



Selected Opinions Volume XVII

From July 1, 2011 to June 30, 2012

Compiled by

Technical Services Directorate

The Institute Of Chartered Accountants Of Pakistan

INTRODUCTION

This report is the seventeenth compilation of selected opinions issued by the Technical Advisory Committee on inquiries raised by the members and other agencies during the period from July 2011 to June 2012 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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ACCOUNTING

1.1 TEMPORARY EXCHANGE FLUCTUATION

Enquiry: Various financial reporting standards, dealing with valuation of assets and liabilities, including financial assets and liabilities, suggest that temporary fluctuation in value should not be considered while valuing an asset or liability. However, as far as IAS 21 is concerned, it requires each financial asset and liability to be recognized on closing date exchange rate prevailing at each reporting date.

Now we request Institute's guidance on the matter that if the fluctuation in the exchange rates movement is temporary, i.e. exchange rate is artificially high or artificially low as on reporting and represent a "kink" or a "dip" in the curve of exchange rate movements over a close period, does accounting standards still require any reporting entity to value its financial assets and liabilities at such abnormal closing date's rate or allow to use another rate for a meaningful presentation and reporting of a foreign exchange financial asset or liability?

Such question arises with more strength when impairment in the form of "exchange loss" is recognized in a period which requires to be reversed in the next month just due to correction in exchange rate movement.

Opinion: The Committees would like to draw your attention towards the following paragraphs of IAS 21 (revised):

BC24 The previous version of IAS 21 allowed a limited choice of accounting for exchange differences that arise 'from a severe devaluation or depreciation of a currency against which there is no practical means of hedging and that affects liabilities which cannot be settled and which arise directly on the recent acquisition of an asset'.* The benchmark treatment was to recognise such exchange differences in profit or loss. The allowed alternative was to recognize them as an asset.

BC25 The Board noted that the allowed alternative (of recognition as an asset) was not in accordance with the Framework for the Preparation and Presentation of Financial Statements because exchange losses do not meet the definition of an asset. Moreover, recognition of exchange losses as an asset is neither allowed nor required by any liaison standard-setter, so its deletion would improve convergence. Finally, in many cases when the conditions for recognition as an asset are met, the asset would be restated in accordance with IAS 29 Financial Reporting in Hyperinflationary Economies. Thus, to the extent that an exchange loss reflects hyperinflation, this effect is taken into account by IAS 29. For all of these reasons, the Board removed the allowed alternative treatment and the related SIC Interpretation is superseded.

Keeping in view the above, the Committee is of the view that IAS 21 does not require any reporting entity to value its financial assets and liabilities at any rate other than the closing rate.

(December 28, 2011)

1.2 DEFERRED TAXATION

Enquiry: Our client is an unlisted public limited company. We seek your advice regarding the recognition of deferred tax asset / liability.

Due to admissible lease rent and substantial amount of unabsorbed tax depreciation losses normal tax is not likely to be payable for a number of years. However, on the other hand due to increase in the rate of minimum turnover tax applicable to the company there will be no benefit to the company in the future years for the aforesaid unabsorbed tax depreciation losses/business losses. The only benefit available to the company in future may be on account of credit for turn over tax paid, provided the same does not expire and there is sufficient taxable profit.

The company has been recognizing deferred tax asset/liability in the past keeping in view the temporary differences between the tax base of assets or liability and its carrying amount in the statement of financial position. Para IN4 of IAS 12 (revised) requires the recognition of deferred tax asset when it is probable that taxable profits will be available against which the deferred tax asset can be utilized, there are sufficient taxable differences and there is convincing other evidence that sufficient taxable profit will be available. Para IN6 of the Standard prohibits recognition of such deferred tax liabilities to the extent that the temporary difference will not reverse in the foreseeable future. In case of prohibition resulting in no deferred tax liability only disclosure of the aggregate amount of the temporary differences concerned is required.

In view of the above, we understand that as the timing differences on account of accelerated tax depreciation, lease rental tax expenses etc. will not be reverse, no deferred taxation is to be provided there against. Deferred tax asset to the extent of turnover tax paid should however be recognized to the extent of the amount likely to be offset against tax of future normal taxable income.

We shall be grateful if you will kindly confirm that our above understanding is correct. In such situation when only turnover tax asset adjustable in future will be recognized as deferred tax asset whether separate disclosure for other non-reversible timing differences is also required? Alternatively, what other options are available to the entity to comply with IAS 12.

Opinion: The Committees would like to draw your attention towards the following paragraphs of IAS 12 (revised):

- 35 The criteria for recognising deferred tax assets arising from the carry forward of unused tax losses and tax credits are the same as the criteria for recognizing deferred tax assets arising from deductible temporary differences. However, the existence of unused tax losses is strong evidence that future taxable profit may not be available. Therefore, when an entity has a history of recent losses, the entity recognises a deferred tax asset arising from unused tax losses or tax credits only to the extent that the entity has sufficient taxable temporary differences or there is convincing other evidence that sufficient taxable profit will be available against which the unused tax losses or unused tax credits can be utilised by the entity. In such circumstances, paragraph 82 requires disclosure of the amount of the deferred tax asset and the nature of the evidence supporting its recognition.
- 36 An entity considers the following criteria in assessing the probability that taxable profit will be available against which the unused tax losses or unused tax credits can be utilised:
 - (a) whether the entity has sufficient taxable temporary differences relating to the same taxation authority and the same taxable entity, which will result in taxable amounts against which the unused tax losses or unused tax credits can be utilised before they expire;

(b) whether it is probable that the entity will have taxable profits before the unused tax losses or unused tax credits expire;

(c) whether the unused tax losses result from identifiable causes which are unlikely to recur; and

(d) whether tax planning opportunities (see paragraph 30) are available to the entity that will create taxable profit in the period in which the unused tax losses or unused tax credits can be utilised.

To the extent that it is not probable that taxable profit will be available against which the unused tax losses or unused tax credits can be utilised, the deferred tax asset is not recognised.

82 An entity shall disclose the amount of a deferred tax asset and the nature of the evidence supporting its recognition, when:

(a) the utilisation of the deferred tax asset is dependent on future taxable profits in excess of the profits arising from the reversal of existing taxable temporary differences; and

(b) the entity has suffered a loss in either the current or preceding period in the tax jurisdiction to which the deferred tax asset relates.

Based on above, the Committee is of the view that no deferred taxation is to be recognised when the temporary differences are not expected to reverse in future.

With regard to your second query, the Committee is of the view that separate disclosure for other non-reversible timing differences is not required.

(December 28, 2011)

1.3 PRESENTATION OF NON CONTROLLING INTEREST IN CONSOLIDATED FINANCIAL STATEMENTS

Enquiry: Preparation of consolidated financial Statements of a family owned Holding and Subsidiary company is in progress. Both the companies are managed/owned by the same family however 40% shares of subsidiary are directly owned by the family whereas 60% owned by the Holding company.

What should be the presentation/accounting treatment in consolidated financial statements of Non Controlling interest artificially arise due to holding of subsidiary shares in individual capacity by the shareholders.

Opinion: The Committee would like to draw your attention to the definitions of 'Non-controlling interest' and 'Parent' given in IAS 27 'Consolidated and Separate Financial Statements':

Non-controlling interest is the equity in a subsidiary not attributable, directly or indirectly, to a parent.

A **parent** is an entity that has one or more subsidiaries.

The Committee is of the view that it is evident from the above that direct shareholding by individual family members in the subsidiary company will not be converted into controlling interest even though the same family members are shareholders of the holding company.

(March 1, 2012)

1.4 ACCOUNTING TREATMENT OF AN INVESTMENT IN A GROUP COMPANY

Enquiry: The query pertains to accounting treatment of an investment in a group company and whether to treat the investment as an associate under IAS - 28 or not.

Companies involved are as follows;

Holding Company A (a public unlisted company) owns 66.66% shares of Our Company B (a listed company) and 60.36% of Company C (a private company).

Company B owns 9.09% shares of Company C.

The Management (of Company B) believes that it has no influence on the financial and operating policies of the investee company (Company C) and projecting it as an associate under IAS - 28 will give wrong impression to the shareholders of the Company B (the company is listed). The query pertains to Company B's investment in Company C.

Holding Company A has placed three non executive directors on the board of the Company B, two of them are also the non executive directors and one is an executive director of Company C.

The management of Company B understands that Company B and Company C are related parties but pleads that these are not associated undertakings under IAS-28 as no significant influence exist over the Company C and so associate accounting should not be done in the consolidated financial statements.

The management has taken its view from IAS-28 itself as it states that:

"If an investor holds, directly or indirectly (e.g. through subsidiaries), 20 per cent or more of the voting power of the investee, it is presumed that the investor has significant influence, unless it can be clearly demonstrated that this is not the case. (*Company C does not hold 20% or more shareholding.*)

Conversely, if the investor holds, directly or indirectly (e.g. through subsidiaries), less than 20 per cent of the voting power of the investee, it is presumed that the investor does not have significant influence, unless such influence can be clearly demonstrated. A substantial or majority ownership by another investor does not necessarily preclude an investor from having significant influence. (*It clearly states that in less than 20% holding, it should be presumed that it is not significant influence unless some factors demonstrate otherwise and Company has 9.09% shares*)"

Further, Standard gives examples of factors which can give rise to significant influence when having less than 20% ownership as follows:

The existence of significant influence by an investor is usually evidenced in one or more of the following ways:

- (a) representation on the board of directors or equivalent governing body of the investee;
(Management pleads that representation on board would mean any of Company B's employee or executive director on the board of Company C. Merely common directorship through non executive directors does not include representation on the board of directors. None of the employee or executive director of Company B is a director of Company C and therefore Company B has no representation on the Board of Company C).

- (b) participation in policy-making processes, including participation in decisions about dividends or other distributions; (No decision making rest with Company B)
- (c) material transactions between the investor and the investee;
(The only transaction is purchase of office space in the building being owned and constructed by Company C. The portion is approximately 5% of the total project. Other than that only shares have been purchased of Company C which is 9.09% of total share capital. Company C has not made any investment or any other transaction with Company B.)
- (d) interchange of managerial personnel; (There is no interchange of managerial personnel) or
- (e) provision of essential technical information. (None)

Further points to be considered:

- 1) Holding Company A has placed three non executive directors on the board of the Company B, two of them are also the non executive directors and one is an executive director of Company C.
- 2) Company B is a listed entity. Management believes that presenting Company C as associate in the financial statements may give a wrong information to minority shareholders.
- 3) Company C is a private company but has 26% ownership from outside the group and is also bound by the debt contract with the foreign lender as the project is majorly financed by the foreign lender.
- 4) Some views suggests that company C is an associate undertaking under IAS 28 based on COMMON DIRECTORSHIP and they believe that investment in group company automatically qualifies for associate accounting.
- 5) Share holding of Company A in Company B and Company C includes shareholding of directors of the company A.
- 6) The management of Company B has determined that it has no influence on the financial and operating policies of Company C.

Assistance of the esteemed technical committee is requested so that we can follow the treatment in our separate and consolidated financial statements.

Opinion:

Paragraph 7 (a) of IAS 28 'Investment in Associate' as also reproduced in your enquiry clearly says that investor has significant influence when the investing company has representation on the board of directors of the investee.

Based on above, the Committee is of the view that Company C is an associate undertaking as per IAS 28 based on the ground of Common Directorship.

(March 1, 2012)

1.5 INTERPRETATION OF SEC 208 OF THE COMPANIES ORDINANCE 1984

Enquiry:

As per the requirements of Sec 208 of the Companies Ordinance 1984 (Investment in Associated Companies), Loans and Advances (not in the nature of normal trade credit) given by an associated undertaking to other, form part of the definition of Investments that should be authorized by a special resolution. The question in this regard is whether

the interest amount cumulated on these loans and advances should be added up to the original principal balance of loans and advances for the purpose of complying with the **limit on investment** as mentioned in the relevant forms (Form 26 and 30) of the special resolution pertaining to Sec. 208.

Apparently, the wording of Sec 208 leads us to believe that the investment mentioned in this section, that should be authorized by special resolution mainly refers to the amount of investment at the time of initiation of original transaction i.e. at the time of the giving of loans and advances and not the subsequent impact of the interest impact added up to the original principal balance. Please clarify?

Opinion: The Committee examined your query and is of the view that investment under section 208 of the Companies Ordinance 1984 refers to the amount of investment at the time of initiation of original transaction i.e. at the time of the giving of loans and advances.

(March 1, 2012)

1.6 APPLICABLE TAX RATE ON SHARE OF SURPLUS ON REVALUATION OF PROPERTY PLANT AND EQUIPMENT OF ASSOCIATE

Enquiry: Company A and B are the associated companies due to common directorship. Company A also has 20% shareholding in Company B and cost of investment is Rs 1,000,000/-. Being associated, the Company A applies equity method of accounting in its books, in accordance with the provision of IAS 28 'Investment in Associate'.

Company B revalues its Plant, Property and Equipment that result in surplus of Rs. 50,000,000/-. Due to this revaluation, Company A accounts for its share of surplus on revaluation of plant, property and equipment of associate in its books, which is Rs 10,000,000/ i.e. 20% of Rs. 50,000,000/- and discloses this amount in its Account under the head "surplus on revaluation of property plant and equipment" in accordance with the provision of Section 235 of the Companies Ordinance.

Normal tax rate on the profits of the Company A is 35%. Company A however, computes deferred tax liability on this surplus at the rate of 10%, instead of 35% and submits its argument that:

"Amount received from investment will be in form of Dividend and the rate of tax on Dividend received by public listed company is 10%, therefore rate of deferred tax on share of associate is considered @ 10%".

Moreover, auditor of the Company also furnished its comments which are as follows:

"In view of the holding period of the investment in associate and absence of evidence intent to sell, management considers that carrying value of investment in associate will be recovered through use (i.e. recovery via dividend). Accordingly applicable tax rate for dividend income received from a company under Division III of Part I of First Schedule of Income Tax Ordinance 2001 should be used to measure the deferred tax on taxable temporary difference on investment in associate."

In view of above, please confirm applicable tax rate (10% or 35%) for computation of deferred tax liability on share of surplus on property plant and equipment of associate?

Opinion: The Committee would like to draw your attention to the following paras of IAS 12 'Income Taxes' (underline is ours):

38 Temporary differences arise when the carrying amount of investments in subsidiaries, branches and associates or interests in joint ventures (namely the parent or investor's share of the net assets of the subsidiary, branch, associate

or investee, including the carrying amount of goodwill) becomes different from the tax base (which is often cost) of the investment or interest. Such differences may arise in a number of different circumstances, for example:

- (a) the existence of undistributed profits of subsidiaries, branches, associates and joint ventures;
- (b) changes in foreign exchange rates when a parent and its subsidiary are based in different countries; and
- (c) a reduction in the carrying amount of an investment in an associate to its recoverable amount.

In consolidated financial statements, the temporary difference may be different from the temporary difference associated with that investment in the parent's separate financial statements if the parent carries the investment in its separate financial statements at cost or revalued amount.

- 42 An investor in an associate does not control that entity and is usually not in a position to determine its dividend policy. Therefore, in the absence of an agreement requiring that the profits of the associate will not be distributed in the foreseeable future, an investor recognises a deferred tax liability arising from taxable temporary differences associated with its investment in the associate. In some cases, an investor may not be able to determine the amount of tax that would be payable if it recovers the cost of its investment in an associate, but can determine that it will equal or exceed a minimum amount. In such cases, the deferred tax liability is measured at this amount.
- 47 Deferred tax assets and liabilities shall be measured at the tax rates that are expected to apply to the period when the asset is realised or the liability is settled, based on tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period.
- 51 The measurement of deferred tax liabilities and deferred tax assets shall reflect the tax consequences that would follow from the manner in which the entity expects, at the end of the reporting period, to recover or settle the carrying amount of its assets and liabilities.
- 51A In some jurisdictions, the manner in which an entity recovers (settles) the carrying amount of an asset (liability) may affect either or both of:
- a. the tax rate applicable when the entity recovers (settles) the carrying amount of the asset (liability); and
 - b. the tax base of the asset (liability).
- In such cases, an entity measures deferred tax liabilities and deferred tax assets using the tax rate and the tax base that are consistent with the expected manner of recovery or settlement.

Based on above, in determining whether tax on the temporary differences arising from an investment in an associate should be provided for on a rate based on use, or based on disposal, consideration is to be given to the expected manner of recovery of the investment.

If Company A intends not to hold the investment in associate for a long term, then recovery of investment is assumed to be through disposal of shares; which would consequently be liable to tax at rates applicable for capital gains for a company.

Where Company A intends to hold investment in associate for long term then recovery of the investment may be assumed through dividends; consequently chargeable at the rates of dividends.

(May 18, 2012)

1.7 ACCOUNTING TREATMENT OF REAL ESTATE DEVELOPMENT BUSINESS

Enquiry: Our Company has diversified its business by carrying out a large scale mixed use Real Estate Development on the land owned by the Company. A housing scheme has been launched during the current financial year, which has raised certain unprecedented questions on treatment of revenue and related expenses. Following is the detailed background, project structure and related accounting queries:

Background

The Company was incorporated in 1961 engaged in the production of cement. Due to obsolescence of technology used in the production of cement, the Company changed its business strategy and shifted its business towards real estate. As a result, management decided that they would develop the land and would sell it in the ordinary course of business. Recently, management has started selling plots of the land into various phases as discussed in project status below.

Project Structure

The land development business of the Company is structured as follows:

1. The project is divided in to various phases, out of which phase 1 has been launched. Phased 1 consists of four blocks namely;
 - a. Block A - Consists of open plots of land
 - b. Block B - Consists of constructed bungalows
 - c. Block C - Consists of open plots of land (Similar to Block A)
 - d. Block D - Consists of open plots of land (Similar to Block A)
 - i) Contruction on open plots of land will be made by the allottee in accordance with design (exterior) approved by the Company. The allottees will be allowed to start construction work after they have obtained possession and title has been transferred to them.
 - ii.) Bungalows in Block "B" will be constructed by the Company in accordance with their standard design. The Allottee has no right to change basic structure and outer design of bungalow. However minor alteration may be made on the request of allottee.
2. The housing colony will be constructed which will include Mosque, hospital, schools etc. This housing colony will be completed in five years.
3. Possession and title of open plot of lands (Block A, B, C or D) will be transferred to allottees after building housing colony as discussed in 2 above, subject to payments of all installments received by the Company.
4. Similarly, possession and title of constructed bungalow (Block B) will also be transferred to allottees after building housing colony as discussed in 2 above, subject to payments of all installments received by the Company.

Accounting Queries

Considering the above background and project structure, our questions are as follows:

1. Are the agreements to sell open plots of land and constructed bungalows within the scope of IAS 11 or IAS 18?
2. When should the revenue from the sale of open plots and constructed bungalows be recognized?
3. What will be the accounting treatment for marketing, selling and administrative expenses? Will the incurring of this expense without any corresponding revenue be against the matching concept of accounting standards as applicable in Pakistan?

While answering to the above queries it should be kept in mind that the Company is a public listed Company and to the best of our knowledge no other company with similar business exists in Pakistan.

Opinion: The Committee considered your enquiry and its views on each question are as follows:

1. The Committee would like to draw your attention to the following paras of IAS 2 'Inventories' and IAS 18 'Revenue' (underline is ours):

IAS 2

- 6 **Inventories** are assets:
 - (a) held for sale in the ordinary course of business;
 - (b) in the process of production for such sale; or
 - (c) in the form of materials or supplies to be consumed in the production process or in the rendering of services.
- 8 Inventories encompass goods purchased and held for resale including, for example, merchandise purchased by a retailer and held for resale, or land and other property held for resale..... In the case of a service provider, inventories include the costs of the service, as described in paragraph 19, for which the entity has not yet recognised the related revenue (see IAS 18 Revenue).

IAS 18

Revenue is defined in IAS 18 as follows:

Revenue is the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants.

Your attention is also drawn to the following paragraph of IFRIC 15 'Agreements for the Construction of Real Estate':

- 12 In contrast, an agreement for the construction of real estate in which buyers have only limited ability to influence the design of the real estate, e.g. to select a design from a range of options specified by the entity, or to specify only minor variations to the basic design, is an agreement for the sale of goods within the scope of IAS 18.

Based on above, selling of open plots of land and construction of bungalows is an ordinary course of business of the company. Further, in accordance with the requirement of para 12 of IFRIC 15 the buyers have only limited ability to influence the design of the real estate which is also a condition in your stated case (para1(ii) of your enquiry).

Keeping in view of above, the Committee is of the view that the company will recognize the revenue in accordance with the requirements of IAS 18.

2. The Committee is of the view that the revenue from the sale of open plots and constructed bungalows will be recognized when all the requirements of para 14 of IAS 18 are fulfilled. Relevant paras of IAS 18 are reproduced below:

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.....

The Committee is also of the view that further guidance on transfer of risk and reward of ownership in case of agreement for sale of goods may be obtained from para 16-18 of IFRIC 15.

3. The Committee would like to draw your attention to the following paras of IAS 2 'Inventories'(underline is ours):

15 Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition. For example, it may be appropriate to include non-production overheads or the costs of designing products for specific customers in the cost of inventories.

16 Examples of costs excluded from the cost of inventories and recognised as expenses in the period in which they are incurred are:

(a) abnormal amounts of wasted materials, labour or other production costs;

(b) storage costs, unless those costs are necessary in the production process before a further production stage;

- (c) administrative overheads that do not contribute to bringing inventories to their present location and condition; and
- (d) selling costs

In view of the above, the Committee is of the opinion that any cost which is necessary to bringing the inventories to their present location and condition should be included in the cost of inventories except the cost excluded in para 16 above.

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

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

It will not be against the concept of matching principle as the nature of business of the company is such that in the initial years the company will have to incur heavy marketing expenses without any corresponding revenue. However, in the subsequent years, these expenses will be automatically adjusted with the earning of revenue from customers.

Further, please refer Selected Opinion No.1.1 of Vol. XII issued by Institute in 2007 on the same issue. Relevant para of the selected opinion is also reproduced below:

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

(May 18, 2012)

1.8 APPLICATION OF IRR ON HFT CATEGORIZED INSTRUMENT

Enquiry: This is with reference to the requirement of para 30 of IAS-18 “Revenue Recognition” which states that:

“Revenue shall be recognized on the following bases:

- a) interest shall be recognized using the effective interest method as set out in IAS 39, paragraphs 9 and AG5–AG8;.....”

Para 9 of IAS-39 states that;

“The effective interest method is a method of calculating the amortized cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) and of
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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)."

Linking the requirement of IAS-18 with the para 9 of IAS 39, IAS-18 para 30 require the recognition of markup income using effective interest rate method which in the light of IAS 39 para 9 will result in amortized cost of the instrument irrespective of the category. That suggests that whenever one applies the effective interest rate methodology, it consequently will impact the amortized cost of the instrument. It is important to note here that IAS-18 did not put any restriction of the classification of instrument i.e. through PL, AFS and HTM.

Our deliberation to above mentioned requirement for an instrument that is classified in HFT or Through Profit or loss category are narrated as;

Income to be recorded on effective interest rate method

It resultantly will have impact on the amortized cost (carrying cost) of the instrument. As the instrument is classified as HFT /Through P&L, it needs to be mark to market at the current market price. The impact on amortized cost of the instrument would ultimately have implications of unrealized gain / loss as well.

Let's check this numerical example;

Example of calculating amortized cost; debt instrument with stepped interest payments

Sometimes entities purchase or issue debt instruments with a predetermined rate of interest that increases or decreases progressively (stepped interest) over the term of the debt instrument. If a debt instrument with stepped interest and no embedded derivative is issued at CU 1,250 and has maturity amount of CU 1,250,

On 01 January, 2000 entity A issued a debt instrument for a price of CU 1250. The principle amount is CU 1250 and the debt instrument is repayable on 31 December 2004. The rate of interest and market value of the instrument each year would supposed to be as follows;

Year	Interest Rate	Market Value
2000	6%	100
2001	8%	101
2002	10%	102
2003	12%	103
2004	16.4%	104

Effective interest rate comes out to be 10%.

Impact Analysis on income statement of such an instrument classified as Held for Trading with markup recognized on IRR basis and instrument carried at market value would be as follows; (keeping other factors remains constant it is presumed that market rates will exactly move in upward direction to reflect the increasing return scenario of the instrument.)

Year	Carrying Cost Beginning	Interest Income (IRR)	Cash Flows	Amortized Cost	Market Rate (FV)	Market Value
2000	1250	125	75	1300	104.00	1300
2001	1300	130	100	1330	106.40	1330
2002	1330	133	125	1338	107.04	1338
2003	1338	134	150	1322	105.76	1322
2004	1322	133	1250+205	-		

Adding a little adjustment in the above scenario, suppose the market rate of the instrument is constantly reported as 100 for all four years despite the increase in interest rate of the instrument each year which is a case with most of instrument for which valuation is provided in the industry by one of the association.

Now there will be nil impact of IRR on the income statement as the incremental markup based on IRR will be offset exactly by the unrealized loss on revaluation.

Year	Carrying Cost Beginning	Interest Income (IRR 10%)	Cash Flows	Incremental income based on IRR	Principle repaid	Amortized Cost	Market Rate (FV)	Market Value	Unrealized (loss) for Year
	A	B=A*IRR	C=FV*Int rate	B-C		A+B-C			
2000	1250	125	75	50		1300	100	1250	(50)
2001	1300	130	100	30		1330	100	1250	(30)
2002	1330	133	125	8		1338	100	1250	(8)
2003	1338	134	150	(16)		1322	100	1250	16
2004	1322	133	205	(72)	1250	-			72

We would like to seek opinion of the technical committee of The Institute of Chartered Accountants of Pakistan on the implementation of requirement of IAS-18 para 30 (a) read with IAS-39 para 9 using the illustration above for HFT / Through P/L categorized instrument.

Opinion:

The Committee examined your enquiry and appreciates the concerns raised by you in the enquiry. The Committee would like to draw your attention to the following para of IFRS 7 'Financial Instruments: Disclosures': (underline is ours)

20 An entity shall disclose the following items of income, expense, gains or losses either in the statement of comprehensive income or in the notes:

(a)

(b) total interest income and total interest expense (calculated using the effective interest method) for financial assets that are measured at amortised cost or financial liabilities not at fair value through profit or loss.

The Committee is of the view that for financial assets at fair value through profit or loss, there is no need to distinguish between the fair value changes and interest income and

dividend or expense. However, fair value changes (net gains or net losses) on such instruments should be presented separately, if they are material. If interest income or expense includes both amounts from instruments at fair value through profit or loss and amounts from instruments not at fair value through profit or loss, then the disclosure of total interest income and total interest expense for financial assets that are not at fair value through profit or loss is required.

In addition, if interest is presented separately, then it should be measured on an effective interest basis and presented as interest income or expense. Your attention is also drawn to the following paras of IFRS 7 and IAS 1: (underline is ours)

IFRS 7

BC34 Some entities include interest and dividend income in gains and losses on financial assets and financial liabilities measured at fair value through profit or loss and others do not. To assist users in comparing income arising from financial instruments across different entities, the Board decided that an entity should disclose how the income statement amounts are determined. For example, an entity should disclose whether net gains and losses on financial assets or financial liabilities measured at fair value through profit or loss include interest and dividend income (see Appendix B, paragraph B5(e)).

B5(e) Paragraph 21 requires disclosure of the measurement basis (or bases) used in preparing the financial statements and the other accounting policies used that are relevant to an understanding of the financial statements. For financial instruments, such disclosure may include:

(a)-(d)

(e) how net gains or net losses on each category of financial instrument are determined (see paragraph 20(a)), for example, whether the net gains or net losses on items at fair value through profit or loss include interest or dividend income.

IAS 1

1.35 In addition, an entity presents on a net basis gains and losses arising from a group of similar transactions, for example, foreign exchange gains and losses or gains and losses arising on financial instruments held for trading. However, an entity presents such gains and losses separately if they are material.

1.82 As a minimum, the statement of comprehensive income shall include line items that present the following amounts for the period:

(b) finance costs;

The Committee is also of the view that the total of interest and other fair value change (gains/ losses) should not exceed the total of fair value changes (i.e. the changes in presentation will not affect the net results in the income statement).

In addition, the entity should also disclose within its accounting policies whether or not interest income and expense on items at fair value through profit or loss are separated.

The above may be illustrated (case A and B) as follows:

CASE A - POSITIVE FAIR VALUE CHANGES

	2011	2012
	----- Rs -----	
Fair value of financial assets	100	80

Total changes in fair value (100- 80)	20
Interest income <i>at effective interest basis</i>	5

CASE A - SOLUTIONS**Option 1 - Interest presented separately –at effective interest basis**

	2011	2012
Balance sheet	-----	Rs -----
Financial assets at fair value through profit or loss	100	80
Income statement		
Net changes in fair value (20- 5 interest)	15	
Interest income <i>at effective interest basis</i>	5	
Total Income	20	

Option 2 - Interest is not presented separately

	2011	2012
Balance sheet	-----	Rs -----
Financial assets at fair value through profit or loss	100	80
Income statement		
Changes in fair value (20- 10)	20	

CASE B- NEGATIVE FAIR VALUE CHANGES

	2011	2012
	-----	Rs -----
Financial assets at fair value through profit or loss	65	80
Total changes in fair value (65- 80)	(15)	
Interest income <i>at effective interest basis</i>	5	

CASE B - SOLUTIONS**Option 1 - Interest presented separately –at effective interest basis**

	2011	2012
Balance sheet	-----	Rs -----
financial assets at fair value through profit or loss	65	80
Income statement		
Net changes in fair value ((-15) – 5 interest)	(20)	
Interest income <i>at effective interest basis</i>	5	
Total Income	(15)	

Option 2 - Interest is not presented separately

	2011	2012
	-----	Rs -----
Balance sheet		
Financial assets at fair value through profit or loss	65	80
Income statement		
Changes in fair value (80- 65)	(15)	

(June 27, 2012)

1.9 RECOGNITION OF DEFERRED TAX ASSETS**Enquiry: BACKGROUND**

Company A is the listed company incorporated under Companies Ordinance 1984. The Company recognized deferred tax assets of Rs 200.667 million (2009: Rs 203.397 million) in its annual audited accounts for the year ended June 30, 2010 on account of deductible temporary difference in respect of unused tax losses. The Company stated the argument that *"deferred tax asset has been recognized based on the projections prepared by the management indicating reasonable profitability that taxable profits will be available in the foreseeable future against which the unused tax losses will be utilized"*.

The Auditor of the Company issued modified audit report on the Accounts 2010 stated that *"in our opinion and to the best of our information and according to the explanations given to us, the balance sheet, profit and loss, account, cash flow statement and statement of changes in equity together with the notes forming part thereof conform with approved accounting standards as applicable in Pakistan, and, give the information required by the Companies Ordinance, 1984, in the manner so required and, except for the fact that deferred tax asset has been recognized despite the availability of unused tax losses, give a true and fair view of the state of the Company's affairs as at 30 June, 2010 and of the profit, its cash flows and changes in equity for the year then ended"*.

Upon seeking clarification on modified audit opinion, the Auditor furnished the basis of his modified audit opinion and stated that "Considering the criteria prescribed by IAS 12 Income Taxes, availability of tax losses aggregating Rs 573.335 million and the general tax exemption granted by the federal Government under clause 126F of the second Schedule to the Income Tax Ordinance, the Company should not have recognized deferred tax asset as at June 30, 2010.

Next year ended June 30, 2011, the Company again recognized the deferred tax assets in respect of unused tax losses. However, auditor of the Company issued unmodified opinion on the Accounts for the year ended June 30, 2011, in respect of recognition of deferred tax asset.

Upon clarification auditor of the Company furnished the following justification:

- The Company recognized deferred tax assets based on the guidance available in IAS 12.
- The Company has achieved significant growth in turnover i.e. increase in sale of 26.5% during the year ended June 30, 2011 as compared to the previous year ended June 30, 2010.
- The company earned before tax profit of Rs 27.771 million for the year ended June 2011 as compared to Rs 21.652 million in previous year, thereby showing an increase of 28%.

- The Company during the financial year 2011 generated cash flow from operations aggregating Rs. 158.882 million as compared to Rs 147.786 million in previous year.

Auditors stated the report to the members was not modified on the following basis:

- Company made turn around as it is earning profit since year 2010, whereas Company sustained losses since year 2005.
- We had doubt about the projection made by the company during the year ended June 2010; therefore we modified the auditor's report.
- Profit and gains are exempted for the tax year 2010-12, under clause 126F of the second schedule of Income tax ordinance 2011.
- Auditors' opinion expressed on financial statement of one financial year cannot be compared with that of another year as different circumstances exist in both the years.
- It is the exclusive prerogative of the auditor to apply his professional judgment and express his opinion in accordance with the relevant provisions

QUERY

In view of above, you are requested to confirm the following:

1. Whether the Company should recognize the deferred tax assets on unused tax losses considering the following fact. At this point of time, it is important to point out the following:

- Profits of the Company are exempt for the period of three years from 2010 to 2012, since the general tax exemption has been granted by the Federal Government under clause 126F of the second Schedule to the Income Tax Ordinance.
- The Company sustained losses since year ended June 30, 2005.
- Profit before tax and after tax as on June 30, 2009 and June 30, 2010 of the Company is as follows:

	June 30, 2010	June 30, 2011
Profit before tax	Rs 21.652 million	Rs 27.771 million
Profit after tax	Rs 16.459 million	Rs 6.433 million

- The Company has accumulated losses as on June 30, 2009 and June 30, 2010 as Rs. 226.94 million and Rs 195.256 million respectively.
- The Company has aggregate tax losses of Rs 573.335 million as on June 30, 2010.
- The Company disclosed in its accounts 2010 that tax provision for the year ended June 30, 2010 is made under Section 113 of the Income Tax Ordinance.
- The Company disclosed in its Accounts 2011 that no adjustment has been incorporated in deferred tax asset account as taxable profits will not be available during the tax exemption period against which the deferred tax asset may be utilized.

2. Moreover please also confirm that whether the auditor of the company should:

- issue modified audit report for the year ended June 30, 2010 or not?
- modified his audit report for the year ended June 30, 2011 or not?

Opinion: The Committee deliberated on the issue based on the facts provided to us and is of the opinion that the entity should recognize deferred tax assets only to the extent that the entity has sufficient taxable temporary differences or there is convincing other evidence that sufficient taxable profit will be available against which the unused tax losses or unused tax credits can be utilised by the entity. The instances, where unused losses expire after a period, or where losses are not allowed to be carried forward to the next period, may inhibit creation of a deferred tax asset.

With regards to your second query, the Committee is of the view that expression of auditor's opinion on the financial statements is based on the professional judgment of the auditor taking in to account substance of the transaction and audit evidences obtained.

(June 27, 2012)

1.10 OBLIGATION TO FOLLOW IAS/IFRS BY GOVERNMENT INSTITUTION

Enquiry: A & Co. and B & Co are joint auditors of a government institution naming 'Korangi Fisheries Harbour Authority' (KoFHA) established under Ordinance No. XVI of 1982 as 'Korangi Fisheries Harbour Authority Ordinance 1982' (KoFHA Ordinance 1982). KoFHA is presently working under the administrative control of Federal Ministry for Ports & Shipping, GOP and is a Body Corporate like Port Qasim Authority. As such KoFHA, not being a company falls under the definition of sub clause (iii) of sub section 4 of section 2 of Companies Ordinance 1984. The creation of the Authority was notified in the Gazette of Pakistan dated July 12, 1982, copy of the Ordinance is attached.

As per KoFHA Ordinance 1982 related paragraphs of Audit and Accounts sections are as follows:

- (1) The accounts of the Authority shall be maintained by the Authority in such forms as may be prescribed by the Auditor-General of Pakistan consistent with the requirements of this Ordinance.
- (2) The accounts of the Authority shall be audited by not less than two auditors who are Chartered Accountants within the meaning of the Chartered Accountants Ordinance, 1961, appointed by the Federal Government in consultation with the Auditor-General of Pakistan, on such remuneration, to be paid by the Authority, as the Federal Government may fix.
- (3) Every auditor appointed under sub-section (2) shall be given a copy of the annual balance sheet of the Authority, and shall examine it together with the accounts and vouchers relating thereto and shall have a list delivered to him of all books kept by the Authority; and shall at all reasonable times have access to the books, accounts and other documents of the Authority, and may in relation to such accounts examine any officer of the Authority.
- (4) The auditors shall report to the Federal Government upon the annual balance sheet and accounts and in their report state whether in their opinion the balance sheet is a full and fair balance sheet containing all necessary particulars and properly drawn up so as to exhibit a true and correct view of the state of the Authority's affairs, and, in case they have called for any explanation or information from the Board, whether it has been given and whether it is satisfactory.

The Authority is not in the list of Exempt entities contained in Schedule 2 of Manual of accounting principles (MAP) issued by AGPR.

Here we want to know that:

1. Either Authority is under obligation to follow International Accounting Standards as applicable in Pakistan?
2. What will be the format of Auditors Report for audit of such institutions?
3. Can auditors qualify the Auditors' report on the basis of non compliance with any IFRS/IAS, if answer to question 1 is yes?
4. What will be the course of action available to management and either of joint auditors if there is dispute on the opinion between joint auditors?

Opinion: The Committee has examined your enquiry and its views on each of the questions raised are as follows:

1. The Committee would like to draw your attention to the following para of the 'KoFHA Ordinance 1982': (underline is ours)
 - 4(2) The Authority shall be a **body corporate** having perpetual succession and a common seal, with powers, subject to the provisions of this Ordinance, to acquire and hold property, both moveable and immovable, and shall by its name sue and be sued.

For further clarification your attention is drawn to the following paras of ISA 210 'Agreeing the Terms of Audit Engagements': (underline is ours)

3. The objective of the auditor is to accept or continue an audit engagement only when the basis upon which it is to be performed has been agreed, through:
 - (a) Establishing whether the preconditions for an audit are present; and
 - (b) Confirming that there is a common understanding between the auditor and management and, where appropriate, those charged with governance of the terms of the audit engagement
6. In order to establish whether the preconditions for an audit are present, the auditor shall:
 - (a) Determine whether the financial reporting framework to be applied in the preparation of the financial statements is acceptable; and (Ref: Para.A2–A10)

.....
- A3. Without an acceptable financial reporting framework, management does not have an appropriate basis for the preparation of the financial statements and the auditor does not have suitable criteria for auditing the financial statements. In many cases the auditor may presume that the applicable financial reporting framework is acceptable, as described in paragraphs A8–A9.
- A8. At present, there is no objective and authoritative basis that has been generally recognized globally for judging the acceptability of general purpose frameworks. In the absence of such a basis, financial reporting standards established by organizations that are authorized or recognized to promulgate standards to be used by certain types of entities are presumed to be acceptable for general purpose financial statements prepared by such entities, provided the organizations follow an established and transparent process involving deliberation and consideration of the views of a wide range of stakeholders. Examples of such financial reporting standards include:
 - International Financial Reporting Standards (IFRSs) promulgated by the International Accounting Standards Board;
 - International Public Sector Accounting Standards (IPSASs) promulgated by the International Public Sector Accounting Standards Board; and

- Accounting principles promulgated by an authorized or recognized standards setting organization in a particular jurisdiction, provided the organization follows an established and transparent process involving deliberation and consideration of the views of a wide range of stakeholders.

These financial reporting standards are often identified as the applicable financial reporting framework in law or regulation governing the preparation of general purpose financial statements.

- A10. When an entity is registered or operating in a jurisdiction that does not have an authorized or recognized standards setting organization, or where use of the financial reporting framework is not prescribed by law or regulation, management identifies a financial reporting framework to be applied in the preparation of the financial statements. Appendix 2 contains guidance on determining the acceptability of financial reporting frameworks in such circumstances.

Based on the information provided to us, it is clear that the KoFHA is a body corporate established by the Federal Government and not formed under the sub clause (iii) of sub section 4 of section 2 of Companies Ordinance 1984.

Keeping in view of above paras of ISA 210, the Committee is of the view that there should be an accounting framework mutually agreed between the management and the auditor according to which financial statements should be prepared. As the KoFHA Ordinance 1982 is silent about the applicable financial reporting framework, therefore, apparently the KoFHA is under no obligation to follow IAS/IFRSs as applicable in Pakistan.

The Committee would also like to refer following para of TR-5: (underline is ours)

- 2.6 Furthermore, while expressing an opinion on financial statements of public utility entities or similar entities that provide an essential public service or regulatory agencies that do not fall under the regulatory jurisdiction of SECP, such entities shall ensure that accounting frameworks as prescribed in their relevant statutes are complied with. However, where the relevant statute is silent or does not prescribe any accounting and financial reporting framework or treatment, the Institute recommends that such entity shall comply with IASs/IFRSs as applicable.

Based on the requirements of TR-5 the Committee is also of the opinion that if the relevant statute is silent or does not prescribe any accounting and financial reporting framework and it is difficult to determine the applicable financial reporting framework, it is recommended to comply with applicable IASs/IFRSs.

2. The Committee is of the view that the report format will be in accordance with the requirement of ISA 700 'Forming an Opinion and Reporting on Financial Statements':

However, in the opinion paragraph of the report, the requirements of subsection 18(5) of the 'KoFHA Ordinance 1982' could be used which is reproduced below: (underline is ours)

- 18(5) the auditors shall report to the Federal Government upon the annual balance sheet and accounts and in their report state whether in their opinion the balance sheet is a full and fair balance sheet containing all necessary particulars and properly drawn up so as to exhibit a true and correct view of the state of the Authority's affairs, and, in case they have

called for any explanation or information from the Board, whether it has been given and whether it is satisfactory.

3. If the applicable financial reporting framework is other than IAS/IFRS then the auditor's report cannot be qualified based on the non compliance with any IFRSs/IASs and vice versa. (refer answer no. 1)
4. Joint auditors are jointly liable for the audit. Any dispute between the two should be resolved before the issuance of auditor's report.

(June 27, 2012)

1.11 IMPAIRMENT OF AFS INVESTMENT AS PER IAS 39

Enquiry: ABC Company has made investment in shares and classified it as Available for sale investment. During the year the market value of shares is significantly below then its cost. As per paragraphs 67 to 70 of IAS 39 (2009 edition) its shares are impaired by Rs. 80 million, but in 2010 edition above paragraphs (67 to 70) have been deleted. Kindly advise us whether there is need to charge impairment or not. If yes and ABC Company refuse to charge impairment, what will be our course of action as an auditor? Please note that the above assets are marked to market and the resultant reduction in value has been charged to equity.

Some extract of financial information are:

Profit for the year (before impairment)	Rs.	120 million
Profit for the year (if impairment charged)	Rs.	40 million
Materiality	Rs.	5 million

Opinion: The Committee examined your enquiry and is of the view that para 67 to 70 of IAS 39 (2009 edition) will remain applicable until the Institute adopts IFRS 9 'Financial Instruments'.

(June 27, 2012)

AUDITING

2.1 OPINION REGARDING DATE OF SIGNING OF AUDIT REPORT BY THE EXTERNAL AUDITOR

Enquiry: The auditor initialled draft accounts for the year ended December 31, 2010 and same was submitted to its company along with the letter to the management of the company dated March 15, 2011 and it was stated therein that the accounts will be signed after these are approved by the management of the company and receipt of other necessary documents by the company as are required at the time of finalization of audit like representation letter.

The auditor however, received duly signed accounts by the management of the company on August 3, 2011 for signing of audit report. The examination of the Audit report in question revealed that, the date of signing of audit report was April 8, 2011. On inquiry, the Auditor of the company informed that they signed the audit report on April 8, 2011 due to the reason that, these accounts were approved by the management on April 8, 2011.

An opinion is sought as to whether, the auditor can sign and dated the audit report on back dates i.e. April 8, 2011 while the signed accounts have been received late i.e. August 8, 2011.

Opinion: The Committee would like to draw your attention to the following paras of ISA 700 'Forming an Opinion and Reporting on Financial Statements':

41. The auditor's report shall be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements, including evidence that: (Ref: Para. A38–A41)
 - (a) All the statements that comprise the financial statements, including the related notes, have been prepared; and
 - (b) Those with the recognized authority have asserted that they have taken responsibility for those financial statements.
- A38. The date of the auditor's report informs the user of the auditor's report that the auditor has considered the effect of events and transactions of which the auditor became aware and that occurred up to that date. The auditor's responsibility for events and transactions after the date of the auditor's report is addressed in ISA 560.
- A39. Since the auditor's opinion is provided on the financial statements and the financial statements are the responsibility of management, the auditor is not in a position to conclude that sufficient appropriate audit evidence has been obtained until evidence is obtained that all the statements that comprise the financial statements, including the related notes, have been prepared and management has accepted responsibility for them. (Underline is ours)

Based on the above, the Committee is of the view that the auditor should sign audit opinion after all the sufficient appropriate audit evidence has been obtained i.e. audit has been completed in all respects and the accounts have been duly approved by the management.

(Dec 28, 2011)

2.2 EXTERNAL AUDITOR CONFLICT OF INTEREST ON REVIEW WORK DIRECTLY RELATED TO SUBJECT MATTER OF ASSURANCE ENGAGEMENT

Enquiry: A brief synopsis of the matter and our query is as follows:

- The external auditors have been engaged by management for review work (agreed upon procedures) on a matter that is directly related to the subject matter of the assurance engagement and the auditor's report/opinion.
- The Chairman Audit Committee has stated to the CFO that this is a conflict of interest viz a vis the external auditor and Internal Audit has been corresponding with the CFO to provide Management's representation on the engagement of the external auditors for this review work prior to Audit Committee decision/approval. Internal Audit had requested the CFO to provide the following information;
 - a. Representation from external auditor stating safeguards taken for providing non audit services that directly affect the subject matter of the assurance engagement;
 - b. Clarification from ICAP on non-audit work assigned to the external auditor that directly affects the subject matter of the assurance engagement to ensure compliance with applicable Code and Guidelines (i.e., Code of Ethics etc.);
 - c. Clarification on what work the external auditor has been engaged for and a copy of the 'agreed upon procedures' engagement letter between the Company and the external auditor;
 - d. Legal opinion (management stated that it obtained two legal opinions to validate the action of the Company) and statement of facts submitted for obtaining the legal opinion. Internal Audit communicated to the CFO (all correspondence on this has been with the CFO) that representation from external auditor on safeguards for conflict of interest/threat mitigation and clarifications obtained from Regulators (SECP, ICAP) viz a viz Code of Corporate Governance and Code of Ethics etc. is more appropriate rather than legal opinion as the latter is only an opinion on the interpretation of laws and regulations.
- Chairman Audit Committee and Internal Audit's view has been that where an external auditor is engaged for a financial statement audit and in the same period provides non audit services that directly affect that subject of the engagement and the auditor opinion/report, there is an inherent conflict of interest and self-review/independence threat. This however may be minimized to an acceptable level and/or mitigated against by putting in place safeguards (as also stated in the Code of Ethics for Chartered Accountants) and these representations i.e. Management and external auditor be discussed with the Audit Committee and the latter shall then decide if the external auditor can be engaged for the review work.
- However, management responded stating that 'after due discussions with experts/professionals had decided to assign the work' to the external auditor and 'has also obtained an independent legal opinion which confirms that there is no conflict of interest for external auditors to carry out such assignment related to audit services'. Management has been requested to provide the above listed information but it has not provided the above as yet and has responded that that 'there is no conflict of interest and will give its own representation to the Audit Committee and the Board'.

- The Chairman Audit Committee is not satisfied with Management's response and on it not providing information (as listed above) including the external auditor representation (listed as point (a) above) for review when queried and has directed me to refer the matter to the regulators for their advice on the actions taken by the CFO and Management in violation of ICAP, SBP, SECP and other regulations /Code of Conduct', relating to the conflict of interest and related self-review/independence threat (as stated the financial statements for the year ended 31 December 2011 have still not been approved thus the review work would fall under non-assurance service provided to a financial statement audit client during the period of the audit engagement).
- Chairman Audit Committee has also stated 'appropriate regulators may also take necessary action against CFO'.
- As management has not provided the external auditor representation on the said matter, please confirm if Internal Audit (on behalf of the Audit Committee) is empowered to write to the external auditor and query it on the said matter including mitigating factors put in place to minimize threats to an acceptable level etc?
- Also, if your response confirms that Internal Audit/Audit Committee is empowered to write to the external auditor and based on the reply received if the Chairman Audit Committee is not satisfied with the external auditor representation on the assignment and conflict of interest mitigation etc., then what would the next steps be in regards to referring back to the ICAP?

Opinion:

The Code of Ethics for Chartered Accountants 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 as well as in appearance is necessary for the practicing chartered accountants to enable them to express a conclusion, without bias, conflict of interest or undue influence.

Practicing chartered accountants are expected to provide a variety of non-assurance services that are consistent with their skills and expertise. While rendering other non-assurance services to an audit client, practicing chartered accountants are required to apply the conceptual framework to identify threats to comply with the fundamental principles and assess their significance and implication.

The responsibility of evaluation of such threats rests on the practicing chartered accountants and they should consider qualitative as well as quantitative factors while doing so. The 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.

With regard to your query whether Internal Audit (on behalf of the Audit Committee) is empowered to write to the external auditor, the Committee would like you to refer section 290.157, 290.159, 290.161 and 290.162 of Part B of 'Code of Ethics for Chartered Accountants' for guidance.

The Committee is of the view that it is the prerogative of Audit Committee to recommend the appointment of auditor to the BOD for conducting non-assurance services. Likewise, the Audit Committee may recommend termination if they foresee conflict of interest and threat of self-review and independence arising by the acceptance of non-assurance services by the external auditor. In such cases, the Audit Committee has a right to recommend to the BOD appointment of a person having requisite qualification and experience for performing non-assurance services.

To evaluate the various threats arising out of the acceptance of non-assurance services by the external auditor, the Audit Committee may communicate directly with the external auditor and request information about the safeguards that may have been applied by them, in reducing the threats to an acceptable level.

With regard to your second query, the Committee is of the opinion that if the Chairman Audit Committee is not satisfied with the external auditor's representation then he should first discuss this within the Audit Committee and then take to the Board (if Audit Committee agrees) before approaching ICAP. If Board agrees with the recommendation of the Audit Committee to approach ICAP then a formal complaint may be referred to ICAP.

(June 27, 2012)

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