

# Selected Opinions Volume XIX

From July 1, 2013 to June 30, 2014

Compiled by Technical Services Directorate  
*The Institute of Chartered Accountants of Pakistan*

## INTRODUCTION

This report is the nineteenth compilation of selected opinions issued by the Technical Advisory Committee on inquiries raised by the members and other agencies during the period from **July 2013 to June 2014** 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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## 1.1 AUDITORS' REPORT ON GOING CONCERN ASSUMPTION

**Enquiry:** Technical advice is sought on the following matters:

(1) A company ceased its operations since last three years due to adverse economic conditions. The company did not obtain any loan from the financial institutions or otherwise. Liquid funds available with the company cover 73.00 times of current liability. The financial statements of the company show the positive equity although there is accumulated loss. Further, the management has no intention to liquidate the company.

In the perspective of the aforesaid facts, what is the auditors' responsibility as per International Standard on Auditing– 570?

(2) A company was incorporated four years back. The company did not commence its operations due to adverse economic conditions. The company has no long and short term liabilities except immaterial balance payable to the directors against payments made during the last three years for government fee (SECP and miscellaneous) and auditors remuneration etc. Further, the management has no intention to liquidate the company.

In the perspective of the aforesaid facts, what is the responsibility of auditors as per International Standard on Auditing?

**Opinion:** The Committee would like to draw your attention to the following: (underline is ours)

**Conceptual framework of financial reporting defines “Going Concern” assumption as:**

4.1 The financial statements are normally prepared on the assumption that an entity is a going concern and will continue in operation for the foreseeable future. Hence, it is assumed that the entity has neither the intention nor the need to liquidate or curtail materially the scale of its operations; if such an intention or need exists, the financial statements may have to be prepared on a different basis and, if so, the basis used is disclosed.

**IAS 1 ‘Presentation of Financial Statements’ provides the following requirements of Going Concern:**

25 When preparing financial statements, management shall make an assessment of an entity's ability to continue as a going concern. An entity shall prepare financial statements on a going concern basis unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so. When management is aware, in making its assessment, of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, the entity shall disclose those uncertainties. When an entity does not prepare financial statements on a going concern basis, it shall disclose that fact, together with the basis on which it prepared the financial statements and the reason why the entity is not regarded as a going concern.

- 26 In assessing whether the going concern assumption is appropriate, management takes into account all available information about the future, which is at least, but is not limited to, twelve months from the end of the reporting period. The degree of consideration depends on the facts in each case. When an entity has a history of profitable operations and ready access to financial resources, the entity may reach a conclusion that the going concern basis of accounting is appropriate without detailed analysis. In other cases, management may need to consider a wide range of factors relating to current and expected profitability, debt repayment schedules and potential sources of replacement financing before it can satisfy itself that the going concern basis is appropriate.

The Committee would also like to draw your attention to the following para of the **ISA 570 'Going Concern'**: (underline is ours)

2. Under the going concern assumption, an entity is viewed as continuing in business for the foreseeable future. General purpose financial statements are prepared on a going concern basis, unless management either intends to liquidate the entity or to cease operations, or has no realistic alternative but to do so. Special purpose financial statements may or may not be prepared in accordance with a financial reporting framework for which the going concern basis is relevant (for example, the going concern basis is not relevant for some financial statements prepared on a tax basis in particular jurisdictions). When the use of the going concern assumption is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business. (Ref: Para. A1)
6. The auditor's responsibility is to obtain sufficient appropriate audit evidence about the appropriateness of management's use of the going concern assumption in the preparation of financial statements and to conclude whether there is material uncertainty about the entity's ability to continue as a going concern... ..
12. The auditor shall evaluate management's assessment of the entity's ability to continue as a going concern.
17. Based on the audit evidence obtained, the auditor shall conclude whether, in the auditor's judgment, a material uncertainty exists related to events or conditions that, individually or collectively, may cast doubt on the entity's ability to continue as a going concern. A material uncertainty exists when the magnitude of its potential impact and likelihood of occurrence is such that, in the auditor's judgment, appropriate disclosure of the nature and implications of the uncertainty is necessary for:
- a) In the case of a fair presentation financial reporting framework, the fair presentation of the financial statements.....
18. If the auditor concludes that the use of going concern assumption is appropriate in the circumstances but a material uncertainty exists, the auditor shall determine whether the financial statements:
- a) Adequately describe the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with these events or conditions; and
- b) Disclose clearly that there is a material uncertainty related to events or

conditions that may cast significant doubt on the entity's ability to continue as a going concern and, therefore, that it may be unable to realize its assets and discharge its liabilities in the normal course of business.

19. If adequate disclosure is made in the financial statements, the auditor shall express an unmodified opinion and include an Emphasis of Matter paragraph....."
20. If adequate disclosure is not made in the financial statements, the auditor shall express a qualified opinion or adverse opinion, as appropriate, in accordance with ISA 705.

It is apparent from a reading of the above that management has to make an assessment that the entity will continue as a going concern. The entity may make this assessment without detailed analysis where the entity has a history of profitable operations and ready access to financial resources. In other cases, management may need to consider a wider range of factors.

The auditor's responsibility is to obtain sufficient appropriate audit evidence about the appropriateness of management's assessment of the going concern assumption and to conclude whether there is material uncertainty about the entity's ability to continue as a going concern, or not. Where conditions or events have been identified that may cast a significant doubt, the auditor may perform additional audit procedures illustrated in para 16 of the ISA 570 'Going Concern' to obtain sufficient and appropriate audit evidence.

The Committee is of the view that the going concern assessment by management is required where the company ceases its operations or does not commence its operations, both due to adverse economic conditions. Although the company has sufficient liquid assets to settle its liabilities without incurring losses, ceasing or not starting operations are an indication that a material uncertainty is present. In both these cases, the auditor's responsibility is to obtain sufficient appropriate audit evidence and to conclude whether there is material uncertainty, or not. In case where auditor's conclusion is different from the management's assessment, appropriate reference in the opinion is required as illustrated in ISA 570 'Going Concern'.

In view of above opinion, the ICAP Selected Opinion No. 2.5 of Volume IX earlier issued by the Committee on 'Qualification of Going Concern assumption for a Dormant Company' stands withdrawn.

(July 4, 2013)

## 1.2. OPINION REQUIRED REGARDING WAIVER FOR FINANCIAL COVENANTS

### **Enquiry:**

**Background:** An entity 'A' has a long term loan from commercial bank for tenure of 5 years. Payments are to be made in semi-annual installments of equal amount. However, as per the loan agreement between the bank and the Company, the Company is required to maintain certain financial ratios, say a current ratio of 0.6 at the end of the year ending 31 December 2011.

**Scenario:** Before the year-end 31 Dec 2011, the Company, keeping in view its statement of financial position, requested the Bank to waive off the requirement of meeting the current ratio and defer it until Dec 2012. The Bank, after due verification of the Company's status

and its future projections, waives the requirement and communicates it to the Company on 05 January 2012 (after year end).

*Quote from the Bank letter:*

*"The Bank has waived the Company's requirement to meet its current ratio of 0.6 effective from 31 December 2011...."*

**Quote from IAS 1 para 74:**

*When an entity **breaches a provision** of a long-term loan arrangement on or before the end of the reporting period with the effect that the liability becomes payable on demand, it classifies the liability as current, even if the lender agreed, after the reporting period and before the authorisation of the financial statements for issue, not to demand payment as a consequence of the breach. An entity classifies the liability as current because, at the end of the reporting period, it does not have an unconditional right to defer its settlement for at least twelve months after that date.*

**Another view:**

The Bank has not deferred payment as a consequence of the breach (as mentioned above). Rather, the Bank has waived the requirement of meeting the ratio. **There was no breach of the loan** covenant at the year end, and thus para 74 is not applicable.

The Bank agreeing after the reporting period is simply because of their verification exercise, the proceedings for the same has already begun before the year end.

In view of the above, the Company was not required to meet the ratio at the year end. Waiving the requirement effective from 31 Dec 2011 means that such covenant was not applicable. Hence the loan can be classified as long term with its current maturity under short term.

Is the Company still required to classify its long term liability into short term on account of the above situation?

**Opinion:** The Committee considered your query and from the information provided to us, we understand that the breach of specified "current ratio" limit constitutes an event of default of covenants in your instance. Accordingly, the Committee is of the view that since at the date of balance sheet the bank has not waived the covenant of maintaining "current ratio" at specified limits, the company would need to reclassify the debt from "Non-current" to "Current".

(August 29, 2013)

### **1.3 QUERY REGARDING IMPLICATION OVER CHANGE OF NAME IN THE AUDITED FINANCIAL STATEMENT**

**Enquiry:** We wanted your advice on the implication over change of name as per Companies' Ordinance 1984 on issuance of audited financial statements. The following is the scenario:

A company is a manufacturing concern having its financial year end on June 30 and is in operation since years. The management of the company wants to change its name and in this respect all the formalities regarding change of name as per companies' ordinance

1984 have been compiled with before the year end. However, the Certificate of Incorporation of change of name from Securities and Exchange Commission of Pakistan (SECP) will be received subsequent to the year end in the month of **August**.

In **September**, company wants to issue its audited financial Statements and wants to know whether it can issue financial statements with its new name or with its old name as Certificate of Incorporation of Change of Name was received subsequent to the year end in month August.

According to Section 40 and 143 of the Companies ordinance 1984:

Where a company changes its name it shall, for a period of one year from the date of issue of a certificate by the registrar, continue to mention its former name along with its new name on the outside of every office or place in which its business is carried on and also in every official document like bills of exchange, hundis, promissory notes, endorsements, cheques and orders for money or goods purporting to be signed by or on behalf of the company, and in all bills of parcels, invoices, receipts and letters of credit of the company.

On the basis of above Sections, company is eligible to use its new name along with its former name from August. Financial statements are going to be issued in the month of September.

Our query is that the company in the audited financial statements should use its old name or new name based on the above scenario and sections quoted above?

**Opinion:** The Committee considered your enquiry and is of the view that once the certificate by the registrar confirming change of name is issued, all documents, reports and statements of the company should be titled according to the new name. The company shall also mention its former name for a period of one year along with the new name. Therefore the financial statements and audit report signed after the issuance of certificate should refer the company by its new name.

(August 29, 2013)

#### 1.4 AUDITOR'S QCR STATUS IN CASE OF CO-AUDIT

**Enquiry:** Kindly refer to the requirement that auditor of ESE should have satisfactory QCR rating. The question is that in case of co-audit whether both the auditors should be QCR certified or not.

**Opinion:** The Committee would like to refer the following wordings of SECP SRO 268(1)/2012 dated March 16, 2012 which relates to the issue:

“.....the SECP is pleased to direct all non-listed companies, falling under the definition of ‘economically significant companies’ in terms of clause (iii) of para 2 of Part-1 of the Fifth Schedule to the said Ordinance, to appoint as its statutory external auditors of the firms of Chartered Accountants which hold satisfactory rating under the ‘Quality Control Review Program’ of the Institute of Chartered Accountants of Pakistan. The requirement of this directive shall be effective from the financial year beginning on or after July 1, 2012”.



The Committee is of the view that in case of co-audit both the auditors should hold satisfactory rating under the QCR program of the Institute.

(August 29, 2013)

## 1.5 CLARIFICATION REQUIRED ON ICAP OPINION 'ACCOUNTING FOR DEMUTUALIZATION OF STOCK EXCHANGES'

**Enquiry:** The Committee interpretation is requested on the following lines:

**Quote :** At any subsequent date, if an entity is able to estimate a reliable fair value for shares by any method, the gain will be recognized according to IAS 39. **Un Quote :**

By word subsequent, our client has an interpretation as if today market conditions.

Whereas keeping in view paragraph 15 of ICAP opinion on subject, we differently interpret that the subsequent date is the date by which the blocked shares will be sold out to strategic investor or general public not before and active market is developed for these shares not earlier.

**Paragraph 15 of the ICAP opinion says that:**

**Quote :** Any subsequent measurement of the shares and / or TREC would only be possible where their reliable fair values can be measured. This would most likely happen when the blocked shares are sold to the strategic investor or to the general public through an IPO and an active market develops for the TREC. **Un Quote**

Please guide on our understanding.

**Opinion:** The Committee considered your query and would again like to reproduce para 15 of the opinion:

"Any subsequent measurement of the shares and / or TREC would only be possible where their reliable fair values can be measured. This would most likely happen when the blocked shares are sold to the strategic investor or to the general public through an IPO and an active market develops for the TREC".

The Committee in its opinion had no intention to time bound the subsequent measurement of fair value. An entity can determine the reliable fair value through an appropriate price finding mechanism any time after initial recognition.

(August 29, 2013)

## 1.6 OPINION REGARDING DEFERRED TAXATION RATE

**Enquiry:** Before Finance Act, 2013, the Division II of the First Schedule to the Income Tax Ordinance, 2001 read as under:

"(i) The rate of tax imposed on taxable income of a company for the tax year 2007 and onwards shall be 35%]".

Through Finance Act 2013 the following proviso has been add in the above clause (i):  
"Provided that the rate of tax imposed on taxable income of a company other than a banking company shall be 34% for the tax year 2014."

The above proviso relate to the tax year 2014 only. Kindly advise at which tax rate the temporary differences as at June 30, 2013 will be converted into deferred tax. Your advice is particularly required regarding temporary differences outstanding as at June 30, 2013 that will be reversing in the:

01. year ending on June 30, 2014; and
02. years ending on June 30 , 2015 and onwards.

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

- 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.

On the basis of above, the Committee is of the view that the tax rate of 34% shall be applied for temporary differences outstanding as at June 30, 2013 that will be reversing in the year 2014. The differences outstanding as at June 30, 2013, that will be reversing in the year 2015 and onwards, shall be accounted for at the rate of 35%.

(August 29, 2013)

## 1.7 TECHNICAL OPINION ON IAS 39

### **Enquiry: ISSUE-I**

Many entities have continued financial support from their directors/ sponsors etc. in form of interest free loans. There are normally no determinable repayment terms.

*IAS-39 requires*

*Borrowings are initially recognized at fair value less attributable transaction cost. Subsequent to initial recognition, these are stated at amortized cost with any difference between cost and redemption value being recognized ' in profit or loss over the period of the borrowings on an effective interest basis."*

As per paragraph 47 of the Standard, all financial liabilities, with exception of certain liabilities specifically excluded by the standard from scope of the paragraph, are required to be measured at amortized cost using the effective interest method

The normal treatment in the audited financial statements is through disclosure in the notes to the accounts with emphasis on the fact that repayment terms are not determinable.

*IAS 1 requires.*

15. Financial statements shall present fairly the financial position, financial performance and cash flows of an entity. Fair presentation requires the faithful representation of the effects of transactions other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the Framework The application of IFRSs, with additional disclosure when necessary, is presumed to result in financial statements that achieve a fair presentation.

- 16 An entity whose financial statements comply with IFRSs shall make an explicit and unreserved statement of such compliance in the notes. An entity shall not describe financial statements as complying with IFRSs unless they comply with all the requirements of IFRSs.
- 17 In virtually all circumstances, an entity achieves a fair presentation by compliance with applicable IFRSs. A fair presentation also requires an entity:
  - (a) to select and apply accounting policies in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors. IAS 8 sets out a hierarchy of authoritative guidance that management considers in the absence of an IFRS that specifically applies to an item.
  - (b) to present information, including accounting policies, in a manner that provides relevant reliable, comparable and understandable information.
  - (c) to provide additional disclosures when compliance with the specific requirements in IFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance.
- 18 An entity cannot rectify inappropriate accounting policies either by disclosure of the accounting policies used or by notes or explanatory material.

It is clear that IAS-I requires compliance to all IFRSs and IASs.

#### **OPINION REQUIRED:**

- 1 Is it sufficient to give disclosure that the repayment terms for the loans from directors' sponsors etc are not determinable?
- 2 Is it not a departure from IAS-39 requirements? Accordingly should not the audit report be qualified indicating that the requirements of IAS-39 have not been met with an explanations of the reasons for non -compliance?
- 3 Should not the departure be identified in the 'Compliance Statement'?
- 4 Is the repayment tenure considered to be determinable if loans from directors' sponsors etc. are subordinated to loans from banks and financial institutions?

It may be noted in some cases where the audit report has been qualified; SECP has forced the entity to measure loans from directors' sponsors etc. at amortized cost using the effective interest method even in absence of determinable repayment terms.

#### **ISSUE-2**

In many entities there are issues pertaining to loans from banks and financial institutions which are in default and/or subjudice. It has been observed that a disclosure to the fact is made in the notes to financial statements with the explanation that classification between current and non-current liabilities is not practicable. Additionally if the matter is subjudice no provisions are made for markup.

#### **OPINION REQUIRED:**

1. Is it sufficient to give disclosure as noted above?
2. Is it not a departure from IAS-I requirements? Accordingly should not the audit report be qualified indicating that the requirements of IAS-I have not been met with an explanation of the reasons for non-compliance?
3. Should not the departure be identified in the 'Compliance Statement'?

**Opinion:** The Committee considered your queries and response to the questions are as follows:

#### **ISSUE-1**

1. If the repayment terms of the loans from directors' sponsors are not determinable then the payment of loan would remain on demand by the director's sponsor; and hence should be disclosed as short term loan.

However, if the loan is of long term nature then there should be a loan covenant and in that case, the loan shall be stated at amortized cost in accordance with the requirements of IAS 39

- 2 & 3. It will always be the auditor's prerogative to give an opinion, based upon the evidence obtained whether or not to qualify audit report. The Committee is of the view that the auditor will have to form an appropriate opinion, based on his own judgment, after analyzing the evidences obtained.
4. The Committee is of the view that a director loan subordinated to a bank loan will be payable after the bank loan has been fully extinguished. Therefore, the minimum term of the director's loan can be taken as the term of the bank loan, however, the exact term is indeterminable in the absence of a covenant.

#### **ISSUE-2**

- 1 Where the loans from banks or financial institutions are in default or subjudiced, the payment of loan would be considered on demand; and therefore classified as current.
- 2 It will always be the auditor's prerogative to give an opinion, based upon the evidence obtained whether or not to qualify audit report. The Committee is of the view that the auditor will have to form an appropriate opinion, based on his own judgment, after analyzing the evidences obtained
- 3 The issue identified in the query does not raise any effect on the 'Compliance Statement'.

(August 29, 2013)

### **1.8 GUIDANCE FOR TREATMENT OF MEMBERSHIP CARD OF STOCK EXCHANGE BROKERS**

**Enquiry:** I would like to highlight issues pertaining to the treatment of Membership card surrendered by members in favour of stock exchanges and issuance of TREC and Shares against such membership card.

- ICAP had graciously advised me vide letter No. ICAP/DTS/1/7038/2532 dated February 25, 2013 through "Opinion on accounting for exchange of membership card with shares and trading right entitlement certificate on demutualization of stock exchanges.
- On the advice of ICAP cost of Membership Card is allocated on the shares of stock Exchange and TREC on the basis of fair value of respective assets (TREC and Shares).
- The Lahore stock exchange has determined value of TREC at Rs.4,000,000/- for the purpose of BMC and value of share is Rs.10 per share. Thus value of TREC and Shares is calculated as under:-

	Value	%
TREC	Rs.4,000,000/-	32.15%
Shares (843,975 shares @10 each)	Rs.8,439,750/-	67.85%
Total	Rs.12,439,750/-	100%

The cost of membership card is allocated between two assets on the basis of 32% for TREC and 67.85% for Shares at the time of acquisition of TREC and Shares.

You are requested to guide me as to whether or not the above treatment be continued without charging any impairment for the financial year 2013 where following circumstances exists:-

1. 60% of the shares are kept by stock exchanges in the blocked account and divestment of the same will be made in accordance with the requirements of the Act within two years from the date of demutualization. Similarly, rest of 40% shares are credited to the brokers CDC account and cannot be sold out because of non - existence of market.
2. The fair value of such shares is not available because of the reason that there is no market available for sale or purchase of such shares.
3. It is not expected that the value per share will remain at Rs.10 per share at the time when "permission to sale" will be granted to member.
4. Similarly, the fair value of TREC cannot be determined because of the fact that there is no parallel transaction to be followed and if some transaction is made, it is purely on private basis and not on fair market basis.

**Opinion:** The accounting treatment stated in ICAP Selected Opinion No. 1.2 of Volume XVIII on 'Accounting for Exchange of Membership Card with shares and trading right entitlement certificate on demutualization of the Stock Exchanges' issued in February 2013, is applicable at the initial stage. Subsequently, fair value adjustment or revaluation as the case may be, is to be carried out when fair values are determined. However, the impairment test should be performed in accordance with relevant IFRSs.

(November 08, 2013)

## 1.9 OPINION REGARDING CONSOLIDATION OF FINANCIAL STATEMENTS

**Enquiry:** The Technical guidance is requested from the Committee on consolidation of accounts by a listed company (hereinafter referred to as LC) which has recently acquired another listed

company (hereinafter referred to as ALC) operating in financial sector – a bank. The LC has acquired 43.15% shares of ALC directly and 10.94% shares through its another subsidiary. Year 2013 will be the first year after acquisition of ALC that the holding company will be preparing its F.S. Following are the issues faced for consolidation.

1. LC holds 43.15% shares of ALC directly and 10.94% indirectly through its subsidiary.
2. In terms of section 3(2) of the Companies Ordinance, 1984 (CO-1984) the LC has become a holding Co. of ALC.
3. Owing to the application of section 3 of CO-1984, presentation of consolidated financial statements of the group as a single entity in terms of section 237 of CO-1984, are also required to be made by LC, in addition to the standalone financial statements. Such consolidated financial statements are to be prepared in accordance with the disclosure requirements of the Fourth Schedule of CO-1984 and International Accounting Standards (IAS) notified under section 234 (3) of CO-1984.
4. The ALC, being a company in financial sector is regulated by SBP while the holding Co. (LC) is regulated by SECP
5. As directed by SBP, IAS 39 & 40 are not applicable to ALC while as mandated by SECP, all IAS/IFRS as notified by it are applicable on companies regulated by SECP. Such IAS/IFRS include IAS 30 & 40
6. IAS 27 on consolidated and separate financial statements requires that the consolidated financial statements shall be prepared using uniform accounting policies. In other words, additional financial statements of the subsidiary (ALC) are required to be prepared using policies and bases as that of LC in order to facilitate consolidation.

#### **Difficulties in complying with the reporting requirements:**

##### **1. Nature of the businesses of LC and ALC**

LC and the ALC are both public listed companies, however, their nature of business and economic sectors are very different. The statutory, regulatory and the reporting requirements of the two companies are poles apart, on individual basis. The LC is regulated by SECP under C.O 1984, while ALC is regulated by SBP under BCO 1962. All IFRS notified by the SECP are applicable on LC while ALC has been exempted by the SBP from application of IFRS 39 & 40.

##### **2. LC ownership does not constitute control in terms of IFRS 10:** IFRS 10 which is effective from accounting periods starting 01 January, 2013, has not yet been adopted by ICAP/SECP. Once adopted, this will replace IAS 27. As required by IFRS 10, an entity that is a **parent** shall present consolidated F/S and the entity shall determine whether or not it is a **parent** by assessing whether it **controls** the investee (para 5 of IFRS 10). An entity controls an investee when it is exposed or has the rights to variable returns from its involvement in the investee. (para 6 of IFRS 10). Thus an investor controls an investee if and only if investor has all the following;

1. power over the investee,
2. exposure, or rights, to variable returns from its involvement with the investee; and,
3. the ability to use its power over the investee to affect the amount of the investor's returns. (para 7)

While the FFCL holds 43.15% of the Bank's shares, however, it does not have **"control"** as defined by IFRS 10. It does not fulfil any of the following conditions of IFRS 10 para 7, necessary to constitute a **"control"**.

- Power over the investee
- Exposure, or rights, to variable returns from its involvement with the investee; and
- The ability to use its power over the investee to affect the amount of the investor's returns.

We have been informed by LC that it also does not have control over the appointment of Board members and influencing the decision making processes, which, in this respect, rests with the parent organisation of LC. This fact is demonstrable from the composition of the board of directors of the ALC which has only 2 directors nominated by LC.

### 3. Value to the users of the financial statements

The Framework for the preparation and presentation of financial statements (the Framework) issued by the International Accounting Standard Committee (IASC), prescribes that one of the key objectives of Financial Statements is its usefulness to the wide range of users in making economic decisions. Balance sheet size of the LC is approximately Rs. 65 billion while that of ALC, Rs. 340 billion (approximately 5 times of the holding Co.). As on 30 June 2013, the LC has posted a PBT of Rs. 6.6 billion while ALC has posted a loss of 6.8 billion. As mentioned above, the consolidated financial position and results of operations may differ significantly compared to the standalone results of the ALC and LC. In other words, the users of consolidated Financial Statements would be getting two drastically different set of financial information of the ALC and LC, which would be counterproductive and against the objectives of issuing the Financial Statements and the Framework for the preparation and presentation of FS. **International Accounting Standard 1 – Presentation of Financial Statements, also allows that in the extremely rare circumstances in which management concludes that compliance with a requirement in an IFRS would be so misleading that it would conflict with the objective of financial statements set out in the Framework, the entity shall depart from that requirement.**

As has already been discussed above, the regulatory and reporting requirements of the two companies are significantly different along with business dynamics. As a result:

- Balance sheet size of LC is around Rs.65 billion whereas total assets of the ALC hovers around Rs.340 billion – approximately 5 times of LC.
  - Components of balance sheet and income statements are completely unrelated and highly different to each other.
  - LC statutory reporting format is on the basis of current and non-current assets and liabilities, whereas such bifurcations are not required for ALC.
4. IAS 27 on consolidated and separate financial statements requires that the consolidated financial statements shall be prepared using uniform accounting policies. In other words, additional financial statements of the subsidiary (ALC) are required to be prepared using policies and bases as that of holding company in order to facilitate consolidation. For the purpose of consolidated financial statements, ALC will be required to prepare additional financial statements as per the policies of LC, which would require considerable amount of additional resources, costs, and time. However, even if the ALC prepares specific purpose financial statements;



- i. the accuracy of these FS may still be questionable in view of the fact that SBP guidelines in respect of certain intricate matters would not be available;
- ii. these FS are subject to the review of the auditors including all interim FS of ALC. The adequacy of skills and expertise for conducting audit of such FS is also not available in Pakistan;
- iii. these FS would significantly differ from the financial statements prepared and disseminated by the ALC to the users of FS on a standalone basis.
- iv. significant differences between the accounting and reporting frameworks of the BCO 1962 and the CO 1984 including the following, which requires an additional set of financial statements above the already prepared standalone and consolidated financial statements by ALC:
  - a. recognition of interest income on impaired assets (Non-Performing Loans)
  - b. Accounting and presentation of Investments
  - c. impairment of advances
  - d. investment properties
  - e. ALC's segment reporting disclosures (including commercial banking, retail banking, asset management, brokerage business etc.)
  - f. ALC requirement to consolidate its more than 250 branches in addition to subsidiaries, resulting in holding of BOD meetings in the month of August, in comparison to LC's Board meetings in the month of July.
  - g. Uniform Accounting Policies – Aligned with FFC
- v. revaluation of ALC's Fixed and other assets for determination of Goodwill.

### Guidance Sought from the ICAP

In view of the factual position narrated above and provisions of relevant IFRS/IAS/IFRIC (specifically in view of pending adoption of IFRS 10 in Pakistan), is it still technically essential & practically possible for the LC to consolidate ALC financial statements?

**Opinion:** Your attention is drawn to the following paragraphs of IAS 27 'Consolidated and Separate Financial Statements' and the requirements of section 237 of the Companies Ordinance 1984, which are self-explanatory: (underlining is ours)

- 9 A parent, other than a parent described in paragraph 10, shall present consolidated financial statements in which it consolidates its investments in subsidiaries in accordance with this Standard.
- 10 A parent need not present consolidated financial statements if and only if:
  - (a) the parent is itself a wholly-owned subsidiary, or is a partially-owned subsidiary of another entity and its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements;
  - (b) the parent's debt or equity instruments are not traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets);



(c) the parent did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organization for the purpose of issuing any class of instruments in a public market; and

(d) the ultimate or any intermediate parent of the parent produces consolidated financial statements available for public use that comply with International Financial Reporting Standards.

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

The Committee would recommend that the Company take guidance from the above paragraphs while preparing consolidated financial statements.

(November 08, 2013)

#### 1.10 OPINION REGARDING BIOLOGICAL ASSETS UNDER IAS 41

**Enquiry:** The company is engaged in poultry business i.e. breeding the birds, selling the eggs and then bird is sold. The whole life of the bird is two years and in two years it lays eggs eighteen months. Please give your opinion regarding the followings:

- 1 Whether the cost of breeding the bird is to be treated as biological asset or inventory?
- 2 If it is treated as a biological asset at what cost it should be recognized?
- 3 How the cost of biological asset is to be charged cost of production?

**Opinion:** The Committee considered your queries and its views on each question are as follows  
1. Your attention is drawn to the paragraph 10 of IAS 41 'Agriculture' which says that

- 10 An entity shall recognise a biological asset or agricultural produce when and only when:
  - (a) the entity controls the asset as a result of past events;
  - (b) it is probable that future economic benefits associated with the asset will flow to the entity; and
  - (c) the fair value or cost of the asset can be measured reliably.

In view of the above, the cost of breeding the birds will be capitalized as a biological asset till such time the birds start producing eggs. Subsequent costs, incurred after production of eggs, are cost of sales and will be charged to profit and loss.

(November 08, 2013)

## 1.11 CAPITALIZATION OF ASSETS

**Enquiry:** Initially, we are foreseeing the following circumstances;

1. First Gas Production (FGP) has started.
2. Title has not been transferred in the name of Company
3. Provisional or Final Acceptance Certificate (PAC/FAC) is yet to be given to Contractor

But over the period of two months the whole scenario has been changed. As of December 31, 2013 year ending it is now clear that we shall not transfer the cost from CWIP to Plant and Machinery. Reason being the trial production is scheduled in January 2014 and acceptance certificate will be issued in mid of 2014.

**We** would really appreciate if you can give your opinion whether we have to decide whether to transfer cost from CWIP to P&M or not.

**Opinion:** The Committee considered your enquiry and would like to refer following paragraphs of IAS 16 Property, Plant and Equipment:

20. Recognition of costs in the carrying amount of an item of property, plant and equipment ceases when the item is in the location and condition necessary for it to be capable of operating in the manner intended by management. Therefore, costs incurred in using or redeploying an item are not included in the carrying amount of that item. For example, the following costs are not included in the carrying amount of an item of property, plant and equipment:
  - (a) costs incurred while an item capable of operating in the manner intended by management has yet to be brought into use or is operated at less than full capacity;
  - (b) initial operating losses, such as those incurred while demand for the item's output builds up; and
  - (c) costs of relocating or reorganising part or all of an entity's operations.
55. Depreciation of an asset begins when it is available for use, i.e. when it is in the location and condition necessary for it to be capable of operating in the manner intended by management. Depreciation of an asset ceases at the earlier of the date that the asset is classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with IFRS 5 and the date that the asset is derecognised. Therefore, depreciation does not cease when the asset becomes idle or is retired from active use unless the asset is fully depreciated. However, under usage methods of depreciation the depreciation charge can be zero while there is no production.

The Committee is of the view that an item will be capitalized once it is in the location and condition necessary for it to be capable of operating in the manner intended by management. Recognised asset will be depreciated according to paragraph 43-49 of IAS 16.

(March 19, 2014)

## 1.12 OPINION ON CAPITALIZATION OF DEFERRED REVENUE EXPENDITURE

**Enquiry:** We would like to draw your kind attention towards a general issue related to Capitalization of Deferred Revenue Expenditure (Preliminary Expenses). According to para 69 (a) of International Accounting Standards-38 (IAS-38) Intangible Assets:-

### QUOTED

“68 Expenditure on an intangible item shall be recognized as an expense when it is incurred unless:

**a) it forms part of the cost of an intangible asset that meets the recognition criteria( see paragraphs 18-67); or**

**b) The item is acquired in a business combination and cannot be recognised as an intangible asset. If this is the case, it forms part of the amount recognized as goodwill at the acquisition date (see IFRS 3).**

69 *In some cases expenditure is incurred to provide future economic benefits to an entity, but no intangible asset or other asset is acquired or created that can be recognised. In the case of the supply of goods, the entity recognizes such expenditure as an expense when it has a right to access those goods. In the case of the supply of services, the entity recognizes the expenditure as an expense when it receives the services. For example, expenditure on research is recognized as an expense when it is incurred (see paragraph 54), except when it is acquired as part of a business combination. Other examples of expenditure that is recognized as an expense when it is include:*

*(a) Expenditure on start-up activities (i.e. start-up costs), unless this expenditure is included in the cost of an item of property, plant and equipment in accordance with IAS 16, Start-up costs may consist of establishment costs such as legal and secretarial costs incurred in establishing a legal entity, expenditure to open a new facility or business (i.e. pre-opening costs) or expenditure for starting new operations or launching new products or processes (Ice, preconditioning costs).”*

### UNQUOTED

Under the light of the above paragraph, it is not allowed to capitalize the preliminary expenditure in the period it is incurred.

According to the Section 25 of the Income Tax Ordinance, 2001, pre-commencement expenditures are allowable a tax expense for the purpose of calculating Taxable Income.

### QUOTED

“25. **Pre-commencement expenditure.**- (1) a person shall be allowed a deduction for any pre-commencement expenditure in accordance with this section.

2) *Pre-commencement expenditure shall be amortized on a straight line basis at the rate specified in Part III of the Third Schedule.*

3) *The total deduction allowed under this section in the current tax year and all previous tax years in respect of an amount of pre-commencement expenditure shall not exceed the amount of the expenditure.*

*4) no deduction shall be allowed under this section where a deduction has been allowed under another section of this Ordinance for the entire amount of the pre-commencement expenditure in the tax year in which it is incurred.*

*5) In this section- pre-commencement expenditure means any expenditure incurred before the commencement of a business wholly and exclusively to derive income chargeable to tax, including the cost of feasibility studies, construction of prototypes and trial production activities , but shall not include any expenditure which is incurred in acquiring land or which is depreciated amortized under section 22 or 24.”*

#### UNQUOTED

Based on the above paragraph, we are of the opinion that in the financial statements the Deferred Revenue Cost should be capitalized, for the reason that incase the incremental laws conflicts with the local laws, the local laws will prevail.

**Opinion:** The financial reporting framework as applicable in Pakistan comprises of IASs/ IFRSs, Companies Ordinance 1984 and notifications issued by SECP as explained in ICAP Circular No. 7 of 2007. The relevant extracts of the circular is as follows:

The Professional Standards and Technical Advisory Committee in its 56<sup>th</sup> meeting held on September 10, 2007 also reviewed the following draft of the Statement of Compliance to be included in the financial statements of companies other than MSEs and SSEs:

“These financial statements have been prepared in accordance with approved accounting standards as applicable in Pakistan. Approved accounting standards comprise of such International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board as are notified under the Companies Ordinance, 1984, provisions of and directives issued under the Companies Ordinance, 1984. In case requirements differ, the provisions or directives of the Companies Ordinance, 1984 shall prevail.”

It is clear from reading the above that financial reporting framework as applicable in Pakistan does not include Income Tax laws. Further, under Section 25 of the Income Tax Ordinance, 2001, pre-commencement expenditures are allowable only as tax expense for the purpose of calculating Taxable Income.

The Committee is of the opinion that there is no ambiguity in the accounting treatment of preliminary expenses in IASs/ IFRSs and Companies Ordinance 1984 and these should not be capitalized.

(March 19, 2014)

#### 1.13 DEFERRED TAX

**Enquiry:** ISA 12 states that deferred tax should be provided if there is a difference in accounting profit and taxable profit and timing differences are temporary differences i.e. reverse in one or more subsequent period (certainly not in indefinite period).

Tax laws in Pakistan are mainly based on fixed tax (presumptive tax) and minimum tax U/s 113. Under such provisions of law the accounting profit and taxable profit become immaterial and baseless. Economic conditions in Pakistan are such that almost every company pays minimum tax U/s 113.

Under such circumstances i.e. minimum tax, the concept of timing difference does not apply.

Kindly advise, if a company is paying minimum tax U/s 113 for the last 6 years and expects to pay minimum tax for all the years to come

- i) Should that company calculate deferred tax?
- ii) Does any provision of deferred tax distort the financial statements?

We understand that under such circumstances no calculation for deferred tax should be made as timing difference does not exist.

**Opinion:** The Committee considered your query and would like to highlight the following paragraphs of TR- 27:

- 3.1 In case in a particular year, current tax liability is calculated under provisions of Section 113 due to taxable loss the effect of temporary differences should be calculated and deferred tax liability/ asset should be recognized.
- 3.3 A deferred tax asset should be recognized for the carry forward of unused tax losses and unused tax credits (as allowed under the provisions of the Income Tax Ordinance, 2001) to the extent that it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilized.

Based on above, the Committee believes that the calculation of deferred tax should be made when an entity is paying tax under Section 113.

For recognition of deferred tax asset and deferred tax liability, the Committee would like to draw your attention to the following paragraphs of IAS 12:

- 15 A **deferred tax liability** shall be recognised 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).

However, for taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint arrangements, a deferred tax liability shall be recognised in accordance with paragraph 39.

- 16 It is inherent in the recognition of an asset that its carrying amount will be recovered in the form of economic benefits that flow to the entity in future periods. When the carrying amount of the asset exceeds its tax base, the amount of taxable economic benefits will exceed the amount that will be allowed as a deduction for tax purposes. This difference is a taxable temporary difference and the obligation to pay the resulting income taxes in future periods is a deferred tax liability. As the entity recovers the carrying amount of the asset, the taxable temporary difference will reverse and the entity will have taxable profit. This

makes it probable that economic benefits will flow from the entity in the form of tax payments. Therefore, this Standard requires the recognition of all deferred tax liabilities, except in certain circumstances described in paragraphs 15 and 39 (underline is ours).

- 24 A **deferred tax asset** shall be recognised for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised, unless the deferred tax asset arises from the initial recognition of an asset or liability in a transaction that:

- (a) is not a business combination; and
- (b) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).

However, for deductible temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint arrangements, a deferred tax asset shall be recognised in accordance with paragraph 44.

- 25 It is inherent in the recognition of a liability that the carrying amount will be settled in future periods through an outflow from the entity of resources embodying economic benefits. When resources flow from the entity, part or all of their amounts may be deductible in determining taxable profit of a period later than the period in which the liability is recognised. In such cases, a temporary difference exists between the carrying amount of the liability and its tax base. Accordingly, a deferred tax asset arises in respect of the income taxes that will be recoverable in the future periods when that part of the liability is allowed as a deduction in determining taxable profit. Similarly, if the carrying amount of an asset is less than its tax base, the difference gives rise to a deferred tax asset in respect of the income taxes that will be recoverable in future periods.
- 34 A deferred tax asset shall be recognised for the carryforward of unused tax losses and unused tax credits to the extent that it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilised.
- 35 The criteria for recognising deferred tax assets arising from the carryforward of unused tax losses and tax credits are the same as the criteria for recognising 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.

(March 19, 2014)

#### 1.14 CHANGE IN INVENTORY VALUATION METHOD

**Enquiry:** This is with reference to two different views over change in inventory valuation method (cost formula) from weighted average to first-in first-out (FIFO) basis or vice versa.

In this connection, one of view is that change in cost formula from weighted average to FIFO or vice versa is a change in accounting estimate as International Accounting Standard (IAS) 2, 'Inventories' ("IAS-2 ") do not state that the selection of a cost formula under IAS-2 falls under the ambit of accounting policies. Therefore, change in the cost formula would not be attributed as change in accounting policy. To support this view, following paras (32 to 37) of IAS 8, 'Accounting Policies, Changes in Accounting Estimates and Errors' ("IAS-8 ") are relevant:

- "32. As a result of the uncertainties inherent in business activities, many items in financial statements cannot be measured with precision but can only be estimated. Estimation involves judgments based on the latest available, reliable information. For example, estimates may be required of
- a) bad debts;
  - b) inventory obsolescence;
  - c) The fair value of financial assets or financial liabilities,'
  - d) the useful lives of, or expected pattern of consumption of the future economic Benefit embodies in depreciable assets; and
  - e) warranty obligations
33. The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.
34. An estimate may need revision if changes occur in the circumstances on which the estimate was based or as a result of new information or more experience. By its nature, the revision of an estimate does not relate to prior periods and is not the correction of an error.
35. A change in the measurement basis applied is a change in an accounting policy, and is not a change in an accounting estimate. When it is difficult to distinguish a change in an accounting policy from a change in an accounting estimate, the change is treated as a change in an accounting estimate.
36. The effect of a change in an accounting estimate, other than a change to which paragraph 37 applies, shall be recognised prospectively by including it in profit or loss in:
- a) the period of the change, if the change affects that period only;' or
  - b) the period of the change and future periods, if the change affects both.
37. To the extent that a change in an accounting estimate gives rise to changes in assets and liabilities, or relates to an item of equity, it shall be recognised by adjusting the carrying amount of the related asset, liability or equity item in the period of the change. "

Another view in this regard is that the change in inventory valuation method from weighted average to FIFO or vice versa is a **change in accounting policy** instead of change in accounting estimate. Basis for this view are given as under:

- The change of cost formula does not fall under the definition of ' change in accounting estimate', defined below, as it cannot be construed as the assessment of the present status of, and expected future benefits of assets. Therefore, the change of cost formula of inventory valuation is to be considered as change in accounting policy under IAS-8. However, it falls under the definition of accounting policies defined below.



- Moreover, change in measurement basis is a change in accounting policy rather a change in accounting estimate.

Para 35 of the IAS-8 states that;

*"A change in the measurement basis applied is a change in an accounting policy and is not a change in an accounting estimate. When it is difficult to distinguish a change in an accounting policy from a change in an accounting estimate, the change is treated as a change in an accounting estimate. "*

- In chapter 18, 'Accounting Policies, Estimates and Errors' of Gripping IFRS (Pakistan Edition 2008), in the last paragraph of the overview section, it is clearly stated that change in inventory valuation method will be a change in accounting policy. The referred para from the book is reproduced below:

*"It should be noted, however, that a change in measurement basis is considered to be a change in policy and not a change in estimate (e.g. with respect to inventories, a change from the FIFO method to the WA method would be a change in accounting policy rather a change in estimate). "*

Change in accounting estimate and accounting policies have been defined in IAS-8 as follows:

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

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

Your valuable opinion is solicited as to whether the change of cost formula of inventory valuation from FIFO to Weighted Average or vice versa will be a change in accounting policy or change in accounting estimate.

**Opinion:**

The Committee considered your enquiry and in the absence of any specific guidance to the contrary in the standards and based on practices generally followed for treatment of changes in methods of determining cost of inventory, agrees with the second view described in note 3 of your letter that change in the cost formula from a weighted average cost formula to FIFO-based cost formula or vice versa is a change in accounting policy.

The change in a cost formula represents a change in the bases on which the value of the inventory has been determined. Therefore, a change in the cost formula represents a change in specific bases and hence will be treated as a change in accounting policy.

(March 19, 2014)



## TECHNICAL OPINION REGARDING AUDIT RELATING TO SUBSEQUENT SALE OF AN ENTITY AND ALL ITS ASSETS AFTER REPORTING DATE

### **Enquiry:**

1. The Company was a GOING CONCERN as at June 30, 2012 and there was no intention of the management to dispose of the assets of the company. In fact the company earned reasonable profits during the period.
2. Financial Statements of Company 'A' for the year ended June 30, 2013 have been prepared on historical cost basis. The management concludes that the Going Concern basis is appropriate. No material uncertainties leading to significant doubts about Going Concern have been identified. However, the Auditor does not agree with management conclusion that the Going Concern basis is appropriate due to the fact that the assets of the company have been disposed off in subsequent period.
3. Due to unavoidable circumstances the company stopped its operations during the period under audit i.e. June 30, 2013.
4. After reporting date i.e. June 30, 2013 the company 'A' disposed all of its assets (including land, building & machinery).
5. No revaluation of Assets including Land, Building and Plant & Machinery was carried out by the company before the sale of the company 'A' assets.
6. No depreciation has been charged on assets of the company during the period under audit.

### **MANAGEMENT OPINION**

There was no revaluation carried out by the company before the sale of the company 'A' that is why the accounts have been prepared on historical cost basis.

Management of company 'A' is of the opinion that as the company have been sold out there is no need to provide depreciation in the period under audit.

Your opinion is sought for the correct treatment of the afore-stated events in case the Company had not accounted for the afore-stated events in accordance with the IAS, IFRS & ISA.

### **Opinion:**

The Committee would like to draw your attention to the following paragraph of ISA 570 'Going Concern' which is self-explanatory:

### **Use of Going Concern Assumption Inappropriate**

21. If the financial statements have been prepared on a going concern basis but, in the auditor's judgment, management's use of the going concern assumption in the financial statements is inappropriate, the auditor shall express an adverse opinion. (Ref: Para. A25–A26)

However, where management also concludes or agrees with auditors that the going concern assumption is not appropriate, they should comply with the requirements of para A26 of ISA 570 which is reproduced below for ready reference:

A26. If the entity's management is required, or elects, to prepare financial statements when the use of the going concern assumption is not appropriate in the circumstances, the financial statements are prepared on an alternative basis (for example, liquidation basis). The auditor may be able to perform an audit of those financial statements provided that the auditor determines that the alternative basis is an acceptable financial reporting framework in the circumstances. The auditor may be able to express an unmodified opinion on those financial statements, provided there is adequate disclosure therein but may consider it appropriate or necessary to include an Emphasis of Matter paragraph in the auditor's report to draw the user's attention to that alternative basis and the reasons for its use.

Further, the management must be apprised of the fact that when a going concern assumption becomes inappropriate, the financial statement must be prepared on an alternative basis (for example, liquidation basis) instead of normal fair value presentation framework.

In conclusion, where the going concern assumption does not remain appropriate, the carrying values of assets and liabilities must be reassessed and stated at their recoverable/ realizable and settlement values, respectively.

(March 19, 2014)

#### 1.16 QUERY REGARDING POLICY FOR REVENUE RECOGNITION

**Enquiry:** It is informed that presently 'Revenue' is being booked by Aviation regulator on account of various services against the billing of an airline. However, since July 2009, no dues are being paid by above airline. Per monthly billing is approx.. Rs.xxx million. Consequently the outstanding amount has been accumulated to Rs. xxx billion of December 2013

While referring IAS-18 regarding 'Revenue Recognition'. It revealed that following conditions are requested to be fulfilled for booking of Revenue:

**Quote:**

**Rendering of services**

For revenue arising from the rendering of services, provided that all of the following criteria are met, revenue should be recognized by reference to the stage of completion of the transaction at the balance sheet date (the percentage of completion method): (IAS 18.20)

- a) The amount of revenue can be measured reliably
- b) It is probable that the economic benefits will flow to the seller (service provider):
- c) The stage of completion at the balance sheet date can be measured reliably ; and
- d) The costs incurred or to be incurred of the transaction can be measured reliably

When the above criteria are not met, revenue arising from the rendering of services should be recognized only to the extent of the expenses recognized that are recoverable (a “cost-recovery approach”. (IAS 18.26)

**Un-quote:**

It may be noted that condition (b) is not being fulfilled under the present scenario. Therefore, we believe that Aviation regulator should not book Revenue on accrual basis and should move to **Cash basis** for recognizing Revenue. It may also be noted that Aviation regulator was established under ABC Ordinance (the prevalent Ordinance) and the mandatory requirements under Companies Ordinance 1984 are not applicable for Aviation regulator. Similarly, IAS-18 is also not compulsorily applicable for Aviation regulator. In this context, it is pertinent to mention that Institute of Chartered Accountants (ICAP) also follows this policy as mentioned in the Notes of Accounts. The same is being reproduced as under:

**4:14 Revenue recognition**

Revenue is recognized to the extent that the economic benefits will flow to the institute and revenue can be reliably measured. Revenue from different sources is recognized on the following basis:

- Income from subscription and fee from members and students is accounted for on receipt basis. Fee/ subscription receipts relating to periods beyond the current financial year are shown as advance fee.
- Profit on investments is accrued on the basis of effective yield of respective investments.
- Profit on savings accounts is recognized on accrual basis.

Owing to the reason mentioned above, Aviation regulator is facing financial hardship as without receipt of any amount from above Airline. Aviation regulator has to pay income tax @ 35% on its billings. So far Aviation regulator has paid substantial amount on account of Income Tax i.e. Rs xxx billion.

It is clarified that the bills/invoices are raised against the airline on account of various services as per rates duly approved by aviation Board. These rates are notified to all Airlines through NOTAM (Notice to Airmen) before implementation. Since, presently, aviation regulator is following “**Accrual based policy**”; the “**Revenue**” is being recognized against these invoices. It is also clarified that there is no binding contract/terms and conditions agreed with the airline.

We feel that in view of the fact that substantial amount is not being received, and as such IAS 18's condition of booking Revenue is not met. Hence we cannot book Revenue as per IAS 18, and will have to move to “**cash basis**”.

Considering the requirements of IAS 18, we desire to adopt “**Cash based**” policy for recognition of “Revenue”. In this regard, guidance is required to change the policy for Revenue recognition.

**Opinion:** The Committee has examined your enquiry and would like to draw your attention to the following paras of IAS 18 ‘Revenue’:

- 18 Revenue is recognised only when it is probable that the economic benefits associated with the transaction will flow to the entity. In some cases, this may not

be probable until the consideration is received or until an uncertainty is removed. For example, it may be uncertain that a foreign governmental authority will grant permission to remit the consideration from a sale in a foreign country. When the permission is granted, the uncertainty is removed and revenue is recognised. However, when an uncertainty arises about the collectibility of an amount already included in revenue, the uncollectible amount or the amount in respect of which recovery has ceased to be probable is recognised as an expense, rather than as an adjustment of the amount of revenue originally recognised.

**20 When the outcome of a transaction involving the rendering of services can be estimated reliably, revenue associated with the transaction shall be recognised by reference to the stage of completion of the transaction at the end of the reporting period. The outcome of a transaction can be estimated reliably when all the following conditions are satisfied:**

- (a) the amount of revenue can be measured reliably;**
- (b) it is probable that the economic benefits associated with the transaction will flow to the entity;**
- (c) the stage of completion of the transaction at the end of the reporting period can be measured reliably; and**
- (d) the costs incurred for the transaction and the costs to complete the transaction can be measured reliably.**

21 The recognition of revenue by reference to the stage of completion of a transaction is often referred to as the percentage of completion method. Under this method, revenue is recognised in the accounting periods in which the services are rendered. The recognition of revenue on this basis provides useful information on the extent of service activity and performance during a period. IAS 11 also requires the recognition of revenue on this basis. The requirements of that Standard are generally applicable to the recognition of revenue and the associated expenses for a transaction involving the rendering of services.

22 Revenue is recognised only when it is probable that the economic benefits associated with the transaction will flow to the entity. However, when an uncertainty arises about the collectibility of an amount already included in revenue, the uncollectible amount, or the amount in respect of which recovery has ceased to be probable, is recognised as an expense, rather than as an adjustment of the amount of revenue originally recognised.

The Committee considers that the probability of future economic benefits relates to the level of certainty that the revenue amount will be received. In some cases, revenue recognition may not be appropriate until the consideration is received or the cause of uncertainty is removed.

The Committee would further like to refer to the following para of IAS 18:

**26 When the outcome of the transaction involving the rendering of services cannot be estimated reliably, revenue shall be recognised only to the extent of the expenses recognised that are recoverable.**

27 During the early stages of a transaction, it is often the case that the outcome of the transaction cannot be estimated reliably. Nevertheless, it may be probable that the entity will recover the transaction costs incurred. Therefore, revenue is recognised only to the extent of costs incurred that are expected to be

recoverable. As the outcome of the transaction cannot be estimated reliably, no profit is recognised.

- 28 When the outcome of a transaction cannot be estimated reliably and it is not probable that the costs incurred will be recovered, revenue is not recognised and the costs incurred are recognised as an expense. When the uncertainties that prevented the outcome of the contract being estimated reliably no longer exist, revenue is recognised in accordance with paragraph 20 rather than in accordance with paragraph 26.

The Committee considers that the management of the aviation regulator needs to assess all the conditions surrounding the transaction and to reach a conclusion. If the management's conclusion is that probability of recovery is extremely remote at the time of rendering of services and any requirement of para 20 of IAS 18 is not being met; they may decide not to recognize revenue from such transactions.

In this case, the revenue recognition policy is not being changed; only management has concluded that one of the conditions for recognizing revenue is not present for the transaction or set of transactions. The amount recovered in subsequent period if any will be recognized in accordance with the requirement of relevant standards.

It is imperative to note that the basic principle remains to be accrual and recording of revenue on cash basis is not appropriate.

The Committee would also like to advise the management that while making its assessment it needs to consider that late recovery or part recovery of revenue recognized in the past may not on its own be an appropriate indicator for concluding that economic benefits of similar transactions in future will not flow to the entity. Further, the management also needs to consider whether both the parties to transaction are related, and the late or non-payment of revenue is for reasons other than commercial. In such a scenario non-recognition of revenue may not be appropriate.

(March 19, 2014)

## 1.17 TECHNICAL QUERY ON COMMON CONTROL

### Enquiry:

#### Common Control

	A	B	C
Percentage of Shareholding in 'z'	3.19	11.18%	18.44%
Percentage of Shareholding of 'A' in			50.01 %
		60.25%	
Total Direct & Indirect Shareholding of A' in 'z'	19.14%		

**The question arises whether this constitutes Business Combinations under Common Control (BCUCC)?**

The issues related to BCUCC are still at the discussion stage at IASB (refer to IFRS-Staff Paper of September 2013). IFRS-Staff Paper also refers to the discussion paper of European Financial Reporting Advisory Group-EFRAG.

**IFRS-Staff Paper suggests that the scope of 'common control' could possibly be restricted to transactions within a group controlled by a single ultimate parent entity.**

**There also suggestions that control is only possible if the subsidiaries are wholly owned subsidiaries.**

## **ACCOUNTING PRACTICES**

Both the above referred discussion papers acknowledge prevalent diverse accounting treatments. These include Acquisition Method, Predecessor Accounting (Purchase Method & Pooling of Interests) and Fresh Start Accounting.

It was also suggested by many respondents to the discussion paper of EFRAG that diversity in accounting treatment was not necessarily undesirable.

**In the bifurcation and subsequent merger under consideration all requirements of the Purchase Method were applied which also conforms with the acquisition method with the exception of creation of Capital Reserve.**

## **APPLICATION OF IAS-8**

**IAS 8 Para 10,11 & 12 'Applying Changes in Accounting Policies' stipulates**

***Para-10:*** *In absence of an IFRS that specifically applies to a transaction, other event or condition, management shall use its judgement in developing and applying an accounting policy that results in information that is.*

- a) *Relevant to the economic decision making needs of the users, and*
- b) *Reliable, in that financial statements.'*
  - I. Represent faithfully the financial position, financial performance and cash flow of the entity,*
  - II. Reflect the economic substance of transactions, other events and conditions and not merely the legal form,*
  - III. Are neutral i.e. free from bias,*
  - IV. Are prudent, and*
  - V. Are complete in all material respects.*

***Para-11.*** *In making the judgement described in paragraph 10 management shall refer to and consider the applicability of the following sources in descending order:*

- a) *The requirements in IFRSs dealing with similar or related issues, and*
- b) *The definition, recognition criteria measurement concepts for assets and liabilities, income and expenses in the 'Framework'.*

***Para-12:*** *In making the judgment described in paragraph 10 management **MAY** also consider the most recent pronouncements of other standard-setting bodies that use a **SIMILAR CONCEPTUAL FRAMEWORK** to develop accounting standards, other accounting literature and accepted industry practice, to the extent that these do not conflict with the sources in paragraph 11 .*

If you examine the Economic Substance particularly in the case of Company 'B' & 'C', assets and liabilities were transferred to them in lieu of investments already in 'Z'. As

such the excess of net assets transferred to 'B' & 'C', has to be recognized as gain on disposal of investments.

Some practicing firms advocate the application of US GAAP in accordance with Para 12 of IAS-8. My objection to the same is that till US GAAP is totally converged there are a lot of differences between US GAAP & IFRSs. US GAAP doesn't even recognize the Revaluation Model, the very essence of Business Combinations.

As such there is no justification to equate US GAAP as Similar Conceptual Framework and the same should not be applied.

We shall be grateful to provide technical opinion on the above referred matters. We also seek the opinion of the Technical Committee on application of US GAAP.

**Opinion:** The Committee considered both of your enquiries and concurs with your views that that in the absence of IFRS that specifically applies to any transaction, it is necessary for an accounting policy to be developed in accordance with the guidance given in para 8 to 10 of IAS 8.

For transactions which have economic substance, because IFRS does not specify the accounting approach to be followed, an entity should select one of the following two approaches as an accounting policy choice to be applied consistently to all business combinations involving entities under common control:

- The acquisition method (as set out in IFRS 3), or
- Book value accounting (often referred to as the 'pooling of interests' method).

The acquisition method is only available if a business combination involving entities under common control has economic substance. If a transaction does not have economic substance, then acquisition accounting is not appropriate and book value accounting is followed instead. Careful consideration needs to be given to whether a common control transaction has economic substance, from the perspectives of all entities involved. This is because it is possible for a business combination under common control to be undertaken at the direction of a parent entity, and not because there is a substantive transaction with an unrelated third party. Factors to consider include:

- The purpose of the transaction
- Whether the transaction price is at fair value (when the transaction is not effected through the issue of equity shares)
- The activities of the entities involved in the transaction.

For substantive transactions, the rationale for applying IFRS 3 would be that, although it is part of a group of entities under common control, the acquirer is still a separate entity in its own right. The rationale for book value accounting would be that the business has simply been moved from one part of a group of entities under common control to another. Because business combinations involving entities under common control typically arise from businesses being moved around a group as part of a restructuring, to effect a tax planning arrangement, or in preparation for the sale or listing of part of an existing group, it is likely that the appropriate approach will be to use book value accounting.

Based on information provided to us, the Committee is of the view that there is no economic substance in this transaction. Further, in either case the gain arising on such business combination would go to equity and will not be recognized in P&L.



With regard to your query regarding application of US GAAP, the Committee believes that it is matter of judgment of the management of the Company to decide which similar conceptual framework or other accepted industry practices to be used which is best appropriate with the scenario, to the extent that it is not in conflict with paragraph 11 of IAS 8.

(June 27, 2014)

#### 1.18 REQUEST FOR EXEMPTION FROM DISCLOSURE ABOUT IMPACT OF IFRIC-4 & IFRIC-12

**Enquiry:** A Commission has forwarded a requested which was received from a utility company (the subject Company). The provided information is given below:

1. the subject Company has sought exemption from disclosure about impact of IFRIC-4 "Determining whether an arrangement contains a lease" and IFR1C-12 "Services Concession Arrangements" on its balance sheet based on the operational difficulties it has been facing from various stakeholders.
2. It is pertinent to mention here that, the Securities and Exchange Commission of Pakistan (the "Commission") vide S.R.O. 24 (1)/2012 dated January 16, 2012 after consultation with the Institute of Chartered Accountants of Pakistan (ICAP) provided relaxation to all companies including the "Power Sector Companies" and the companies that are not otherwise required to comply with International Financial Reporting Standards (IFRSs) from the requirements of IFRIC-4 and IFR1C-12. The aforesaid exemption was however subject to compliance with the related disclosure requirements applicable in case of departure from any IFRS. Please note that, similar exemptions were also granted through Circular # 21/2009 dated June 22, 2009 and S.R.O. 87(1)/2011 dated February 02, 2011.
3. In the instant scenario, the Commission previously has not granted any such exemption from disclosure requirements of IFRIC-4 and IFR1C-12 as it is contrary to the provisions of para 19 and 20 of International Accounting Standard (IAS)-1 (Presentation of Financial Statements). However, before proceeding further in the matter, we would like to have your view point in the subject matter being the apex regulator of the accounting profession in Pakistan.

**Opinion:** The Committee considered your enquiry and would like to reiterate its earlier view that being a member body of International Federation of Accountants (IFAC), ICAP has committed through signing the Statement of Membership Obligations (SMO) to make all possible endeavors to adopt and implement the International Financial Reporting Standards in our jurisdiction. Therefore, Institute is of the view that exemptions to individual companies from provisions of IFRS will defeat the objective of comparability and transparency of the financial statements.

(June 27, 2014)



## 2.1 QUERY REGARDING PROFESSIONAL CLEARANCE LETTER

**Enquiry:** We are a firm of chartered Accountant and this letter aims at requiring a professional advice regarding the following situation:

Our firm has been appointed as auditors of the company and as per the requirements of code of ethics, a professional clearance letter has been sent to previous auditor. However, no response is received from previous auditor'.

Based on the above situation, kindly guide us the procedures we are required to perform if there is no response from previous auditor on this matter despite a reminder has also been sent to them.

**Opinion:** We would like to draw your attention to the following paragraphs of the ICAP Code of Ethics for Chartered Accountants: (underline is ours)

210.16 A chartered accountant in practice will ordinarily need to obtain the client's permission, preferably in writing, to initiate discussion with an existing accountant. Once that permission is obtained, the existing accountant should comply with relevant legal and other regulations governing such requests. The existing accountant should promptly transfer to the new chartered accountant in practice all books and papers of the client, which are or may be held after the change in appointment has been effected and should advise the client accordingly, unless he has a legal right to withhold them. Where the existing accountant provides information, it should be provided honestly and unambiguously. If the proposed accountant is unable to communicate with the existing accountant, the proposed accountant should try to obtain information about any possible threats by other means such as through inquiries of third parties or background investigations on senior management or those charged with governance of the client.

210.17 Where the threats cannot be eliminated or reduced to an acceptable level through the application of safeguards, a chartered accountant in practice should, unless there is satisfaction as to necessary facts by other means, decline the engagement.

### Conclusion:

The Committee emphasize that it is a professional and moral obligation for a Chartered Accountant, especially one in practice, to respond to communication from other Chartered Accountants. However, in case such a response is not forthcoming, a Chartered Accountant should take account of section 210.16 and 210.17 referred above.

(Nov 08, 2013)

## 2.2 REMOVAL OF AUDITOR BEFORE COMPLETION OF THEIR TERM AND ACCEPTANCE OF APPOINTMENT BY THE PROPOSED AUDITORS

**Enquiry:** We seek your technical opinion and guidance in the following circumstances for accepting the appointment of Auditor of a Private Limited Company.

The existing auditors of the company were removed by a special Resolution of the Board of Directors of the Company before completion of their term (This being first year of operation of the company) and the proposed firm of Chartered Accountants was offered appointment as statutory Auditors for the referred year. Resultantly, in compliance with requirements of revised code of ethics 210.10, the proposed auditors sent letter through URGENT MAIL SERVICE asking for NOC from existing auditors. The existing Auditor did not respond to the proposed auditor even after the laps of 30 days.

Your opinion is sought in this respect that what options does the proposed auditor will have and what procedure should be adopted by the proposed Auditors in above mentioned circumstances.

**Opinion:** We would like to draw your attention to the following paragraphs of the ICAP Code of Ethics for Chartered Accountants, explaining the procedures where existing auditor is removed before completion of his term: (underline is ours)

210.19 Where an existing chartered accountant is removed by the proprietors of the business before he has completed the audit and submitted his report, the existing chartered accountant must immediately inform the Institute with relevant facts about his removal.

210.20 The proposed chartered accountant in practice should not only follow the procedure detailed in the preceding paragraphs of this Section, he should also inform the Institute about the offer of appointment.

210.21 The proposed chartered accountant in practice should not accept the offer without prior clearance from the Institute, which clearance shall not be unreasonably withheld. Provided however, in case the Institute refuses to give its clearance, it shall communicate its decision within 15 (fifteen) days with reasons therefore.

210.16 .... If the proposed accountant is unable to communicate with the existing accountant, the proposed accountant should try to obtain information about any possible threats by other means such as through inquiries of third parties or background investigations on senior management or those charged with governance of the client.

210.17 Where the threats cannot be eliminated or reduced to an acceptable level through the application of safeguards, a chartered accountant in practice should, unless there is satisfaction as to necessary facts by other means, decline the engagement.

The Committee advises all practicing accountants that where an auditor has been removed before completion of the audit both the removed auditor and the proposed

auditor must inform the Institute about relevant facts. Furthermore, the proposed auditor must not accept an audit if clearance from Institute has not been obtained in such cases.

The Committee emphasize that it is a professional and moral obligation for a Chartered Accountant, especially one in practice, to respond to communication from other Chartered Accountants. However, in case such a response is not forthcoming, a Chartered Accountant should take account of section 210.16 and 210.17 referred above.

(November 08, 2013)

## **2.3 QUERY REGARDING APPOINTMENT OF QCR RATED AUDITOR FOR STOCK BROKER**

**Enquiry:** Can a SME / SSE Company doing the business as a stock broker in Stock Exchange can appoint an auditor who is not in the list of QCR Panel?

**Opinion:** We invite your attention to the definition of MSE as defined in the Accounting and Financial Reporting Standards for MSEs and SSEs issued by ICAP and notified by the SECP:

"A Medium-Sized Entity (MSE) is an entity that:

- (a) is not a listed company or a subsidiary of a listed company;
- (b) has not filed, or is not in the process of filing, its financial statements with the Securities and Exchange Commission of Pakistan (SECP) or other regulatory organisation for the purpose of issuing any class of instruments in a public market;
- (c) does not hold assets in a fiduciary capacity for a broad group of outsiders, such as a bank, insurance company, securities broker/dealer, pension fund, mutual fund or investment banking entity;
- (d) is not a public utility or similar entity that provides an essential public service;
- (e) is not economically significant on the basis of criteria as defined in paragraph 3 below; and
- (f) is not a Small-Sized Entity (SSE) as defined in paragraph 4 below."

In view of the clause (c) above the Committee is of the opinion that the Company doing the business as a stock broker falls under the definition of Economically Significant Company and OCR rated firm is required to be appointed as its external auditors.

(November 08, 2013)

## **2.4 ADVICE ON AUDIT REPORT**

**Enquiry:** We request you to please give your valuable opinion in the following matter:

- a) What is the significance of an initialed audit report.
- b) The client did not return the initialed audit report with qualified opinion to us for full signature although the audited account, i.e. Balance Sheet and Income Expenditure have been signed by the management. We request you to clarify that can an initialed audit report be changed from qualified opinion to disclaimer although these accounts have been signed by the management as during the audit of subsequent years we

found that the initialed audit report with qualified opinion given by us in previous years is not suitable under the circumstance and hence Disclaimer must be given.

We request you to give us your precious opinion that can we change the initialed audit report to a disclaimer opinion (although these have been signed by management) when we sign the audit report which is issued by us.

**Opinion:** The Companies Ordinance 1984 and ISAs do not have a requirement to initial the audit report. This practice was originated as evidence that audit has been completed subject to satisfactory clearance of outstanding matters described in the covering letter.

Accordingly, the audit report is not issued until it has been signed by the auditor. However, those charged with governance/ Board of Directors must be properly communicated about the subsequent change in auditor's opinion according to the provisions of ISA 260 'Communication with those charged with Governance'.

(March 19, 2014)

## 2.5 APPOINTMENT OF CONSULTANT FOR INTERNAL AUDIT ASSIGNMENTS

**Enquiry:** Company ABC Ltd (hereinafter referred to as 'Company') is a Public Sector Enterprise listed at all Stock Exchanges of Pakistan. The Company complies with Code of Corporate Governance 2012 and Public Sector (Corporate Governance) Rules 2013, both issued by Securities and Exchange Commission (SECP) of Pakistan.

The Company has a well-equipped Internal Audit Department, headed by a Qualified Professional (FCA), and the Department carries out all Internal Audit Assignments in-house, except for few third party audits which are outsourced, keeping in view availability of staff resources.

Public Sector (Corporate Governance) Rules 2013 (hereinafter referred to as 'Rules 2013') requires all Public Sector Enterprises to implement, as far as practicable, International Standards for the Professional Practice of Internal Auditing (the Standards) issued by the Institute of Internal Auditors (the IIA).

**External Quality Assessment Review:** The Board Audit Committee (BAC) of the Company decided to conduct an External Quality Assessment Review (QAR) of Internal Audit Department, keeping in view the provisions of the IIA Standard 1312. The objective of this review was to assess the effectiveness of Audit Function, and to identify areas where improvement can take place. Furthermore, another objective of this review was to obtain independent assurance that all legal and regulatory requirements associated with Internal Audit Function are being complied with and that sufficient procedures exist within the Internal Audit Department to ensure that Quality work is performed.

**Draft Internal Audit Manual:** The Internal Audit Department has also prepared a Draft Internal Audit Manual, detailing procedures that should be implemented in the Audit Department, so as to achieve more efficiency and standardization of audit work. The procedures are in draft form, and are different from existing procedures being followed. Keeping in view that an External QAR may take place, it was envisaged that results of QAR are likely to impact the Draft Procedures which may require amendment/improvement. Therefore, it was decided that results of QAR will be incorporated in the draft Manual, so that its implementation will not cause any inconsistency with the results and recommendations of QAR.

### **Scheme of Work:**

For this purpose, Internal Audit Department wants to appoint a Consultant, to broadly cover the following work:

1. Carry out QAR in line with guidelines of the Standards issued by IIA, and produce a report highlighting areas in Internal Audit Department where improvement is sought, including the blend of staff and core competencies required, scope of work, effectiveness of existing procedures, etc.
2. To take the results of QAR and review the Draft Audit Manual and ensure that the draft procedures are in line with the results and recommendations of QAR. Where any inconsistency is noted, the Consultant will be required to make suitable amendments or additions in draft procedures to bring them in line with results of QAR.

### **Question:**

The Management of the Company is evaluating whether the above scheme of work raises any question of 'Conflict of Interest' or 'Independence' if the work of QAR and Revalidation of Draft Audit Manual is given to a single consultant. The Management has the following questions:

1. If the Consultant who is carrying out QAR is also required to revalidate the Draft Procedures, will it create a 'Conflict of Interest', keeping in view the requirements of IIA Standard?
2. Does QAR falls under the 'Attribute' Standards, and Review of Manual falls under 'Performance' Standards, and if so, do the Standards require that these work be carried out mandatorily by two separate consultants?

Internal Audit Department of the Company has reviewed the Standards in detail, including Practice Advisory on QAR (1312-1) and finds that no such conflict of interest prevails if a single consultant is required to carry out QAR and revalidation of draft Internal Audit Manual. Furthermore, QAR covers compliance of all Standards, and not just Attribute standards, and review of existing procedures is also part of such QAR.

### **Request to ICAP Committee:**

The Committee is requested to kindly provide its view on the questions 1 and 2 noted above. The opinion of honorable Committee will assist the Company in opting a way forward.

### **Opinion:**

The Committee has considered your enquiry and would like to state in the beginning that the Committee primarily deals with matters related to accounting, auditing, governance and related laws and regulations. Accordingly, the knowledge and expertise of standards issued by the Institute of Internal Auditors are not available with the Committee and accordingly we are constrained to issue any views and opinions on these standards.

However, since the matter relates to practicing members of the Institute, the Committee is expressing its views in accordance with the ICAP Code of Ethics, as applicable in Pakistan, which is obligatory on ICAP members.

Accordingly, we are expressing views on question 1 only.

Based on the available information the Committee considers that conflict of interest situation does not appear to arise when both the engagements are performed by a single consultant.

However, the Committee would like to emphasize that one of the primary responsibilities of the Audit Committee is to assess independence while approving engagement of consultants. The Audit Committee must take into account relevant facts, including an inquiry from prospective consultants regarding their own independence assessment of the engagement, and firm level risk mitigation and threat safeguard procedures to be adopted by the firm.

(April 22, 2014)

## **2.6 QUERY REGARDING APPOINTMENT OF EXTERNAL AUDITORS FOR FATCA IMPLEMENTATION ADVISORY SERVICES**

**Enquiry:** Public sector is seeking FATCA implementation advisory services. The Consultant will be responsible for performing a detailed FATCA assessment followed by development of remediation plans and provision of implementation advisory for assisting the Bank in its timely compliance with FATCA requirements. The TOR of FATCA requirements are given below:

### **Introduction**

Recent developments in the international efforts for preventing tax evasion including introduction of the Foreign Account Tax Compliance Act (FATCA) by the US Internal Revenue Service (IRS) aimed primarily at facilitating global information exchange have impacted the financial sector including banks across the globe. As a response to these developments, financial institutions are required to align their customer due diligence/ Identification and reporting practices to be able to play their part in facilitating information exchange with US under FATCA.

The governmental, regulatory and other stakeholders in Pakistan are engaged in joint efforts to respond to challenges arising out of the developments at international level. The State Bank of Pakistan has advised Financial Institutions/ Banks to initiate necessary actions and preparation to comply with FATCA as per the timelines in order to protect the financial sector from negative implications.

In pursuance to SBP instructions, National Bank of Pakistan (NBP) is engaged in preparatory efforts for ensuring timely compliance with FATCA requirements while a *formal* regulatory framework and issuance of necessary implementation guidelines and circulars by SBP are in progress. As a part of these efforts, NBP intends to put in place the required internal framework/ system for ensuring ongoing and consistent fulfillment of its role towards information exchange and introduce focused enhancements to functional aspects, structures, systems as well as processes to provide a sound basis for implementing the framework/ system under SBP instructions and in accordance with FATCA regulations.

### **Key Components of FATCA Exercise**

The following are some key elements of the exercise:

- Legal entity analysis and documentation of the Bank's expanded affiliate group structure (EAG) covering all subsidiaries/ related entities and all foreign branches.
- Developing a detailed FATCA governance framework including governance responsibilities/ structure, responsibilities for regulatory returns, roles and responsibilities with respect to collection, screening and submission of information etc. Developing a FA TCA project governance and management structure for efficient management of different aspects of the project

**With respect to NBP Pakistan Operations:**

Collection of relevant information/ documentation for assessment of the existing state of affairs in relation to readiness for FA TCA implementation (including documentation of processes, products, policies, systems and controls in-scope for FA TCA implementation) Assessment of existing! as-is state of operating models/ policy and procedural documentation and practices, templates, tools, checklists, organizational structures, data management structure, systems and MIS/ reporting frameworks to identify gaps/ departures from readiness for implementation of FATCA regulations both for new and pre-existing accounts.

- Development of detailed remediation! implementation plans for remediating the gaps identified to provide blue prints of tasks/ initiatives to be undertaken during the implementation stage including the following:

- ../ Future state data framework identifying relevant information capturing parameters/ fields, fields to be introduced, dropdowns/ LoVs etc .
- ../ Future state system functionalities/ capabilities including account opening information flow dynamics, scrutiny/ authorization matrix automation, centralized quality assurance review, submission and authorization queuing functionalities etc.
- ../ Pre-existing account screening to provide stepwise tasks/ initiatives to be undertaken for screening/ due diligence of pre-existing accounts, method for their classification as per FATCA treatment, development of documentation/ cure procedures for positive screening of accounts etc.
- ../ Identifying the required enhancement to existing MIS; reporting framework of the Bank and development of future state data reporting process flow;
- ../ Future state system functionalities/ capabilities including information flow dynamics for monitoring and reporting purposes, MIS generation etc .
- ../ Transaction monitoring/ KYC/ reporting alignments including FATCA/ indicia scenario development and automation, trigger setting and devising procedures for trigger follow ups
- ../ Updation/ enhancement of existing policy and procedural documentation of the Bank including operations manual, compliance manual and other relevant documentation
- ../ Development of templates including F ATCA compliant workflow for client onboarding, documentation and cure procedures/ requirements, documentation and operational



checklists development, enhancement or relevant templates including account opening, KYC/ CDD, change in customer circumstances and other relevant templates, customer correspondences/notices etc.

../ Development of a process for registration with the IRS; initial and ongoing management of registration aspects

../ Implementation guidelines/ advisory for a defined period in relation to future state models/ remediation/ implementation plans to meet the requirements of FATCA

- **With respect to foreign branches and foreign subsidiaries, technical (local Oil-line based) advice/ feedback on various matters pertaining to compliance with FATCA will be required.**

The Bank intends to undertake the required tasks to be compliant while doing everything in its power to minimize the impact of FATCA upon its customer service, as far as possible. The Bank would attempt to ensure minimum possible impact on customer service standards, TATs of the processes and compliance to other regulatory requirements etc.

In this connection we seek your advice whether services of external auditors of the bank can be hired for the FATCA implementation and conflict of interest will not arise in such case.

**Opinion:**

The Audit Committee of the Bank will need to assess the appointment of external audit for the FATCA assessment engagement in relation to the prohibitions placed under clause 2 and 9 of prohibited services mentioned below. The auditor of a listed company is prohibited from providing financial information technology system design and implementation services to the listed audit clients which may be significant to overall financial statements and performing management functions or decisions.

The Committee would like to draw your attention to the following guidance provided in Code of Corporate Governance 2012 and ICAP Code of Ethics:

**1. Revised Code of Corporate Governance 2012 read with clause 29-C of KSE Listing Regulations:**

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

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

**Explanation:**

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



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

## 2. ICAP Code of Ethics for Chartered Accountants

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

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

The onus of evaluation of such threats to compliance with the fundamental principles rests on the practicing chartered accountants and they should consider qualitative as well as quantitative factors while performing such evaluation. Such obligation on the part of a practicing chartered accountant becomes more critical in a situation where the applicable guidelines or regulations do not clearly prohibit any specific service. In case where practicing chartered accountants render such services which may coincide with management functions and management decision making, the threat of “Self Review” could exist.

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

- “290.183 The provision of services by a firm or network firm to a financial statement audit client that involve the design and implementation of financial information technology systems that are used to generate information forming part of a client’s financial statements may create a self-review threat.
- 290.184 The self-review threat is likely to be too significant to allow the provision of such services to a financial statement audit client unless appropriate safeguards are put in place ensuring that:
- (a) The audit client acknowledges its responsibility for establishing and monitoring a system of internal controls;
  - (b) The audit client designates a competent employee, preferably within senior management, with the responsibility to make all management decisions with respect to the design and implementation of the hardware or software system;
  - (c) The audit client makes all management decisions with respect to the design and implementation process;
  - (d) The audit client evaluates the adequacy and results of the design and implementation of the system; and
  - (e) The audit client is responsible for the operation of the system (hardware or software) and the data used or generated by the system.
- 290.185 Consideration should also be given to whether such non-assurance services should be provided only by personnel not involved in the financial statement audit engagement and with different reporting lines within the firm.
- 290.186 The provision of services by a firm, or network firm, to a financial statement audit client which involve either the design or the implementation of financial information technology systems that are used to generate information forming part of a client’s financial statements may also create a self-review threat. The significance of the threat, if any, should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate the threat or reduce it to an acceptable level.”

Based on the TOR of FATCA implementation provided to us, the Committee believes that following services by the external auditor, may give rise to conflict of interest, unless the management of the bank in accordance with the requirements of para 290.184 of the Code of Ethics take ownership and responsibility of the work performed and decide on recommendations made by the consultant (auditor) and/or the data and information generated by the consultant (auditor) is not material to the financial statements.:

**Management functions or decisions and financial information technology system design & implementation services**

- Developing a detailed FATCA governance framework including governance responsibilities/ structure, responsibilities for regulatory returns, roles and responsibilities with respect to collection, screening and submission of information etc. Developing a FATCA project governance and management structure for efficient management of different aspects of the project.

- Collection of relevant information/ documentation for assessment of the existing state of affairs in relation to readiness for FATCA implementation (including documentation of processes, products, policies, systems and controls in-scope for FATCA implementation).
- Assessment of existing/ as-is state of operating models/ policy and procedural documentation and practices, templates, tools, checklists, organizational structures, data management structure, systems and MIS/ reporting frameworks to identify gaps/ departures from readiness for implementation of FATCA regulations both for new and pre-existing accounts.

**Following remediation/ implementation plans may come under clause 2 'management functions or decisions' and/ or which may come under clause 9 'financial information technology system design and implementation services' of prohibited services:**

- Identifying the required enhancement to existing MIS; reporting framework of the Bank and development of future state data/ reporting process flow;
- Future state system functionalities/ capabilities including information flow dynamics for monitoring and reporting purposes, MIS generation etc.
- Updation/ enhancement of existing policy and procedural documentation of the Bank including operations manual, compliance manual and other relevant documentation.
- Development of templates including FATCA compliant workflow for client onboarding, documentation and cure procedures/ requirements, documentation and operational checklists development, enhancement or relevant templates including account opening, KYC/ CDD, change in customer circumstances and other relevant templates, customer correspondences/notices etc.

(May 13, 2014)