ACCOUNTING

1.1 ACCOUNTING FOR SUGAR SALES BY SUGAR INDUSTRY

The sugar industry's long established practice for selling sugar is that it appoints exclusive brokers for this purpose. There are only a few brokers of sugar in the market. The pricing of sugar sold by the Company to the broker is based on the rates fixed by the management of the Company verbally on phone at the time advance payment is made to it by the broker. The Company issues blank transferable delivery orders to the brokers for a quantity certain but no sale is recorded as the accounting policy of the Company is to record sales against actual delivery of goods. The delivery of the goods is taken by the person presenting the delivery order as and when it so chooses to do. When the goods are delivered, the Company issues a sales tax invoice to the customer presenting the delivery order at the price agreed with the broker at the time it received the advance.

The transaction cycle reflects:

- (i) that the broker deposits on his own account all payments with the Company in advance that are shown by the Company in the books as received from him.
- (ii) that the Company simultaneously issues blank delivery orders in quantities of 10 and 20 tones to the broker against the amount advanced. No entry is passed in the accounts as the accounting policy of the Company requires recording of sale against actual delivery.
- (iii) that the price of sugar is fixed between the management and broker by negotiation when the delivery orders are issued but no commercial invoice or memorandum entry is passed in the books to record this for the reason mentioned in (ii) above.
- (iv) that the goods against the delivery order are lifted on various dates subsequently by the persons presenting the delivery order and the goods are delivered by the Company to the holder in due course. The said persons do not make any payment at the time of lifting to the Company and instead the brokers account is debited for the amount of the sale based on sales tax invoice issued by the Company in their names for the following reasons:
 - (a) that the Company does not issue any commercial invoice at the time it issues blank delivery orders to the brokers, it however, issues a sales tax invoice in the name of the customer as and when the holder in due course presents the delivery order and records the sale against actual delivery in accordance with its accounting policy, and
 - (b) the account of the broker is simultaneously debited with the amount of the sales tax invoice issued in the customer's name and sale is booked by the Company at the price mentioned in the sales tax invoice, which is the one originally agreed between him and the Company as per (iii) above.
- (v) the Company maintains a record of delivery orders with quantity numbered serially without any date and name of customer and the date these are lifted are entered in its records.

In view of the industry practice mentioned above, the broker's account is credited and debited with the amount advanced by him during the year with the amount of the sales tax invoice issued by the Company to the customer.

The above practice of the industry lacks transparency as can be gathered from the following:

- (a) That the Company keeps record of sales to the extents of sales tax invoices issued to actual customers only for sales tax purpose but does not maintain any subsidiary record for customers account as all sales are made against advance payment that are debited to brokers account and hence no trade debts appear as outstanding at reporting dates.
- (b) That there appears to be no relationship legal or otherwise between the customer and the broker to justify the setting off of the amount due from customer against sales tax invoice against the broker's account in the books.
- (c) That the right of the brokers apparently becomes vested in the goods lying in godown of the Company. The Company is bound to give delivery as and when the person to whom the broker gives the deliver order presents that at the mill. As a consequence of this right to handover delivery order at this discretion to anybody and at any time, the brokers acquires the status of a wholesaler and carryout activities of that nature but as the transaction and the accounting policy are so structured that he appears to be a broker only.
- (d) The final scenario is that the brokers name appears in the records to the extent of a meager amount of brokerage income that it reflects as earned from the Company which is subject to a full and final tax in terms of Section 233 of the Income Tax Ordinance, 2001 and remains protected in this manner from income tax. They also remains outside the ambit of sales tax as they not required to be registered for the services provided by them are not taxable under the Sales Tax Act, 1990 or under the Federal Excise Act, 2005.

Issues:

Is the accounting policy of the sugar industry for recording sale appropriate under the circumstances and in line with the revenue recognition criteria given in IAS-18.

Opinion:

The Committee would like to draw your attention to the following paragraphs of IAS 18:

- 14 Revenue from the sale of goods shall be recognised when all the following conditions have been satisfied:
 - (a) the entity has transferred to the buyer the significant risks and rewards of ownership of the goods;
 - (b) the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;
 - (c) the amount of revenue can be measured reliably;
 - (d) it is probable that the economic benefits associated with the transaction will flow to the entity; and
 - (e) the costs incurred or to be incurred in respect of the transaction can be measured reliably.
- 15 The assessment of when an entity has transferred the significant risks and rewards of ownership to the buyer requires an examination of the circumstances of the transaction. In most cases, the transfer of the risks and rewards of ownership coincides with the transfer of the legal title or the passing of possession to the buyer. This is the case for most retail sales. In other cases, the

transfer of risks and rewards of ownership occurs at a different time from the transfer of legal title or the passing of possession.

From the above it is clear that accounting policy of the sugar industry for recording sale appears to be appropriate and in line with the revenue recognition criteria given in IAS-18.

(February 2010)

1.2 BUSINESS COMBINATION INVOLVING COMMON CONTROL TRANSACTIONS

Enquiry: Your valued opinion is sought about the following issue, guidance regarding which is presently not available in the IFRS:

A Company (the "Company") intends to issue 25 million ordinary shares to the general public at Rs.10 per share which is equal to 11.78% of its enhanced paid up capital.

An analysis of its prospectus has revealed that its paid up capital comprises 187.248 million shares of Rs.10 each out of which 9,900 shares are issued against cash while 187.239 million shares are issued against consideration otherwise than cash. These shares were issued pursuant to a scheme of arrangement between the Company and Company "A" whereby the company acquired net assets of Company "A" (except for one asset) worth Rs.552.753 million at a consideration of Rs.1,872.48 million resulting in creation of goodwill amounting to Rs.1,319 billion. The scheme was approved / sanctioned by the High Court.

The said transfer was accounted for under the acquisition method laid down by IFRS-3 as applicable in Pakistan.

Analysis of shareholding:

Pre Combination:

Company "A" (Sponsor Company) is a private company limited by shares. The breakup of shareholding of Company "A" is as follows:

X Group	35%
Y Group	35%
Company D	30%

The Company was incorporated as a private company on December 4, 2008. The scheme of arrangement was signed between the Company and Company A on December 19, 2008. The breakup of shareholding of the Company on incorporation was as follows:

X Group	99%
Company A	1%

Post Combination

A joint petition was filed in High Court and the court sanctioned the said scheme vide order dated May 7, 2009. The Company converted to public limited company on September 16, 2009. Net assets along with three business of Company A stand transferred to the company. Under the scheme company D has been given 30% shareholding of the Company in lieu of transfer of its 30% shareholding in company A to

X and Y Group in equal proportion. After the implementation of the scheme of arrangement the shareholding structure of the Company and Company A is as follows:

Company:

Company D	30%
Company A	70%

Company A:

X Group	50%
Y Group	50%

In the instant case shareholding of the business transferred to the Company from Company A remains the same before and after the scheme. From above it is clear that the transaction comes under the definition of a common control transaction as per IFRS 3 and the same is excluded from its scope. Basis for conclusions on IFRS 3 Business Combinations states that the consideration of the accounting for business combinations involving entities under common control is included in the second phase of the Business Combinations project of the IASB.

Commission's concern:

The Commission, as a regulator of the capital markets, considers that recognition of substantial amount of goodwill on a business combination without any change of underlying ownership defeats the underlying concepts of the IFRS, particularly, wherein recognition of self generated goodwill is expressly disallowed. It is also pertinent that fair valuation principles as laid down in IFRS 3 cannot remain as transparent in a common control transaction as they can be otherwise, indicating that purchase method is not appropriate for such transaction. Moreover, we would also like to point out that we have observed that other international jurisdictions, that can be referred to in the light of guidance given in IAS 8, including Hong Kong and US GAAP, require pooling method or predecessor values method of accounting for such combinations and we feel that the same can be stretched to our jurisdiction.

In view of above, our questions are as follows:

- a) Whether or not, in spite of express scope exclusion from IFRS 3, has the above business combination been correctly accounted for under purchase method?
- b) If the same is correct, will it be fair from the perspective of general public, to whom shares of a company having such a huge intangible asset are offered?
- c) If otherwise, what should be the correct way of accounting for such a transaction?
- d) Lastly, your opinion should address general scenario in Pakistan whereby distinction between management and sponsors cannot be made.

Opinion:

First of all, the Committee would like to thank you to highlight the important issue and appreciates your detailed analysis and concern thereon.

There is currently no specific guidance on accounting for common control transactions under IFRSs. However, in December 2007 the IASB added a project on this topic to its agenda. The project will examine the definition of common control and the methods of

accounting for business combinations under common control in the acquirer's consolidated and separate financial statements.

You have rightly mentioned in your enquiry that in the absence of specific guidance, entities involved in common control transactions may select an appropriate accounting policy using the 'hierarchy' described in paragraphs 10 – 12 of IAS 8 'Accounting Policies, Changes in Accounting Estimates and Errors'.

As the hierarchy permits the consideration of pronouncements of other standard-setting bodies, the guidance on group reorganisations in both UK and US GAAP may be useful in some circumstances. Such hierarchy of guidance states that in the absence of an accounting standard which specifically applies to a transaction, the management should consider the requirements of IFRS dealing with similar and related issues which in this case is IFRS 3 (that prescribes acquisition method of accounting). It is important to note that the reason for exclusion of common control transactions from IFRS 3 does not emanate from the fact that IASB considers purchase method as inappropriate for such transaction but for the reason that it intends to deal them separately.

Accordingly the Committee considers that both the methods i.e. acquisition method and pooling of interest method are equally acceptable internationally for such transactions depending on the accounting policy chosen by the management.

(May 2010)

1.3 CHANGE IN ACCOUNTING POLICY OR PRIOR PERIOD ERROR

Enquiry:

One of our clients, a company has been compliant of all the IAS/IFRS as applicable in Pakistan. All the significant accounting policies were consistently applied and followed under the requirements of relevant IAS / IFRS's. There were, however certain omissions and drafting errors in the accounting policies stated in the financial statements. Examples of such errors and omissions are given in the following paragraphs. It is pertinent to mention that there is no **financial effect** on any of the elements of financial statements of prior years or the current year due to these omission and errors in the accounting policies. The proposed corrections are desired due to better and factual presentation of the accounting policies in the financial statements.

You are requested to guide us whether these corrections will be treated as:

- (i) change in accounting policy; or
- (ii) correction of prior period error; or
- (iii) if none of (i) and (ii) above, please advise how to affect the desired changes.

The following paragraphs of accounting policies contain omission and errors:

1. Policy for Property, Plant & Equipment states that "the depreciation method, useful lives and residual values are reviewed at each reporting date".

We want to make addition in above policy by inserting "and adjusted if appropriate" after the word reviewed. The redrafted policy will appear as "depreciation method, useful lives and residual values are reviewed and adjusted if appropriate at each reporting date"

(This entails no financial effect as no change has ever been warranted as result of such a review)

2. Policy for Property, Plant & Equipment states that "An item of property, plant and equipment is de-recognized when permanently retired from use"

We intend to redraft the above sentence as “An item of property, plant and equipment is de-recognized on disposal or when no future economic benefits are expected from its use or disposal”

(This entails no financial effect as no asset has ever been retired from active use. There have only been disposals of assets by sale)

3. Stores, spare parts and loose tools policy stated that these “are valued at cost determined under First-in-first-out method”. We want to substitute this sentence with the following:

“These are stated at lower of cost determined under first-in-first out method and net realizable value”.

This sentence was missing from the accounting policy. Further, there is no mention in the policy about provisioning for obsolete and slow moving items. We intend to add one sentence in this respect as well.

(No financial effect as none of the stores, spares and loose tools were ever required to be valued at net realizable value as the cost was always lower nor any provision for slow moving /obsolete items was required to be made)

Opinion: We would like to inform that the changes proposed in the above policies are merely for the sake of clarity and improvement and none will result in either change in accounting policy or correction of prior period error.

(November 2009)

1.4 DEFERRED TAX RESERVES

Enquiry: Please clarify the meaning of term "Deferred Tax Reserves". Please also clarify whether "Deferred Tax Reserves" would only include the Reserves separately shown in equity section as 'Deferred Tax Reserves' or it will also include the items (like Deferred Tax Asset) routed through Profit and Loss Account and form part of un-appropriated profit/loss.

It may be mentioned here that "NBFC Rules 2003" (as amended in 2007) define "equity" as:

- (xix) "equity" includes paid up share capital, reserves, subordinated loans and un-appropriated profits (minus accumulated losses) excluding deferred tax reserves, Surplus on Revaluation of Fixed Assets Account as described in section 235 of the Ordinance, treasury stocks and redeemable preference shares: (emphasis added)

Thus, it is to be ascertained whether reserves that form part of the un-appropriated profit/loss account due to recognition of Deferred Tax Assets will be deducted for the purpose of calculating equity as per NBFC Rules 2003. Any reference to IAS/IFRS or local laws where the subject term has been defined/ clarified shall be of great help.

Opinion: The term "Deferred Tax Reserve" is not specially defined in the IFRS. In our local laws (NBFC Rules) the term "Deferred Tax Reserve" was derived from SECP Circular No. 16 of 1999 which was then issued to ensure compliance by the leasing companies with IAS 12 and required to transfer to a capital reserve, amounts equivalent to their deferred tax liability during the period 1 July 1998 to 30 June 2003.

Your attention is drawn to the following paragraphs of IAS 12 “Income Taxes” that deals with recognition of deferred tax liabilities and assets.

58 Current and deferred tax shall be recognised as income or an expense and included in profit or loss for the period, except to the extent that the tax arises from:

(a) a transaction or event which is recognised, in the same or a different period, outside profit or loss, either in other comprehensive income or directly in equity (see paragraphs 61A to 65); or

(b) a business combination (see paragraphs 66 to 68).

61A Current tax and deferred tax shall be recognised outside profit or loss if the tax relates to items that are recognised, in the same or a different period, outside profit or loss. Therefore, current tax and deferred tax that relates to items that are recognised in the same or a different period:

(a) in other comprehensive income, shall be recognised in other comprehensive income (see paragraph 62).

(b) directly in equity, shall be recognised directly in equity (see paragraph 62A).

Based on the above the Committee is of the view that reserves that form part of the un-appropriated profit/ loss account due to recognition of Deferred Tax Assets will not be deducted for the purpose of calculating equity.

(July 2009)

1.5 DESKTOP REVALUATIONS IN TERMS OF IAS 16 (PROPERTY, PLANT AND EQUIPMENT)

Enquiry (a) Case in Point:

It has been found, though in exceptional, that surplus / deficit based on desktop revaluations are taken in the financial statements. Recently, a large listed company preferred to go for desktop revaluations of its major properties (land and buildings only), through the firms of professional valuers. This department sought clarification from the company and the reply was that in 2008 there was a sharp decline in the market value of land and buildings, therefore, in order to incorporate the decline in market value, the major land and buildings were revalued (this time only desktop).

(b) Technical Opinion sought

In this connection, we wish to seek a technical opinion as to:

- (i)** Whether desktop revaluations are specifically allowed in terms of IAS-16 (Property, Plant and Equipment);
- (ii)** In what case and in what form, method, manner or procedure the desktop revaluation may be conducted;

- (iii) How the desktop revaluations of land and buildings could be different from the generally accepted revaluations on market based evidence by appraisal; and
- (iv) Role of the auditors of the company with regard to such desktop revaluations;
- (v) Any comments that you desire to made with respect to our role as a regulator.

Opinion: IAS 16 requires the revaluation to be done with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the end of the reporting period. Following paragraphs of IAS-16 further clarifies the objective of valuation. Further, IAS 16 also adds that such frequent revaluations are unnecessary for items of property, plant and equipment with only insignificant changes in fair value. Instead, it may be necessary to revalue the item only every three or five years.

Relevant paragraphs of IAS 16 are reproduced below:

- 31 After recognition as an asset, an item of property, plant and equipment whose fair value can be measured reliably shall be carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses. Revaluations shall be made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the end of the reporting period.
- 34 The frequency of revaluations depends upon the changes in fair values of the items of property, plant and equipment being revalued. When the fair value of a revalued asset differs materially from its carrying amount, a further revaluation is required. Some items of property, plant and equipment experience significant and volatile changes in fair value, thus necessitating annual revaluation. Such frequent revaluations are unnecessary for items of property, plant and equipment with only insignificant changes in fair value. Instead, it may be necessary to revalue the item only every three or five years.

We understand that the concept of 'Desktop Revaluation' emanates from Annexure IV (R-11) of the Prudential Regulations which defines 'Desktop Evaluation' as "an Interim Brief Review of Full-scope Evaluation, so that any significant change in the factors, on which the full-scope valuation was based, is accounted for and brought to the notice of the lending bank / DFI."

The valuation process, for the purposes of provisioning, prescribed under Annexure IV (R-11) of Prudential Regulations includes conducting a 'Full-scope Valuation' of the securities and collateral in the first year and then followed by 'Desktop Valuations' in the second and third year. Full scope valuation shall be valid for three years from the date of last valuation.

Based on above, the Committee is of the view that IAS 16 does not prescribe any particular method (Full Scope / Desktop). It is management responsibility to report the appropriateness of Company Assets at fair value, based on its judgment.

(November 2009)

1.6 GUIDANCE ON ACCOUNTING FOR SPECIE DIVIDEND ISSUE BY A SUBSIDIARY COMPANY

Enquiry: Our client a private limited company has a substantial stake in a subsidiary company listed on Stock Exchange. The company listed on Stock exchange has a 100% owned subsidiary company which was a private limited company.

The listed subsidiary company in its last AGM approved a specie dividend, being shares of its subsidiary company (private limited company) as permitted under the stock exchange listing regulation VIII (Copy attached).

As per the procedures prescribed in this regulation, the private limited company changed status to a listed company to enable it to distribute specie dividend to the share holder of the first subsidiary listed company.

ACCOUNTING ISSUE INVOLVED

While technical guidance on accounting for bonus shares has been given in TR- 15, the accounting for this kind of dividend i.e., specie dividend has not yet been considered. Our clients all the 3 companies i.e., investor company (private limited) and 2 subsidiaries i.e., first subsidiary – listed company and the sub-subsidiary (now converted into a listed company) are of an opinion that fair value measurement basis given in IAS – 39 (Paragraph 43, 44) may be followed at the date of issue of the aforesaid specie dividend. Therefore, the holding company, and first subsidiary company on receipt of specie dividend recorded the same by investment in the sub-subsidiary company with a corresponding credit to dividend income at fair value considering the same to be not a bonus issue by the subsidiary company.

We feel that the accounting treatment made by the holding company and the subsidiary appear in compliance to IAS – 39 (Para 43, 44). Further, we also feel that the same treatment may appear reasonable if the first mention company would not be holding company but any other investor company. However, we need to confirm the appropriateness of the treatment and wish to obtain a clear guidance from relevant committee of ICAP on the matter.

In our case following three companies are involved:

P	–	Parent having substantial stake in subsidiary S1
S1	–	Subsidiary company of parent
SS1	–	Sub-Subsidiary of S1 (which holds 100% share capital)

S1 distributes its holding in SS1 to the extent of 50% as specie dividend.

P by virtue of its holding in S1 received specie dividend from S1 being shares in SS1.

Common control before and after distribution have been retained as under:

✓	Control by subsidiary (S1) in sub-subsidiary in SS1 before distribution	- <u>100%</u>
✓	Control by the group after distribution:	
	Parent company (P)	- 20%
	Subsidiary (S1)	- 50%
	Common directors of the group	- 7%
	Total control after distribution	- <u>77%</u>

The accounting policy of P provides initial recognition of investment in associates is recorded at cost and equity accounting applied as appropriate.

When considering the above provisions as well as the accounting policies of the company receipt of specie dividend is accounted for as under:

- ✓ Debit to investments at cost of shares in the sub-subsidiary (SS1).
- ✓ Credit to investments account of first subsidiary (S1).

At the year end date the cost of investments in SS1 as well as investments in S1 have been amended by recording the current period share of profit and loss as given in the equity accounting procedures.

Opinion:

At the outset, the Committee would like to highlight that there is some information missing from your enquiry re: whether the holding company (P) and first subsidiary (S1) both prepare consolidated and separate financial statements? However, we have assumed that both the P and S1 prepare separate and consolidated financial statements. We further have assumed that both P and S1 recognize investment in subsidiaries and associates at cost.

The effect of transaction on both separate and consolidated financial statements of P and S1 are summarized below:

Separate Financial Statements

In P's separate financial statements the specie dividend would be recorded as Dividend Income at the value distributed with corresponding debit to the investment in subsidiary/associate SS1.

In S1's separate financial statements, S1 would first recognize liability for dividend payable in relation to profit available for distribution and then the liability for dividend payable would be offset against the value of investments in SS1. S1 can not recognize any gain on such distribution as the liability for dividend is fixed. If the value of investment is determined higher than the carrying value, then the number of shares to be distributed would reduce and vice-a-versa rather than pre-fixing the numbers of shares and then recognizing gain or loss on distribution.

Consolidated Financial Statements

In P's consolidated financial statements there would not be any change other than normal consolidation adjustments and eliminations including elimination of investments and intra group dividend, except where the value of investments is treated as different for distribution purposes from the holding cost of S1, in which case the difference would also need to be eliminated.

In S1's consolidated financial statements dividend distribution would be accounted for normally and there would not be any elimination.

We have not dealt with the issue of appropriateness of determining control over S1 or whether the accounting policies specified in your enquiry are appropriate or not.

(January 2010)

1.7

ISSUE OF BONUS SHARES

Enquiry:

This in connection with accounting treatment, of excess of fair value over par value of shares to be issued upon amalgamation, under the purchase method prescribed by the International Financial reporting Standard – 3 (the “IFRS – 3”)

Company A and B entered into a duly sanctioned scheme of amalgamation. In consideration of amalgamation company A issued specified number of its shares to the shareholders of Company B. The amalgamation was accounted for applying the purchase method provided in IFRS – 3. Since the fair value of shares was determined to be higher than their par value, a reserve has been created to account for the difference. The Company is of the opinion that reserve thus created is in the nature of share premium account and the same can be used for the purpose of issuing bonus shares in terms of Section 83 of the Companies Ordinance, 1984 (“the Ordinance”).

The Commission is of the view that the said reserve, created due to excess of fair value over par value of shares in consequence of the said amalgamation, may be classified as merger reserve and can not be classified as share premium reserve. Further since such reserve comes under the ambit of Rule 8 of the Companies Issue of Capital Rules 1996 therefore can not be utilized for the purpose of issuing bonus shares in terms of Section 83 of the Ordinance.

You are requested to provide opinion:

- a) as to whether this excess of fair value of shares over the par value can be classified as share premium reserve;
- b) its accounting treatment is in accordance with the requirements of IFRS; and
- c) the said reserve can be used for the purpose of issuing bonus keeping in view the requirements of the legal framework.

Opinion:

The International Financial Reporting Standard IFRS 3 – ‘Business Combinations’ requires the application of purchase method of accounting for amalgamations/ business combinations that are within the scope of the standard. Under the purchase method of accounting, the consideration transferred, including in the form of issuance of shares in a business combination shall be measured at fair value notwithstanding the fact that the shares are actually issued at par value. As a result, when the fair value of the shares issued exceeds their nominal or par value, the difference is accounted for in the equity as a “capital reserve” and may even be classified as “share premium” and bonus shares may be issued from the amount credited to the share premium account. This runs contrary to the views expressed by the Commission in the aforesaid enquiry.

The Committee deliberated the issue at length and is of the view that in the absence of a clear stipulation under the Companies Ordinance, 1984 (the Ordinance) restricting the utilization of such “capital reserve” for distribution as bonus shares, a sustainable legal view can be taken that such “capital reserve” can be utilized for the said purpose. The Committee, therefore, is of the considered opinion that if the Commission intends to put restriction on the utilization of such “share premium reserve”, suitable amendments will be required in the Ordinance for which guidance may be taken from the English or Indian Law.

(July 2009)

1.8 PRESENTATION / DISCLOSURE REQUIREMENTS (INVESTMENTS – HELD-TO-MATURITY)

Enquiry: During previous years a Company purchased – ‘Sukuk Bonds’ (SB) for Rs.80.650 million, having face value of Rs.75.00 million. Company recognized and recorded ‘Intangible Asset’ for Rs.5.650 million (premium paid over and above face value and treated as transaction cost) to be amortized over 6.8 years, the maturity period of SB. Investments were disclosed in the financial statements at face value. As per auditors, no active market existed for the investments so fair market-value of the same could not be determined. As per accounting policy, interest income upon SBs was recognized by applying prevailing / applicable base rate plus points.

Accounting policy for investments was not disclosed in the financial statements. Investments classified as ‘Held-to-maturity’ were not disclosed in accordance with requirements of IAS-39.

Recommendation

When a financial asset or financial liability is recognized initially, an entity shall measure it at fair value plus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability (IAS 39, Para 43). Held to maturity investments should be measured at amortized cost, using the effective interest method. In this case, company recognized interest income upon the investments using applicable base rate plus points, the same rate could be applied to calculate the amortized cost of the investments.

Statistics of the case:

Sukuk Bonds (SBs) purchased for Rs. 25.0 million
Number of bonds (Rs. 25.0 million / 100) = 250,000 bonds
Face value: Rs. 100
Purchased at premium Rs.2 per bond Rs. 2.0 million in total
Date of purchase: July 1, 2006
Date of maturity: June 30, 2012
Rate of profit: 6 months KIBOR plus 35 basis points payable semi annually.
Year end is June 30, 2009
Sukuk Bonds are traded in a secondary market through brokers, like money market the way treasury bills are traded.

In the financial statements:

- SBs has been disclosed as held to maturity investment at Rs. 25.0 million;
- Premium has been capitalized to intangible assets at Rs. 2.0 million and is being amortized to date in the financial statements equally on a systematic basis over the period of maturity;
- Interest income being received bi-annually is taken to profit and loss account on simple accrual basis.

Please advice the treatment of above-mentioned case as per IAS 39 especially when KIBOR is rapidly changing. Amount of interest varies each time at the time of payment of profit.

Opinion: Please refer to para 46(b) of IAS 39 *Financial Instruments: Recognition and Measurement* requires *held to maturity* investments to be measured after initial recognition, at the amortised cost using the effective interest method.

Please see the following definitions relating to recognition and measurement as provided in IAS 39:

The *amortised cost of a financial asset or financial liability* is the amount at which the financial asset or financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount, and minus any reduction (directly or through the use of an allowance account) for impairment or uncollectibility.

The *effective interest method* is a method of calculating the amortised cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, an entity shall estimate cash flows considering all contractual terms of the financial instrument (for example, prepayment, call and similar options) but shall not consider future credit losses. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate (see IAS 18 *Revenue*), transaction costs, and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to estimate reliably the cash flows or the expected life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments).

For changing interest rate as referred to in the enquiry, guidance may be taken from the following paragraphs of IAS-39:

- BC35 For consistency with the estimated cash flows approach, the Board decided to clarify that the effective interest rate is calculated over the expected life of the instrument or, when applicable, a shorter period. A shorter period is used when the variable (eg interest rates) to which the fee, transaction costs, discount or premium relates is repriced to market rates before the expected maturity of the instrument. In such a case, the appropriate amortisation period is the period to the next such repricing date. (Underlining is ours)
- AG7 For floating rate financial assets and floating rate financial liabilities, periodic re-estimation of cash flows to reflect movements in market rates of interest alters the effective interest rate. If a floating rate financial asset or floating rate financial liability is recognised initially at an amount equal to the principal receivable or payable on maturity, re-estimating the future interest payments normally has no significant effect on the carrying amount of the asset or liability.
- AG8 If an entity revises its estimates of payments or receipts, the entity shall adjust the carrying amount of the financial asset or financial liability (or group of financial instruments) to reflect actual and revised estimated cash flows. The entity recalculates the carrying amount by computing the present value of estimated future cash flows at the financial instrument's original effective interest rate. The adjustment is recognised as income or expense in profit or loss.

Floating interest rate is defined as an interest rate that, instead of being a fixed percentage, is stated as an amount above or below another rate, such as the prime rate. The interest rate moves up or down in relation to the rate of the controlling index.

The Committee would like to draw your attention to the measurement of amortised cost by using effective interest rate which should include the Premium amount. Therefore as mentioned in the enquiry, amortization of the same separately is not correct.

(November 2009)

1.9 QUERY RELATED TO WPPF

Enquiry: The ABC limited has incurred losses for last five years and in the current year the company earned profit. During the current year, the bank – which has given long term loan to the ABC limited, has re-scheduled the overdue long term and also reduce the rate of mark-up, due to which the ABC limited has reversal of accrual of mark-up expenses of last four years. The effect of reversal of accrued mark-up taken in the current year profit as prior year's adjustment.

In this respect, I want to know your expert opinion whether the WPPF & WWF will be calculated on the profit taking into effect of reversal of mark-up of previous years or not.

Opinion: It shall be appreciated that the Committee does not have the legal expertise and it does not, therefore, deal with contentious legal aspects; the Committee assists the members only in the interpretation of accounting / auditing standards and statutory provisions dealing with these matters.

The Committee is of the view that though the issue under reference appears to be a legal matter, however, it would like to give its opinion on the query raised by you as follows:-

The Committee wish to draw your attention towards section 2(d) of the Companies Profits (Workers' Participation) Act which defines profits as:

"Profits in relation to a company means such of the net profits as defined in Section 87C of the Companies Act, 1913 as are attributable in its business, trade undertakings or other operations in Pakistan."

Section 87C(3) of the Companies Act 1913 (the Repealed Act) defines Net Profits' as under:

"For the purposes of this section 'net profits' means the profits of the company calculated after allowing for all the usual working charges, interest on loans and advances, repairs and outgoing, depreciation, bounties or subsidies received from any Government or from a public body, profits by way of premium on shares sold, profits on sale proceeds of forfeited shares, or profits from the sale of the whole or part of the undertaking of the company but without any deduction in respect of income-tax or super-tax, or any other tax or duty on income or revenue or for expenditure by way of interest on debentures or otherwise on capital account or on account of any sum which may be set aside in each year out of the profits for reserve or any other special fund."

In the opinion of the Committee, considering the definition of profit stated above, especially the underlined portion, it appears that only profits from the ordinary activities of the company should be considered in computing the share of the workers. The Committee feels inclined to hold the view that effect of reversal of mark-up of previous

years due to re-scheduling of the overdue of long term loans and reduction of the rate of mark-up is relevant to the business operations of the company and the same should be construed as part of the profits of the company for all intents and purposes.

Accordingly, in the opinion of the Committee, provision for WPPF and WWF should have been made.

(February 2010)

2. AUDITING

2.1 CLARIFICATION REGARDING HALF YEARLY REVIEW

We conducted the audit of a listed company for the year ended June 30, 2008, and the AGM, during which the above said report and Financial statements for the year ended June 30, 2008, was held in May 2009. During this AGM the company duly appointed another firm of chartered accountants in place of our firm, which means that our firm held the office of external auditor until the conclusion of AGM of the company held in May 2009. Despite our reminders to the company for the review of half yearly accounts for the period ended December 30, 2008, the company did not make any arrangements for the review and hence we were unable to conduct the half yearly review for the said period. Now the company has requested us to conduct the half yearly review for the period ended December 31, 2008.

Considering the scenario given above, following are our queries:-

- a) Whether or not we can conduct the review of half-yearly financial statements for the period ended December 31, 2008, in current date.
- b) Under the given scenario what would be the possible course of action for the company to fulfill the SECP requirement to submit the half yearly review report for the period ended December 31, 2008.

Opinion: The Committee wishes to draw your attention towards clause 4.4 of the ATR -11:

“Since the auditors are appointed for a period up to the conclusion of the next annual general meeting, they can audit more than one year’s accounts during their period in the office. However such situation can only arise if a company fails to prepare and present the accounts at the annual general meeting as required under section 230 of the Ordinance.....”

In view of above, the Committee is of the opinion that only the current auditor can conduct the limited review of half-yearly financial statements for the period ended December 31, 2008 in current date. Retiring auditor cannot conduct the limited review of the previous period because section 252(1) of the Companies Ordinance 1984 provides that an auditor is appointed to hold an office from the conclusion of that annual general meeting until the conclusion of the next annual general meeting. The auditors appointed in the Annual General Meeting held on May 2009 are current auditors of the company; therefore, they can conduct limited review/audit of financial statements of the company for the previous period(s)/year(s) in addition to limited review/audit for the current period/year.

With regard to your second enquiry, please refer section 245 of the Companies Ordinance 1984 which deals with the issue.

(February 2010)

2.2 OPINION ON APPOINTING AN EXTERNAL AUDITOR PROVIDING NON-ASSURANCE SERVICES

Enquiry: A Public Sector Bank (Listed company) is in the process of undertaking a few assignments in which we will require services of external consultants, and our external auditor firms, in their capacity as professional consultants, may also participate in the same. We understand that there are independence and ethics related guidelines in vogue

that are applicable to external auditors' services including guidelines as contained in the listing regulations, which are also applicable on us as a listed company.

We would like to seek your opinion as to whether our external auditors can provide services in the following areas:

Computerized Consumer Record Keeping & Maintenance

This system will be required to maintain customer database on computerized system and would include database management and MIS capabilities. This system would contain all particulars of borrower, details of loans including tenor, markup, payment history, repayment schedule and aging of loan for the purpose of classification.

The firm will provide maintenance services and support to the Bank with respect to housing mortgage and SME products for small borrowers.

Under the agreement the firm will manage the technical maintenance of the System implemented to ensure complete troubleshooting and maintenance support on-site and for this purpose a technical team has to be posted on-site at the Bank. The firm will provide continuous support for system for back office functions. System technical maintenance also includes continuous technical functioning of the application system software together with troubleshooting in case of system errors, removal of bugs, effecting recovery in case of disaster recovery, database corruption in whole or part caused by any event, misuse or corruption due to any computer virus or any other cause.

Loans to be maintained on the new system would approximately represent 1.8% of the gross advances of the bank in the case of housing mortgage and 1% in the case of SME product respectively.

Income Tax Related Advisory:

Can an external audit firm be engaged in services concerning income tax advisory?

Core Banking Application Advisory:

The Bank also intends to acquire consultancy / advisory services with regard to implementation of Core Banking Application software. This software includes bank wide automation of all banking applications. The Bank has set-up a Project Monitoring Officer (PMO) comprising executives of various departments to ensure effective implementation of the system. The main purpose of consultancy is to act as a liaison between the Bank (PMO) and primary vendor for the software. Their function will be to advise on process level integration of the various existing systems with core banking, to highlight issues with the vendor to safeguard the interest of the bank at every stage of design & implementation of the application, assess and advise the bank on the status of preparedness necessary for the implementation of the system and to validate the outcome of the various stages of implementation. The consultants will also be responsible to point out and assist in removing any shortcomings of the system from the Bank's point of view. The actual work of removing the shortcomings will be done by the software vendor.

We would like your opinion as to whether external auditors can participate in the bidding process of such an assignment and can provide such consultancy services to the bank or not.

Opinion:

At the outset the Committee would like to draw your attention to clause xl of Code of Corporate Governance to be read with clause 29-C of KSE Listing Regulations (underline is ours):

“(xl) No listed company shall appoint its auditors to provide services in addition to audit except in accordance with the regulations and shall require the auditors to observe applicable IFAC guidelines in this regard and shall ensure that the auditors do not perform management functions or make management decisions, responsibility for which remains with the Board of Directors and management of the listed company.” (underlining is ours)

“29-C (i) No Listed company shall, appoint or continue to retain any person as an auditor who is engaged by the company to provide services that are prohibited.

(ii) A listed company shall also not appoint or continue to retain any person as an auditor, if a person associated with the auditor is, or has been, at any time during the preceding three months engaged as a consultant or advisor or to provide any services that are prohibited.

Explanation:

For the purposes of this regulation, the expression “associated with” shall mean any person associated with the auditor, if the person:-

- (a) is a partner in a firm, or is a director in a company, or holds or controls shares carrying more than twenty percent of the voting power in a company, and the auditor is also partner of that firm, or is a director in that company or so holds or controls shares in such company; or
- (b) is a company or body corporate in which the auditor is a director or holds or controls shares carrying more than twenty percent of the voting power in that company or has other interest to that extent.

Explanation:

For the purposes of this regulation the services that are **prohibited** shall mean the following:

1. Preparing financial statements, accounting records and accounting services;
2. Financial information technology system design and implementation, significant to overall financial statements;
3. Appraisal or valuation services for material items of financial statements;
4. Acting as an Appointed Actuary within the meaning of the term defined by the Insurance Ordinance, 2000;
5. Actuarial advice and reviews in respect of provisioning and loss assessments for an insurance entity;
6. Internal audit services related to internal accounting controls, financial systems or financial statements;
7. Human resource services relating to:-
 - i. Executive recruitment;
 - ii. Work performed (including secondments) where management decision will be made on behalf of a listed audit client;
8. Legal Services;
9. Management functions or decisions;
10. Corporate finance services, advice or assistance which may involve independence threats such as promoting, dealing in or underwriting of shares of audit clients.
11. Any exercise or assignment for estimation of financial effect of a transaction or event where an auditor provides litigation support services as identified in paragraph 9.187 of Code of Ethics for Chartered Accountants.

12. Share Registration Services (Transfer Agents)" (underlining is ours)

Further we would also like to refer the Code of Ethics for Chartered Accountants which institutes the fundamental principles of professional ethics and provides a conceptual framework for applying those principles. One of the basic elements of the framework is 'Independence'. It is important to note that independence of mind and in appearance is necessary to enable the practicing chartered accountants to enable them to express a conclusion, without bias, conflict of interest or undue influence.

As a value addition, practicing chartered accountants are expected to provide a variety of non-assurance services that are consistent with their skills and expertise, subject to the requirement of applicable regulations including those which are stated above. While rendering other services to an audit client, practicing chartered accountants are required to apply the conceptual framework to identify threats to compliance with the fundamental principles and assess their significance and implication.

The onus of evaluation of such threats to compliance with the fundamental principles rests on the practicing chartered accountants and they should consider qualitative as well as quantitative factors while performing such evaluation. Such obligation on the part of a practicing chartered accountant becomes more critical in a situation where the applicable guidelines or regulations do not clearly prohibit any specific service.

In case where practicing chartered accountants render such services which may coincide with management functions and management decision making, the threat of "Self Review" could exist. One instance of such activity is the preparation of original data used to generate records that could be the subject matter of the audit engagement.

In this connection we would like to refer the following paras of section 290 of Part B of Code of Ethics for Chartered Accountants which states:

"290.166 It is the responsibility of financial statement audit client management to ensure that accounting records are kept and financial statements are prepared, although they may request the firm to provide assistance. If firm, or network firm, personnel providing such assistance make management decisions, the self review threat created could not be reduced to an acceptable level by any safeguards. Consequently, personnel should not make such decisions. Examples of such managerial decisions include:

- Determining or changing journal entries, or the classifications for accounts or transaction or other accounting records without obtaining the approval of the financial statement audit client;
- Authorizing or approving transactions; and
- Preparing source documents or originating data (including decisions on valuation assumptions), or making changes to such documents or data."

With regard to Computerized Consumer Record Keeping & Maintenance services, the Committee would like to state that from your explanation of service it appears that the auditors would only be required to provide system maintenance and support and they would not be involved in feeding data into the system and generating accounting records. The Bank in such a scenario would need to consider whether the accounting firm would retain any responsibility of data generated from the system, if the Bank determines that the firm retains responsibility for the data then the firm may attract provisions of clause 1 of prohibited services stated above as the same may comprise accounting record keeping services.

Further, with regard to Core Banking Application Advisory the Bank would need to assess the appointment of external auditor for this service as it would attract prohibitions placed under clause 2 of prohibited services which prohibits the auditor of a listed company from providing financial information technology system design and implementation services to the listed audit clients which may be significant to overall financial statements.

With regard to Income Tax Related Advisory services, the Committee would like to state that the prohibited services listed above do not provide any restrictions on provisions of taxation services by the listed company's auditors. Further, the committee would also like to draw your attention to the para 290.176 of Code of Ethics for Chartered Accountants:

"290.176 The firm may be asked to provide taxation services to a financial statement audit client. Taxation services comprise a broad range of services, including compliance, planning, provision of formal taxation opinions and assistance in the resolution of tax disputes. Such assignments are generally not seen to create threats to independence."

Based on above and because tax advisory services are not prohibited as per clause 29-C reproduced above, the Committee is of the opinion that the external auditors may engage in tax advisory services. However, tax service may also pose a threat in the form of conflict of interest, self review etc for which the auditor need to take care of.

Finally, the Committee is of the opinion that the first two assignments mentioned in your enquiry should not be rendered by the external auditors.

(January 2010)

2.3

REQUIREMENT TO OBTAIN NOC FROM THE RETIRING COST AUDITOR

Enquiry:

Cost auditor is appointed by the board of directors of the company and thereafter approval from SECP is obtained. Later on cost auditors resign for any reason and board of directors appoint new cost auditor and obtain the approval of SECP. Does new cost auditor require to obtain NOC from the retiring auditors before holding the office? As per understanding the NOC mentioned in the law is required for the financial audit because cost audits can also be carried on by the CA, CMAs.

Opinion:

We wish to draw your attention to the following relevant paragraphs of the ICAP Code of Ethics for Chartered Accountants:

Definition of Existing Accountant

A Chartered Accountant in practice currently holding an audit appointment or carrying out accounting, taxation, consulting or similar professional services for a client.

210.10 A chartered accountant in practice who is asked to replace another chartered accountant in practice, or who is considering tendering for an engagement currently held by another chartered accountant in practice, should determine whether there are any reasons, professional or other, for not accepting the engagement, such as circumstances that threaten compliance with the fundamental principles. For example, there may be a threat to professional competence and due care if a chartered accountant in practice accepts the engagement before knowing all the pertinent facts.

210.11 The significance of the threats should be evaluated. Depending on the nature of the engagement, this may require direct communication with the existing accountant to establish the facts and circumstances behind the proposed change so that the chartered accountant in practice can decide whether it would be appropriate to accept the engagement. For example, the apparent reasons for

the change in appointment may not fully reflect the facts and may indicate disagreements with the existing accountant that may influence the decision as to whether to accept the appointment.

Please also refer clause 7 of Part 1 of 1st Schedule of Chartered Accountants Ordinance 1961 which mentions that:

“A Chartered Accountant in practice shall be deemed to be guilty of professional misconduct, if he:

- (7) Accepts a position as auditor previously held by another members of the Institute without first communicating him in writing.”

Conclusion:

From the above, we can conclude that it appears to be necessary for a chartered accountant in practice to communicate with the existing accountant carrying out an audit appointment including cost audit.

(January 2010)

2.4 SITUATION WHERE A CONFLICT OF INTEREST ARISES

Enquiry: ABC is a public company limited by shares and is listed on all the Stock Exchanges of Pakistan.

The Bank tenders for various consultancy in which the auditors of the bank have also been participating in the past. We would like to know if there is any bar on the auditors of the bank applying for and being given consultancy contracts or would it be considered as conflict of interest.

Opinion: Your attention is drawn to clause 31-C of the Listing Regulations which is reproduced below for reference:

31-C (i) No Listed company shall, appoint or continue to retain any person as an auditor who is engaged by the company to provide services that are prohibited.

- (i) A listed company shall also not appoint or continue to retain any person as an auditor, if a person associated with the auditor is, or has been, at any time during the preceding three months engaged as a consultant or advisor or to provide any services that are prohibited. *(underlining is ours)*

The list of prohibited services as given in the listing regulations may be consulted and are not being reproduced here.

In view of the above, the Committee is of the opinion that consultancy contract in respect of prohibited services can not be given to the auditors of the bank.

(July 2009)