SELECTED OPINIONS

Volume XVI

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COMPILED BY

TECHNICAL SERVICES DIRECTORATE

OF

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF PAKISTAN

INTRODUCTION

This report is the sixteenth compilation of selected opinions issued by the Technical Advisory Committee on inquiries raised by the members and other agencies during the period from July 2010 to June 2011 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.

Haroon Tabraze
Director Technical Services

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1. ACCOUNTING

1.1 ACCOUNTING TREATMENT OF ASSETS HELD FOR SALE

Enquiry: Annual Audited Accounts of Company A for the year ended June 30, 2009 showed that an amount of Rs. 'X' has been categorized under "Current Assets" as "Assets held for Sale". On the other hand the amount has been recognized as "Share Deposit Money" under "Equity". Notes of the Accounts states that this represents commercial and residential properties of the directors of the Company which are under "Equitable Mortgage" with the banks against which financial facilities have been obtained by the Company. The directors have relinquished ownership of the properties in favour of the Company. The transfer of title is subject to clearance from the lending banks. Once all approvals/clearance from the competent authorities for right issue are in place, share of the corresponding value will be issued to the directors of the Company. The afore-mentioned properties are already mortgaged with two commercial banks against various credit facilities availed by the Company.

Moreover, please provide the correct treatment of the afore-stated transaction, in case the Company had not accounted for the afore-stated transaction in accordance with the IAS & IFRS.

Opinion: The Committee would like to draw your attention to the following paragraphs of IAS 32 'Financial Instruments: Presentation':

15 The issuer of a financial instrument shall classify the instrument, or its component parts, on initial recognition as a financial liability, a financial asset or an equity instrument in accordance with the substance of the contractual arrangement and the definitions of a financial liability, a financial asset and an equity instrument.

16 When an issuer applies the definitions in paragraph 11 to determine whether a financial instrument is an equity instrument rather than a financial liability, the instrument is an equity instrument if, and only if, both conditions (a) and (b) below are met:

(a) The instrument includes no contractual obligation:

(i) to deliver cash or another financial asset to another entity; or

(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavorable to the issuer.

(b) If the instrument will or may be settled in the issuer's own equity instruments, it is:

(i) a non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments; or

(ii) a derivative that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments. For this purpose, rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments. Also, for these purposes the issuer's own equity instruments do not include instruments that have all the features and meet the conditions described in paragraphs 16A and 16B or paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the issuer's own equity instruments.

A contractual obligation, including one arising from a derivative financial instrument, that will or may result in the future receipt or delivery of the issuer's own equity instruments, but does not meet conditions (a) and (b) above, is not an equity instrument. As an exception, an instrument that meets the definition of a financial liability is classified as an equity instrument if it has all the features and meets the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D.

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

The Committee is of the view that the substance of the contractual arrangements shall guide the company (issuer of financial instrument) to classify such instrument as equity or liability.

With regard to classification of the above mentioned properties as "Assets held for Sale" the Committee would like to draw attention to the following paragraphs of IFRS 5:

3 Assets classified as non-current in accordance with IAS-1 Presentation of Financial Statements shall not be reclassified as current assets until they meet the criteria to be classified as held for sale in accordance with this IFRS. Assets of a class that an entity would normally regard as non-current that are acquired exclusively with a view to resale shall not be classified as current unless they meet the criteria to be classified as held for sale in accordance with this IFRS.

6 An entity shall classify a non-current asset (or disposal group) as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use.

7 For this to be the case, the asset (or disposal group) must be available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets (or disposal groups) and its sale must be highly probable.

8 For the sale to be highly probable, the appropriate level of management must be committed to a plan to sell the asset (or disposal group), and an active programme to locate a buyer and complete the plan must have been initiated. Further, the asset (or disposal group) must be actively marketed for sale at a price that is reasonable in relation to its current fair value. In addition, the sale should be expected to qualify for recognition as a completed sale within one year from the date of classification, except as permitted by paragraph 9, and actions required to complete the plan should indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn. The probability of shareholders' approval (if required in the jurisdiction) should be considered as part of the assessment of whether the sale is highly probable

In view of the above, the Committee is of the opinion that if the above criteria of IFRS 5 are met then the properties may be recorded as held for sale.

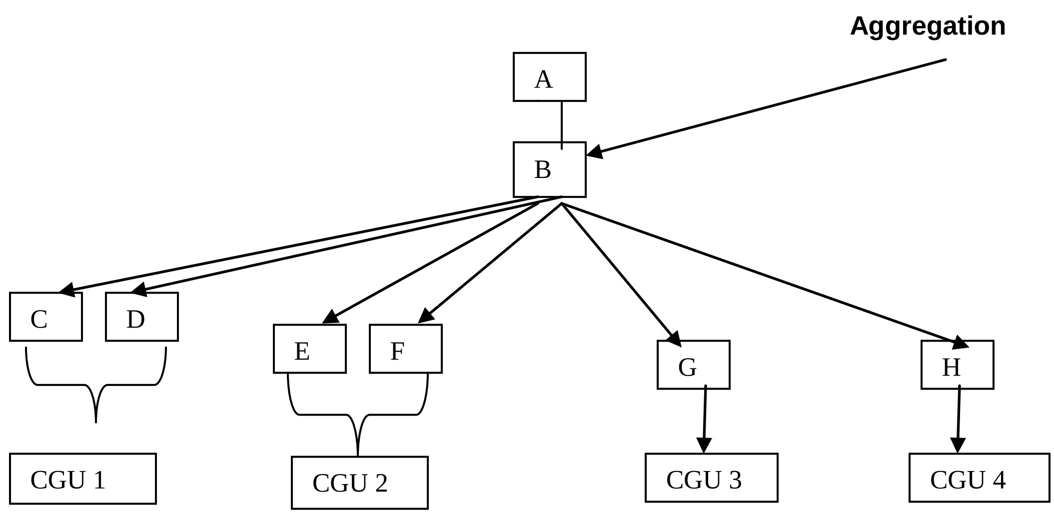
(February 17, 2011)

1.2 AGGREGATION OF CASH GENERATING UNITS TO ASSESS RECOVERABLE AMOUNT BY A HOLDING COMPANY FOR THE PURPOSE OF DETERMINING IMPAIRMENT

Enquiry: **<u>Background</u>**

Company "A" is a listed company, registered in Pakistan and having only one direct subsidiary (incorporated outside Pakistan) with share holding of 60.31%, hereinafter called Company "B". Company "B" has several subsidiaries (herein referred as "indirect subsidiaries"). Some indirect subsidiaries have been directly identified as separate cash generating unit, whereas others indirect subsidiaries have been clubbed to form different cash generating units (CGU). At each CGU level, discounted cash flows have been determined. Then recoverable amount of entity B has been determined by clubbing the discounted cash flows of all the CGUs and, accordingly, impairment has been recorded in the books of company "A" on account of investment in company "B". In other words, recoverable amount has not been assessed at CGU level.

The following diagram depicts the manner in which CGUs have been determined by Company "A":



We would highly appreciate if you would provide your opinion on the following issues in the light of IAS 36 and any other relevant IAS:

1. Should recoverable amount be assessed at each CGU Level?

2. If recoverable amount is assessed at CGU level, how will the impairment be estimated by company "A", as "A" holds investment in CGU through "B"?

3. Whether the treatment adopted by company "A" with respect to aggregation of discounted cash-flows of all CGUs at company "B" level to determine the recoverable value of "B" and then accordingly recording of impairment on account of investment in "B" by "A" is appropriate?

Opinion: The Committee would like to draw your attention to the following paragraphs of IAS 36 'Impairment of Assets':

22 Recoverable amount is determined for an individual asset, unless the asset does not generate cash inflows that are largely independent of those from other assets or groups of assets. If this is the case, recoverable amount is determined for the cash-generating unit to which the asset belongs (see paragraphs 65–103), unless either:

(a) the asset's fair value less costs to sell is higher than its carrying amount; or
(b) the asset's value in use can be estimated to be close to its fair value less costs to sell and fair value less costs to sell can be determine

66 If there is any indication that an asset may be impaired, recoverable amount shall be estimated for the individual asset. If it is not possible to estimate the recoverable amount of the individual asset, an entity shall determine the recoverable amount of the cash-generating unit to which the asset belongs (the asset's cash-generating unit).

67 The recoverable amount of an individual asset cannot be determined if:

(a) the asset's value in use cannot be estimated to be close to its fair value less costs to sell (for example, when the future cash flows from continuing use of the asset cannot be estimated to be negligible); and

(b) the asset does not generate cash inflows that are largely independent of those from other assets.

In such cases, value in use and, therefore, recoverable amount, can be determined only for the asset's cash-generating unit.

74 The recoverable amount of a cash-generating unit is the higher of the cash-generating unit's fair value less costs to sell and its value in use. For the purpose of determining the recoverable amount of a cash-generating unit, any reference in paragraphs 19–57 to 'an asset' is read as a reference to 'a cash-generating unit'.

75 The carrying amount of a cash-generating unit shall be determined on a basis consistent with the way the recoverable amount of the cash-generating unit is determined.

In view of above, the response to your queries is as follows;

1. The Committee is of the opinion that that recoverable amount should be assessed at each CGU level. The CGUs could be a component part of an entity or a group of entities determined based on dependence or independence of cash generation from business operations.

2. The Committee would like to clarify that all the subsidiaries while preparing their financial statements would determine the impairment of the assets as well as recoverable amounts of impaired assets in accordance with IAS 36. Only the impairment loss on impaired assets would be recognised and surplus of any asset will not offset the loss on another asset. Thus the investment of subsidiary B in sub-subsidiaries would incorporate the impairment loss of sub-subsidiaries. Similarly A would also recognise impairment loss on investment in B as a result of B recognising impairment loss on its investment in sub-subsidiaries due to sub-subsidiaries recognising impairment loss on their assets or cash generating units.

3. The Committee is of the opinion that the impairment loss should be assessed at the asset level and where it is not possible then at each CGU level as required in IAS 36.

Further, as explained in 2 above the simple aggregation of cash generating units which results in offsetting losses of independent assets or CGUs is not permitted.

(February 17, 2011)

1.3 APPROPRIATE FINANCIAL REPORTING FRAMEWORK OF NGO/NPO

Enquiry:

1. If an entity is registered under section 42 of Companies Ordinance as a not for profit organization, which framework would be referred in the statement of compliance of the financial statements of that entity? Would we use the MSE/SSE Standards issued by ICAP in which the applicability comes from 5th schedule **OR** NGO/NPO guidelines issued by ICAP. The matter is due to the constitution of the entity under the Companies Ordinance, 1984.

2. MSE standards issued by ICAP uses the word "entity" like Medium Sized Entity, but the 5th schedule uses the word Medium Sized Company. So, if they are applied on entities then can we use these standards for NGOs/NPOs? Further, would you also clarify whether the SSE and MSE standards are applicable to Companies only or can they be used as a framework for other entities as well?

3. If the NGO/NPO is registered under section 42 of Companies Ordinance and is managing different projects having a material funding from one or more than one donors, and donors have not mentioned any framework for the preparation of financial statements but mentioned that the accounts should be prepared and be audited by a reputed firm, then which framework to use MSE/SSE or NPO/NGO guidelines issued by ICAP?

4. If an entity is formed through its own statute through notification by the Prime Minister of Pakistan or President of Pakistan and nothing is mentioned about the applicable framework to use for the preparation of the financial statements, then what to do in that case with respect to the applicable financial reporting framework. Please remember that the entity is not registered as NGO/NPO or a Company under the Companies Ordinance 1984.

5. If an entity/NGO has a further Project whose accounts are prepared separately for example a factory, housing scheme, or manufacturing concern not registered as a separate COMPANY!! Which framework would we use in this case?? Can we use the MSE and SSE standards as it is an entity although not a Company!!

For 1, 3 and 4 above, which audit report should be used in all the cases above?? i.e. Report as per Companies Ordinance Form 35A or ATR 17?

Opinion: The Committee views on the above enquiries are as follows:

1. All NGOs/NPOs registered under section 42 of the Companies Ordinance, 1984 are required to comply with the requirements of section 234 of the Companies Ordinance, 1984 while preparing their financial statements.

   Auditor’s report format – Form 35A should be used.

2. MSE and SSE standards can be used as a framework for other entities as well.

3. Please refer response to enquiry (1) above.

4. Other than NGO/NPO registered under section 42 of the Companies Ordinance, 1984, NGOs registered under Societies Act are required to comply with ATR 17.

The applicable framework of the entities other than above mentioned entities, the guidance may be obtained from NGOs/NPOs Guidelines issued by ICAP while preparing financial statements.

Auditor's report format –Reference may be taken from ISAs/ ATR-17.

5. MSE/SSE standard can be used.

(May 20, 2011)

1.4 CLARIFICATION ON SHARE DEPOSIT MONEY

Enquiry: One of our clients a listed company received contribution from its three directors in 1993 as share deposit money and classified it as part of equity and is still appearing as sub classification of equity. Other brief facts are as under:

1) the Company has to date not initiated any process for right issue.
2) the Company has shown its intentions in the form of written representations to issue shares against this amount (classified as share deposit money) in the future at an appropriate time.
3) the contributors (directors) of have given their written representation to have shares of the Company against this amount as and when Company will issue right shares in future, and not to ask for repayment
4) IFRS framework defines equity as the residual interest (assets less liabilities) and exemplifies contributions from shareholders as sub classification of equity.

It is purely management decision for not issuing the right shares after a lapse of 17th year and further in directors' opinion, continuous problems faced by the textile industry and turbulence in Stock Exchanges prevailing at various point of times did not make it feasible.

The need to seek an opinion after such a long period has arisen as the standards (IASs and IFRSs) and disclosure requirements have undergone immense changes and the professional judgments exercised previously may not be appropriate in the current scenario. Furthermore, the IFRS framework and the Companies Ordinance 1984 also do not clearly describe the treatment of share deposit money when the shares have not been issued and the management has not been required to pay back the amount by the contributories.

It is pertinent to note that the directors have given an undertaking that they would not withdraw the amount and the company has not received any show cause from SECP yet in this regard.

Keeping in view the above facts, we seek your advice about the classification of the amount received from directors (share deposit money) as equity or liability.

Opinion: The Committee is of the view that Section 86 of The Companies Ordinance, 1984 "Ordinance" provides a framework for further issue of capital where directors of the company decide to increase the capital by issuing further shares. However, the Ordinance is silent on the matter of receiving funds in advance for shares to be issued in future. The Fourth Schedule of the Ordinance also does not provide any such category under the headings of Share Capital and Reserves.

However, the Committee would like to draw your attention to the following para of IAS 32' Financial Instruments: Presentation' which may be relevant in the instant matter:

Para 11 of the standard define the "Financial Instrument" as follows:

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

15 The issuer of a financial instrument shall classify the instrument, or its component parts, on initial recognition as a financial liability, a financial asset or an equity instrument in accordance <u>with the substance of the contractual arrangement</u> and the definitions of a financial liability, a financial asset and an equity instrument.

16 When an issuer applies the definitions in paragraph 11 to determine whether a financial instrument is an equity instrument rather than a financial liability, the instrument is an equity instrument if, and only if, both conditions (a) and (b) below are met.

(a) The instrument includes no contractual obligation:
(i) to deliver cash or another financial asset to another entity; or
(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavorable to the issuer.

(b) If the instrument will or may be settled in the issuer's own equity instruments, it is:
(i) a non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments; or

(ii) a derivative that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments. For this purpose, rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments…….

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

and features associated with financial liabilities.

The Committee is of the view that the substance of the contractual arrangements shall guide the company (issuer of financial instrument) to classify such instrument as equity or liability. However, at the time of issue of shares the applicable legal requirements have to be complied with.

Further the Committee is also of the view that proper disclosure required under paragraph 112 of IAS 1 and paragraph 21 of IFRS 7 should be given in the financial statements.

(July 8, 2010)

1.5 CLARIFICATION REGARDING OTHER GENERAL CONSTRUCTION COSTS

Enquiry: Clarification is sought regarding the Guidelines for Accounting & Financial Reporting for NGOs/NPOs.

On page 56 of the Guidelines, para 6.9.38 says:

"In case of self-constructed buildings, the cost would comprise those costs that relate directly to the construction of the building and an appropriate portion of other general construction costs."

Can you please clarify what does other general construction cost mean?

Also please confirm will the cost of Finance and HR personnel involved in the financials and hiring of personnel related to the project such as construction of a University or Hospital will be capitalized in the cost of Capital work-in-progress (CWIP) or will it be expensed out.

Opinion: The Committee is of the view that 'other general construction costs' may refer to costs which are not a component of the cost of property, plant and equipment but they can be directly attributed to the acquisition or construction of the asset or bringing the asset to the location and condition necessary for it to be capable of operating in the matter intended by the management.

With regard to cost of Finance and HR personnel, the Committee is of the view that it does not appear to be directly attributed to the construction of Project.

(November 8, 2010)

1.6 DEFERRED TAX FROM PROFIT FOR DETERMINATION OF EMPLOYEE'S INCENTIVE

Enquiry: We have some arrangements with our working employees to give some share of profit (after tax) at year end. In this year our Auditor has made provision of deferred taxation over and above of normal tax provision (as per rate pervading to Pvt Companies). As per Income tax return of our company the tax calculated is almost same as normal provision of tax calculated by our auditor.

Now we need your technical advice whether we should calculate incentive to our employee after deduction of normal provision of Income tax or also deduct amount of deferred taxation for calculating their incentive. As they claimed that calculation of deferred taxation is based on timing differences of lives of assets and not actually paid expense of the company. And incentive to employees should be calculated after deduction of normal provision of income tax and not deferred tax calculation is included in this calculation.

You are requested to please give your technical opinion about the status of deferred taxation, application of IAS -12 on private limited companies in Pakistan and also advise either it is deducted by calculating incentive to employees of the company.

Opinion: The determination of incentive will be based on two factors i) framework used for preparation of accounts and ii) provisions of the scheme.

For determining appropriate framework applicable to your Company, your attention is drawn to paragraph 2.4.3 of Technical Release 5 (Revised 2006) which defines the qualifying criteria of the entity as ESE, MSE or SSE. If your Company meets the criteria of ESE then full IFRS is applicable and if it is MSE or SSE then you are required to comply with the requirements of Accounting and Financial Reporting Standards for Medium-Sized Entities or Small-Sized Entities respectively.

The employee incentive is a policy matter of the Company and the method of determination of incentive, including definition of profit and additions/deductions there from, would be defined in the scheme.

Therefore, in the absence of appropriate information about the Company to determine applicable framework and without reviewing the provisions of the scheme the Committee is unable to advice on the deductibility or otherwise of deferred tax from profits for the purposes of determination of incentive.

(April 15, 2011)

1.7 ENQUIRY ON PARAGRAPH 17(e) OF IAS 16

Opinion: Generally mining or petrochemical company which has several plants, some ready for use by management and producing goods that are sold in the market and substantial revenue is derived from the same while other plants are still in the commissioning phase and not yet ready for production. The products that are sold in the market cannot be utilized internally as other plants where such products will be used as input are still not ready for use. Based on the above, generally, the proceeds from sale of products (produced from plants which are ready) with the overall capital costs of all plants netted off in accordance with paragraph 17(e) of IAS 16.

Paragraph 17(e) of IAS 16 states that:

"Examples of directly attributable costs are:

a) ……….
b) ………
c) ………
d) ………
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);
f) ………."

Paragraph 24 of IAS 23 states: "When an entity completes the construction of a qualifying asset in parts and each part is capable of being used while construction continues on other parts, the entity shall cease capitalizing borrowing costs when it completes substantially all the activities necessary to prepare that part for its intended use or sale."

It is not uncommon in the mining or petrochemical industry for there to be a long commissioning period, sometimes over 12 months. In these situations, a key question which arises under IFRS is how the revenues and costs incurred during the commissioning period should be accounted for.

IAS 16 'Property, Plant and Equipment' requires that costs can only be capitalized if they are "directly attributable" to the asset, and it also states that revenue from saleable material produced during the testing phase should be deducted from the cost of constructing the asset. So what does this mean for a company with an extended commissioning period?

It is also questionable whether all revenues earned during the commissioning period, particularly if they are substantial, should be deducted from the cost of developing the plant. This would only be appropriate if it can clearly be shown that they are directly attributable to bringing the asset to the condition necessary for it to be capable of operating in the manner intended by management. The example in IAS 16 of what might fall into this category is revenues earned from sales of samples produced when testing equipment. This would suggest that the IASB may not have envisaged a situation where more than an insignificant amount of revenue would be treated in this way.

In our view IAS 16.17(e) applies to each individual plant. Goods sold on the market are produced once the asset is operating in the manner intended by management. Revenue from those products should not give rise to ‘net proceeds’ to be offset against the costs of testing other plants that are part of the complex; rather it should be recognised in profit or loss for the period as it reflects the operations of the entity for the period.

For ease of understanding, the above matter has been illustrated through figures as follows:

Situation A

Costs of testing – 100
Other capital costs - 100
Revenue from sales during commissioning period- 50

Situation B

Costs of testing – 100
Other capital costs - 100
Revenue from sales during commissioning period - 150

Situation C

Costs of testing – 100
Other capital costs - 100
Revenue from sales during commissioning period - 250

What should be the correct accounting treatment of revenue earned and costs (including depreciation of the plant) during commissioning period in each of the above situations?

Opinion: The Committee considered your enquiry and is of the view that paragraph 17(e) of IAS-16 deals with capitalization of cost of testing. These costs are incurred while checking that the asset capitalized is functioning properly and are recognized after deducting the net proceeds from selling any items produced such as samples produced while testing such asset.

The Committee agrees with your views that IAS 16.17(e) apply to each individual plant. Revenue from sale of products from plants which are in operation should not netted off against the costs of testing other plants; rather cost of operation/cost of testing of plant which are not in operation and having an extended commissioning period should be capitalized after netting off with revenue of that plant (if any), if they are directly attributable to the asset as required in IAS 16.17(e). Further the Committee is also of the view that the cost of capitalization of plant should not be more than the fair value of the plant as required in paragraph 19 of IAS 36.

(*May 20, 2011)*

1.8 GUIDANCE FOR THE CORRECT TREATMENT IN FILING OF FORM - 3 (RETURN OF ALLOTMENTS U/S 73(1) OF THE COMPANIES ORDINANCE, 1984)

Enquiry: One of my clients who is a Public Limited Company and is quoted on all the three stock exchanges of Pakistan has just completed the process of issuance of Right Shares which have been offered to all the shareholders.

Necessary requirements of notice under section 86 and 87 (as the case may be) of the Companies Ordinance, 1984 have been complied with and all the other approvals from the concerned authorities were obtained.

The main purpose of the issue as fully described in circular under section 86(3) is to repay the loans obtained for expansion purposes so as to divert the savings in the financial Costs towards payment of dividend to the shareholders.

The sponsors had opted for the conversion of their loans towards subscription of Right Issue. These loans were advanced to the Company from their own private resources, were through normal banking channels and received prior to the announcement of Right Issue.

ISSUE:

In the "Form 3" under section 73 (1) of the Companies Ordinance, 1984 "RETURN OF ALLOTMENTS" There are two columns in the return showing the allotment of shares as follows:

I. Serial number 10 Part A - "SHARES ALLOTTED PAYABLE IN CASH"

2. Serial number 11 Part B - "SHARES ALLOTTED FOR A CONSIDERATION OTHERWISE THAN IN CASH"

Nowhere in the return is a column for the conversion of loans received prior to the issue into equity toward contribution against Right Issue already received through normal banking channels.

I seek your opinion as to where the conversion of loans would appear in the "Form 3" as

1. Shares allotted payable in cash at serial number 10 for the reason that the funds were received by the company through banking channels earlier to the right issue.

OR

2. Shares allotted in consideration otherwise than in cash at serial number II for the reason that it s a conversion of loan into share capital. There is another point that issue of shares otherwise than in cash also need additional requirements such as valuation of assets against which shares are to be issued, contract between the company and the allottee, affidavit by the chief executive and the certificate from the auditor that all requirements have been complied with. In the above case, how can we obtain valuation certificate that the asset against which shares are to be issued is cash/funds received earlier to the decision of allotment of shares.

Opinion: The Committee examined your enquiry and is of the opinion that the conversion of sponsors' loans into equity should be considered as issuance of shares against cash and should appear in the "Form 3" as shares allotted payable in cash.

(July 8, 2010)

1.9 DEFERRED TAX – REVALUATION SURPLUS ON BUILDING

Enquiry: Reference is made to para no. 10 of IAS-12, Income Taxes which is reproduced hereunder:

10 Where the tax base of an asset or liability is not immediately apparent, it is helpful to consider the fundamental principle upon which this Standard is based: that an entity shall, with certain limited exceptions, recognize a deferred tax liability (asset) whenever recovery or settlement of the carrying amount of an asset or liability would make future tax payments larger

(smaller) than they would be if such recovery or settlement were to have no tax consequences.

Furthermore, the reference is also being made to sub-section (8) and (13) (d) of Section 22 of the Income Tax Ordinance, 2001 dealing with the matter of disposal of depreciable assets which are reproduced hereunder:

Quote

(8) Where, in any tax year, a person disposes a depreciable asset, no depreciation deduction shall be allowed under this section for that year and-

(a) if the consideration received exceeds the written down value of the asset at the time of disposal, the excess shall be chargeable to tax in that year under the head "Income from Business" or

(b) if the consideration received is less than the written down value of the asset at the time of disposal, the difference shall be allowed as a deduction in computing the person's income chargeable under the head "Income from Business" for that year.

(13)(d) Where the consideration received on the disposal of immoveable property exceeds the cost of the property, the consideration received shall be treated as the cost of the property.

Unquote

The cumulative effect of above provisions of the Income Tax Ordinance, 2001 is such that if there is a situation where cost of the building is Rs.100,000 and the WDV for tax purposes is Rs.80,000 and the building is sold out at Rs.150,000, the gain or loss on disposal will be calculated as follows:

		Rupees
Consideration received		150,000
Consideration received restricted to cost		100,000
Gain or loss on disposal		
Restricted consideration received	100,000	
Less: WDV	80,000	20,000
Thereby what has been claimed as depreciation and initial allowance now been recouped on disposal		

Keeping in view the above illustration, if there is revaluation of the building, we understand that, for the purpose, the revaluation surplus on disposal of the building will be accounted for as excess of the consideration received over the cost which will not provide any tax consequence in the future keeping in view the above provisions of the Income Tax Ordinance, 2001.

Thus, we understand that the revaluation surplus in relation to the building is not subject to calculation of any temporary difference and therefore the deferred tax is not required to be calculated therefore.

You confirmation to the above treatment will be highly appreciated.

Opinion: The Committee would like to draw your attention to the following paragraphs of IAS 12 'Income Taxes':

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

(a) the initial recognition of goodwill; or

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

(i) is not a business combination; and

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

20 IFRSs permit or require certain assets to be carried at fair value or to be revalued (see, for example, IAS 16 Property, Plant and Equipment, IAS 38 Intangible Assets, IFRS 9 Financial Instruments and IAS 40 Investment Property). 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. In other jurisdictions, the revaluation or restatement of an asset does not affect taxable profit in the period of the revaluation or restatement and, consequently, the tax base of the asset is not adjusted. Nevertheless, the future recovery of the carrying amount will result in a taxable flow of economic benefits to the entity and the amount that will be deductible for tax purposes will differ from the amount of those economic benefits. The difference between the carrying amount of a revalued asset and its tax base is a temporary difference and gives rise to a deferred tax liability or asset.

This is true even if:

(a) the entity does not intend to dispose of the asset. In such cases, the revalued carrying amount of the asset will be recovered through use and this will generate taxable income which exceeds the depreciation that will be allowable for tax purposes in future periods; or

(b) tax on capital gains is deferred if the proceeds of the disposal of the asset are invested in similar assets. In such cases, the tax will ultimately become payable on sale or use of the similar assets.

In view of the above, the Committee is of the opinion that the deferred tax should be recognized.

(April 15, 2011)

1.10 REQUIREMENT OF RELATED PARTY TRANSACTIONS IN CODE OF CORPORATE GOVERNANCE

Enquiry: We are multinational listed automobile company, we purchase raw materials from our associated company in Japan.

With reference to the clause (xiii a) of Code of Corporate Governance, it requires that:

"The Board of Directors of a company shall approve the pricing methods for related party transactions that were made on the terms equivalent to those that prevail in arm's length transaction only if such terms can be substantiated."

We have certain following queries on the above clause:

1) Code has not prescribed any pricing methods for related party transactions. What are the pricing methods? Does it require the same methods prescribed under the Income Tax rules or OECD guidelines? Existing provisions of the code are silent on pricing methods. Therefore, the listed company can approve any pricing method to comply with the requirement of the code.

2) Code has also not mentioned the responsibility, is it the responsibility of buyer or seller in the case of sale/purchase of goods or services?

   In our case, we are the buyer and purchase raw materials from Japan. We have been making the transactions since many years. Any change in prices is negotiated between the parties which are based on the factors changed, it is just the simple negotiation process, as between the unrelated parties.

   It is the basic fact that no seller would disclose its pricing structure to its buyer that he is using either Cost plus or Resale price method. How the buyer can know the pricing method.

   We recommend that it should be the responsibility of seller to disclose and approve the pricing method.

3) What are the benefits of this approval of the method by the board of directors? Because it is not related to income tax or other transfer pricing laws.

Opinion: The Committee's opinion on the three queries raised by you is as follows:

1. Currently there is no pricing method prescribed in the Fourth Schedule and the Code of Corporate Governance, however following pricing methods are internationally used and accepted which may be adopted for related party transactions:

   I Traditional transaction methods

   i. Comparable uncontrolled price method
   ii. Resale price method
   iii. Cost plus method

   II Transactional profit methods

   iv. Transactional net margin method
   v. Transactional profit split method

2. It the responsibility of the reporting entity to approve the pricing method.

3. With regard to your third point regarding benefits of the approval of the method by the board of directors the Committee would not like to give any opinion on this as it does not come under the purview of this Committee.

(February 17, 2011)

1.11 SEPARATE AUDITED FINANCIAL STATEMENT BEFORE COURT ORDER OF MERGER

Enquiry: A Company has applied to the Court for merger with another Company and the order from the Court was made after expiry of submission due date of its annual audited financial statement to the members as well as to the Commission. The Company has not submitted its separate annual audited financial statement on its due date pertains to the year end only due to reason that the case of merger was pending in the Court.

<u>*Chronological Order of Events:*</u>

Date of Application to the Court	November 14, 2009
Effecting Date of Merger (in application)	November 30, 2009
Financial Year End (closing date)	December 31, 2009
Audited Annual Account Submission Due Date	April 30, 2010
Court Order Date (for approval)	July 14, 2010

As per our understanding, at the time where the Company was supposed to submit its audited accounts should submit its under discussion accounts separately (non merged accounts) on the due date even if the matter of merger was sub-judice in the court, whereas subsequent to the order of Court and approval the merger was passed and should disclose the facts in the note to the financial statement.

We think that the merger has nothing to do with the filing of accounts and the accounts should be presented to the members at the time allowed by the Ordinance or the extended time allowed by the Commission.

We believe that the company has violated the law by not submitting the said accounts in its time as required under section 233 of the Companies Ordinance, 1984.

We shall be grateful for your valuable comments on the aforesaid matter as to whether the Company should submit the separate audited accounts on or before April 30, 2010 or not.

Opinion: For ready reference the Committee likes to draw your attention to the following clauses of section 233 of the Companies Ordinance 1984:

(1) The directors of every company shall at some date not later than eighteen months after the incorporation of the company and subsequently once at least in every calendar year lay before the company in annual general meeting a balance sheet and profit and loss account or in the case of a company not trading for profit an income and expenditure account for the period, in the case of the first account for the period since the incorporation of the company and in any other case since the preceding account, made up to a date not earlier than the date of the meeting by more than four months:

Provided that, in the case of a listed company the Commission, and in any other case the registrar, may for any special reason, extend the period for a term not exceeding one month.

(2) The period to which the accounts aforesaid relate shall not exceed twelve months except where special permission has been granted in that behalf by the registrar.

(5) A listed company shall, simultaneously with the dispatch of the balance sheet and profit and loss account together with the reports referred to in sub-section (4), send five copies each of such balance sheet and profit and loss account and other documents to the Commission, the stock exchange and the registrar.

Based on above, the Committee is of the opinion that the Company should have complied with the above sections of the Companies Ordinance, 1984.

(November 8, 2010)

.   AUDITING

2.1   AUDIT FEE OF FUND IN ATR - 14

Enquiry: Our client is an Endowment Fund and as per the criterion laid down in ATR-14, it falls into the category of "Medium Size Entity", though the volume of transactions is small.

The main object of the Fund is to provide perpetual source of income to supplement the income of the parent organization which is an educational institution running on commercial lines but also receives grants from the government regularly.

Guidance is required as to whether the fee for the audit of the Fund should be charged as per paragraph 11 or paragraph 4 of the subject ATR.

Opinion: The Committee has examined your enquiry and is of the opinion that ATR -14 appears to apply to the said organization provided that it is neither charitable institution nor a 'not for profit organization'.

(July 8, 2010)

2.2   AUDIT FEE OF STATUTORY AUDITORS

Enquiry: We would like to submit that our statutory auditors while offering their services for re-appointment for the year ending September 30, 2010 had requested in their consent letter dated December 14, 2009 that their audit fee may be fixed with mutual agreement in accordance with the guidelines given in ATR-14 of ICAP.

In consultation and mutual agreement with the auditors, their audit fee for the year ending September 30, 2010 was fixed in accordance with the guideline given in ATR-14 based on our turnover for the year ended September 30, 2009 and the Board of Directors recommended for re-appointment of the auditors on the agreed fee by the shareholders in the AGM. The auditors were re-appointed and the recommended fee for the year ending September 30, 2010 was approved by the shareholders in our AGM held on January 30, 2010 including the extra fee for CCG and limited scope review of Half Yearly Accounts.

The turnover of our company for the year ending September 30, 2010 (for which the auditors were appointed) has increased due to rise of sugar price in the market. The process of audit is underway but the auditors are insisting to charge increased audit fee for the year ending September 30, 2010 based on the turn over for the year whereas the audit fee for the year is already approved by shareholders in the AGM based on the turnover of last year with mutual consent of Auditors.

Your guidance is needed whether the auditors are justified in insisting to charge increased audit fee than that agreed by them and approved by shareholders for the year ended September 30, 2010 based on the turnover of the year, or they may request to increase their audit fee for the next year i.e. September 30, 2011, which will be mutually agreed and put up before our shareholders for their approval in the forthcoming AGM scheduled to be held in January, 2011.

Opinion: For ready reference the Committee likes to draw your attention to the following clauses of section 252 of the Companies Ordinance 1984:

252. Appointment and remuneration of auditors.

(1) Every company shall at each annual general meeting appoint an auditor or auditors to hold office from the conclusion of that meeting until the conclusion of the next annual general meeting:

(8) The remuneration of the auditors of a company shall be fixed,—

(a) in the case of an auditor appointed by the directors or by the Commission, as the case may be; and
(b) in all other cases, by the company in general meeting or in such manner as the general meeting may determine.

Based on above, the Committee is of the opinion that the Company is required to pay the audit fee fixed or approved in the AGM keeping in view the requirements of audit fee referred to in ATR 14.

(November 8, 2010)

2.3 ISSUANCE OF AUDITORS' REPORT

Enquiry: One of our clients (a private limited company) applied for financing from a bank and provided to the bank financial statements for last three years audited by its statutory auditors (which are not the "Category A" class Audit Firm on the panel of SBP of Auditors) along with other documents needed and as required by the bank for the financial accommodation. Later, the bank approved the financing facilities with the following condition in its approval letter:

"The company shall provide financial statements for the year 2008, 2009, 2010 and future years audited by "Category A" class Audit Firm as mentioned on SBP Panel of Auditors under BSD Circular letter No. 12 dated 16-9-2010.

Now, the company wants to get its financial statements audited by "Category A" class Audit Firm. Please provide us technical opinion, if the company can get its financial statements for last three years re-audited by "Category A" class Audit Firm on the specific request of the management of the company for exclusive use of the bank/financial institution, and if so, does the audit report may be addressed to board of directors using the format of Form 35-A, or should use any other format for auditors report i.e. format of Auditors report under IAS 700 "Forming an opinion and reporting on financial statements" (Paragraphs 20-45).

Opinion: The Committee is of the view that the re-audit of the financial statements of the Company should be carried out in accordance with the specific terms of engagement and should not be considered as a statutory audit.

The Committee is also of the view that auditor's report may be issued under IAS 700 'Forming an opinion and Reporting on Financial Statements'.

(April 15, 2011)

2.4 CERTIFICATE OF NET CAPITAL OF MEMBERS OF KARACHI STOCK EXCHANGE (KSE)

Enquiry: With reference to above subject matter, we are enclosing herewith form of certificate issued by the KSE for reporting on net capital of members of the KSE. The format uses the words 'audited' whereas auditors only arrives at figure by examining ledgers and no other audit procedures are performed. We understand that this engagement may be undertaken as per ISRS No. 4400 'Engagement to perform Agreed upon Procedures Regarding Financial Information'. Considering this, we request you to provide us appropriate advice to understand and appropriately discharge our reporting responsibilities.

Opinion: The Committee considered your enquiry and is of the view that the certification of Net Capital Balance does not fall under the scope of ISRS No. 4400 'Engagement to perform Agreed upon Procedures Regarding Financial Information' rather it is an Assurance Engagement and appropriate assurance procedures would need to be performed to enable the auditor to issue the required certificate.

Further, as this certification is a regulatory requirement on the basis of audit/ review therefore the form of certificate provided by KSE may be followed for the purpose.

(April 15, 2011)

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