# Selected Opinions
# Volume XX

From July 1, 2014 to June 30, 2015



**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 2014 to June 2015** 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.

**Directorate of Technical Services**

## CONTENTS

## ACCOUNTING

### 1.1 DEFERRED TAX IMPACT OF CHANGE IN TAXATION RATE OF COMPANIES

***Enquiry:*** As you are aware, the taxation rate of Companies has been determined at 34% for the tax year 2014 and 33% for tax year 2015. However, both the mentioned amendments have been introduced as provisos to the main section where taxation rate of the Companies mentions at 35%. In light of the same, we would require clarification as to the rate that should be used for recognition of deferred tax asset/ liability.

***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 33% shall be applied for temporary differences outstanding as at tax year 2014 that will be reversing in the year 2015.

The Income Tax Ordinance stipulates the rate of 35% for tax years other then 2014 and 2015. Therefore, unless a new rate is announced, the differences outstanding at the year-end that will be reversing in the tax year 2016 and onwards shall be accounted for at 35%.

*(*September 05, 2014*)*

### 1.2. TECHNICAL OPINION ON CLASS OF ASSETS

***Enquiry:*** It has been noted that in case of a textile Company, building on freehold land, generators and electric installations relating to Power House were revalued while assets of the same class (i.e. building on freehold land, electric installations & plant and machinery) not belonging to Power House were stated at historical costs.

The Company's auditor is of the opinion that Power House which included building, electrical installations do constitute a separate class of assets as their use is distinct to other assets. However, in our opinion para 37 of IAS 16 "Property, plant and Equipment" specifically describes separate class of assets and for constituting a separate class of assets the asset must be of a similar nature and use and for the subject case, the stated assets of Power House are not of a similar nature but use. Hence group of assets forming part of Power House do not constitute a separate class of assets.

Hence selective revaluation done by the Company which resulted in reporting of amounts in the financial statements that are a mixture of costs and their values as at different dates is in contravention with the requirements of IAS-16. Specific paras of IAS 16 are stated below for ready reference.

Para 36 of the International Accounting Standard 16 "Property, Plant and Equipment" ("IAS-16") states that;

> *" If an item of property, plant & equipment is revalued, the entire class of property, plant & equipment to which that assets belongs shall be revalued" (Emphasis Added)*

Para 37 of the IAS-I6 states that:

*"A class of property, plant and equipment is a grouping of assets of a similar nature and use in an entity's operations. The following are examples of separate classes:*

*(a) land;*

*(b) land and buildings;*

*(c) machinery;*

*(d) ships,*

*(e) aircraft;*

*(f) motor vehicles;*

*(g) furniture and fixtures; and*

*(h) office equipment.* " (Emphasis Added)

AND WHEREAS, para 38 of the IAS-16 states that:

*"The items within a class of property, plant and equipment are revalued simultaneously to avoid selective revaluation of assets and the reporting to amounts in the financial statements that are a mixture of costs and values as at different dates. However, a class of assets may be revalued on a rolling basis provided revaluation of the class of assets* is *completed within a short period and provided the revaluations are kept up to date*" (Emphasis Added)

In view of the above, ICAP is requested to provide technical advice on the above stated matter.

***Opinion:*** The Committee considered your enquiry and is of the view that determining the class of assets according to their nature and use is an area involving significant estimates and judgment. There may be instances where management intends to put assets of similar nature to dis-similar use. Accordingly, such assets may be grouped as separate class of assets.

However, in the instant case, the Committee could not reach to a conclusion that the assets comprising land, building and power generators forming part of Power House do not constitute a separate class of assets as all facts which may have been considered by the management in considering the assets as separate class are not available with the Committee.

*(*September 05, 2014*)*

## 1.3 TECHNICAL OPINION ON TRANSFER OF RIGHTS OF HOSPITAL ROOMS

***Enquiry:*** The object of the public unlisted company ("the Company") is to establish, purchase construct and maintain hospitals, nursing homes and other allied health care facilities. The Company is categorized as medium-sized company and in pursuance of SRO 23(1)/ 2012 dated January 16, 2012 (previously SRO 860(I) I 2001 dated August 21, 2007) requires being compliant with the Accounting and Financial Reporting Standards (AFRS) for Medium-sized Entities (MSEs);

(i) The Accounts revealed that the Company disposed of its 'Land' during the years ended June 30, 2011, 2012 and 2013 and recorded / accounted for gains as 'Profit on sale of Patients' Rooms'. Details of which are as under, figures are fictitious:

| Years | 2011 | 2012 | 2013 |
|---|---|---|---|
| **Land (disposed of)** | **120 M** | 20M | 100M |
| **Profit on Sale of Patients' Room** | **2M** | 0.5 M | 0.3M |

(ii) The afore-referred disposal of land as 'Sale of the Patients' Rooms' was recorded on the basis of a 'Sale Agreement' with various individuals at different prices. Salient terms and conditions of the sale agreement are as under:

a) The buyer agrees to purchase a patient admission room category (private) from the Company for a price of Rs.--- paid within one years in ---equal Installments of Rs. ---- each, out of which Rs. --- has been received as down payment;

b) The buyer after making complete payment of the room will own one patient admission room category (private) in the said hospital **without the right to own land, roof and bathroom.** The sale deed shall be registered with the Registrar and documentation charges shall be borne by the buyer;

c) Both the parties agree that 40% of the total monthly admission revenue will be retained by hospital for maintenance and running expenses and 60%will be paid to the buyer by 15 days of every month according to the policy of Company;

d) The seller agrees that the buyer will get income of one room from the first phase of construction of 100 rooms, of all categories, of hospital subject to the condition that the buyer has already paid the total price of the subjected room;

e) The buyer is entitled to transfer / sell the rights of the room(s) only with the consent of the hospital administration and the hospital will have the priority to buy back the room;

f) Room will only be used at the discretion of the management of Company for admission of patients as and when required basis without any interruption;

g) Board of Directors will be the final authority regarding all matters related to room(s);

h) Maintenance of the room(s) will be the responsibility of the hospital's administration;

i) Room rent will be collected and disbursed by the Company ; and

j) Both the parties agree that the management of Company shall be indemnified from any sort of litigation, legal proceedings and the buyer shall refrain from such action. The management of Company reserves the right to revoke this deed due to such unhealthy action and room shall be taken over by the Company's management and cost shall be refunded back after deduction of relevant expenditures;

(iii) The Clauses of the 'Sale Agreement' of the patients' admission rooms indicate that risks and rewards were not fully transferred to the allottees as the control of the patients' admission rooms remain with the Company. Hence this arrangement may not be considered as a valid sale; and

(iv) No mutation of sale was recorded in respect of sale of patients' room. Reference to para 2 of the 'Sale Agreement', SECP also confirmed that they have not been provided any documentary proof that the 'Sale Agreement' is registered with the Registrar of Properties. First, the mutation of the respective property be marked and then process of registration of the 'Sale Agreement' can be initiated.

(v) The Accounts for the years ended June 30, 2011, 2012 and 2013 revealed that there is a reduction in 'Land' owing to the sale of constructed private patients' rooms ( which are not separable from the 'Land').

2. In this regard, ICAP is kindly requested to provide technical opinion/ input on the following queries of the Department:

(i) Whether the Company accounted for the afore-referred transaction in accordance with applicable accounting standards i.e. AFRS for MSEs; and

(ii) If not, please provide the correct accounting treatment in accordance with AFRS for MSEs / IAS / IFRS.

***Opinion:*** The Committee considered your enquiry and its views are as follows:

(i) The Company, being a medium-sized company, is required to comply with the requirements of Accounting and Financial Reporting Standards (AFRS) for Medium-sized Entities (MSEs).

(ii) The terms and condition of Sale Agreement mentioned in point (b) and (c) of the enquiry clearly states that right to own land, roof and bathroom of the patient admission room will not be given to the buyer. Point (f) indicates that the hospital may be retaining control over the rooms which indicate that risks and rewards were not fully transferred to the allottees. In addition, the economic benefit will continue to arise in future in the shape of reimbursement of maintenance.

Based on additional information received, mutation of the sale of patients' room was not undertaken and there is no information whether sales deeds were registered with the Registrar of Properties. Hence, we concur with your views that it is not a sale of land.

With regard to accounting treatment of this transaction, the Committee feels that the transaction may either be a:

- sale of right to use the room depending on the provisions of the contract, for which recognition and measurement criteria of intangible assets as given in Section 5 'Intangible Assets' may apply;
  **or**
- the transaction may also be an operating lease on which provisions of Section 4 'Leases' of AFRS may apply.

The Sales Agreement provided to us does not explicitly explain the terms of contract neither we have all other relevant facts and information to make the judgment of applicability of either of the two options.

Certain provisions of IAS 38 'intangible assets' and IAS 17 'Leases' are not covered in AFRS for MSE, therefore, recognition and measurement requirements as given in respective IFRSs should be used for guidance.

The Committee would also like to draw your attention to the requirements of paragraph 5 and 7 of IFRIC 12 'Service Concession Arrangements' which applies to public-to-private service concession arrangements, and may be used as analogy in this case.

*(*December 02, 2014*)*

## 1.4 CLARIFICATION ON THE DEFINITION OF 'SUBSIDIARY' IN TERMS OF SECTION 237 OF THE COMPANIES ORDINANCE, 1984

***Enquiry:*** The Companies Ordinance, 1984 (the "Ordinance") in its Section 3 lays down the definition of 'subsidiary' and 'holding company' as follows:

*"Meaning of "subsidiary" and "holding company".-(1) For purposes of this Ordinance, a company or body corporate shall be deemed to be a subsidiary of another if –*

*(a) that other company or body corporate directly or indirectly controls, beneficially owns or holds more than fifty per cent of its voting securities or otherwise has power to elect and appoint more than fifty per cent of its directors; or*

*(b) the first mentioned company or body corporate is a subsidiary of any company or body corporate which is that other's subsidiary;*

*Provided that where a central depository holds more than fifty percent of the voting securities of a company, such company shall not be deemed to be a subsidiary of the central depository save where such voting securities are held beneficially by the central depository in its own behalf.*

*(2) For the purpose of this Ordinance, a company shall be deemed to be another's holding company if, but only if, that other is its subsidiary."*

2. In view of this, if a Company 'A' holds, owns or directly controls more than 50 percent of the shares of another company 'B', any such company 'B' would become the subsidiary of company 'A' without any doubt.

3. However, since the financial and operating policies of an organization are governed by the board of directors of a company. Decisions are made through majority rule in a board of directors meeting. Accordingly, there can be certain instances where a company 'A' holds, owns or directly controls quite less than 50 percent of the shares of another company 'B' (assuming that company 'B' does not hold any shares of company 'A'), but both the companies have common board/ directorship or they have majority of the board members in common. In this scenario, the Commission would like to seek the views of the Institute of Chartered Accountants of Pakistan (ICAP) as to whether the company 'B' would be the subsidiary company of company 'A'. What impact would this scenario have if the chief executive of company 'B' is one of the common directors, as chief executive is a position that brings with it, the control of the company in which the person is the chief executive officer?

4. Moreover, there can be such other instances where a company 'A' holds, owns or directly controls quite less than 50 percent of the shares of another company 'B' (assuming that company 'B' does not hold any shares of company 'A'), but both the companies have common board / directorship or they have majority of the board members in common, and the total number of shares of company 'B' are held by all the common directors and the company 'A', which, in aggregate, constitute a collective holding of more than 50 percent shares of company 'B'. So, the Commission would also like to seek the views of the ICAP in this scenario as to whether the company 'B' would be the subsidiary company of company 'A', as company 'A' directly and indirectly holds or controls more than 50 percent shares of company 'B'. What impact would this scenario have if the chief executive of company 'B' is one of the common directors? Will it further strengthen the indirect control of company 'A' over company 'B'?

5. It would be pertinent to state that the definition of subsidiary in Ordinance clearly refers to both direct as well as indirect control and at the same time the Ordinance does not further define the term "control" (be it direct or indirect).

6. For ease of reference, the 9th Edition of the Black's Law Dictionary was also referred, which defines the term 'control' as:

> "**control**, n (16c) The direct or indirect power to govern the management and policies of a person or entity, whether through ownership of voting securities by contract, or otherwise; the power or authority to manage, direct, or oversee <the principal exercised control over the agent>
>
> **control**, vb. (15c) 1. To exercise power or influence over <the judge controlled the proceedings>.
> 2. To regulate or govern <by law, the budget office controls expenditures>. 3. To have a controlling interest in <the five shareholders controlled the company>.

7. From the above-quoted definition of the term 'control', it is quite evident that control is fairly attributable to the direct or indirect power or influence to govern the management and policies of a company, regardless of the fact that such control or power has been acquired or is exercised by means of ownership or otherwise.

8. Your timely valuable opinion in the matter discussed hereinabove would enlighten us and would help the Commission in implementing and enforcing the relevant provisions of the law, accordingly.

***Opinion:*** The Committee considers that the issues highlighted by you are very relevant for corporate structure in Pakistan and would take more significance as IFRS 10 is applied. The Committee also considers that in addition to analysis for the purposes of Companies Ordinance, 1984 (the Ordinance), this analysis should also be carried out for accounting purposes i.e. whether or not these may be regarded as subsidiaries under IAS 27 or IFRS 10. Before this analysis, for ease of reference we have briefly quoted some of the paragraphs of IAS 27 and IFRS 10. However, we emphasize that for each situation all facts and circumstances need to be examined and there may be other paragraphs of the standard which may be relevant.

**IAS 27 *'Consolidated and Separate Financial Statements' (2008*)**

**Definitions**

***Control*** *is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.*

13. Control is presumed to exist when the parent owns, directly or indirectly through subsidiaries, more than half of the voting power of an entity unless, in exceptional circumstances, it can be clearly demonstrated that such ownership does not constitute control. Control also exists when the parent owns half or less of the voting power of an entity when there is:

    (a) power over more than half of the voting rights by virtue of an agreement with other investors

    (b) power to govern the financial and operating policies of the entity under a statute or an agreement;

    (c) power to appoint or remove the majority of the members of the board of directors or equivalent governing body and control of the entity is by that board or body; or

(d) power to cast the majority of votes at meetings of the board of directors or equivalent governing body and control of the entity is by that board or body.

**IFRS 10 '*Consolidated Financial Statements*'**

6. An investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.

7. Thus, an investor controls an investee if and only if the investor has all the following:

(a) power over the investee (see paragraphs 10–14);

(b) exposure, or rights, to variable returns from its involvement with the investee (see paragraphs 15 and 16); and

(c) the ability to use its power over the investee to affect the amount of the investor's returns (see paragraphs 17 and 18).

17. An investor controls an investee if the investor not only has power over the investee and exposure or rights to variable returns from its involvement with the investee, but also has the ability to use its power to affect the investor's returns from its involvement with the investee.

18. Thus, an investor with decision-making rights shall determine whether it is a principal or an agent. An investor that is an agent in accordance with paragraphs B58–B72 does not control an investee when it exercises decision-making rights delegated to it.

B38 An investor can have power even if it <u>holds less than a majority of the voting rights of an investee</u>. An investor can have power with less than a majority of the voting rights of an investee, for example, through:

(a) a contractual arrangement between the investor and other vote holders (see paragraph B39);

(b) rights arising from other contractual arrangements (see paragraph B40);

(c) the investor's voting rights (see paragraphs B41–B45);

(d) potential voting rights (see paragraphs B47–B50); or

(e) a combination of (a)–(d).

B42 When assessing whether an investor's voting rights are sufficient to give it power, an investor considers all facts and circumstances including:

(a) the size of the investor's holding of voting rights relative to the size and dispersion of holdings of the other vote holders noting that:

(i) the more voting rights an investor holds, the more likely the investor is to have existing rights that give it the current ability to direct relevant activities;

(ii) the more voting rights an investor holds relative to other vote holders, the more likely the investor is to have existing rights that give it the current ability to direct the relevant activities;

(iii) the more parties that would need to act together to outvote the investor, the more likely the investor is to have existing rights that give it the current ability to direct the relevant activities;

(b) potential voting rights held by the investor, other vote holders or other parties (see paragraph B47-B50)

(c) rights arising from contractual arrangements (see paragraph B40)

(d) any additional facts and circumstances that indicate the investor has, or does not have, the current ability to direct the relevant activities at the time that decisions need to be made, including voting patterns at previous shareholders' meetings.

B58 When an investor with decision-making rights (a decision maker) assesses whether it controls an investee, it shall determine whether it is a principal or an agent. An investor shall also determine whether another entity with decision-making rights is acting as an agent for the investor. An agent is a party primarily engaged to act on behalf and for the benefit of another party or parties (the principal(s)) and therefore does not control the investee when it exercises its decision-making authority (see paragraphs 17 and 18). Thus, sometimes a principal's power may be held and exercisable by an agent, but on behalf of the principal. A decision maker is not an agent simply because other parties can benefit from the decisions that it makes.

B73 When assessing control, an investor shall consider the nature of its relationship with other parties and whether those other parties are acting on the investor's behalf (i.e. they are 'de facto agents'). The determination of whether other parties are acting as de facto agents requires judgment, considering not only the nature of relationship but also how those parties interact with each other and the investor.

B75 The following are examples of such other parties that, by the nature of their relationship, might act as de facto agents for the investor:

(a) the investor's related parties

(b) ---- (d)

(e) An investee for which the majority of the members of its governing body or for which its key management personnel are the same as those of the investor

An analysis of the three situations for the purposes of the Ordinance and for accounting purposes under IAS 27 and IFRS 10 could be as follows:

**1. Company 'A' holds, owns or directly controls more than 50 percent of the shares of another company 'B'**

| Companies Ordinance, 1984 | IAS 27 | IFRS 10 |
|---|---|---|
| In the absence of any other agreement, the Company B would appear to be subsidiary of Company A. | In the absence of any other agreement, the Company B would appear to be subsidiary of Company A. | In the absence of any other agreement, the Company B would appear to be subsidiary of Company A.<br><br>An analysis of the factors other than voting rights e.g. identification of the relevant activities, understanding the purpose and design of an investee, other contractual arrangements, pattern of voting rights held by others, and specific voting rights for specific relevant activities etc. is also necessary to determine control over an investee. |

| | | |
|---|---|---|
| | | |

2. **Company 'A' holds, owns or directly controls quite less than 50 percent of the shares of another company 'B' but both the companies have majority of the board members in common**

| Companies Ordinance, 1984 | IAS 27 | IFRS 10 |
|---|---|---|
| In the absence of any other agreement giving power to Company A to elect and appoint more than fifty per cent of directors of Company B, Company B would not appear to be subsidiary of Company A. The Company A does not seem to have power to elect and appoint more than fifty percent of directors of Company B.<br><br>The term 'indirectly controls' has not been defined in the Companies Ordinance. In the absence of any other instructions, the committee considers that the term used in paragraph 13 of IAS 27 'indirectly through subsidiaries' should be applied. | Under IAS 27, an investor may have control over an investee while holding less than 50% of the voting rights. Conditions given in para 13 of IAS 27 (reproduced above) need to be carefully reviewed for analyzing control.<br><br>In Committee's view, by having common members on the respective board of directors, or by having Chief Executive Officer of Company B on the board of Company A, may not itself provide corroborative evidence that Company A has a control over Company B. All facts and circumstances would need to be analysed. | Under IFRS 10 as well, an investor can control an investee with less than the majority of voting rights. Refer paragraph B38 above.<br><br>For this to be the case all facts and circumstances reproduced in B42 above would need to be considered.<br><br>B75(e) gives example that an investee for which the majority of the members of its governing body or for which its key management personnel are the same as those of the investor, may act as de facto agents for the investor. |
| | | The Committee considers that common directorship is not a conclusive factor for determining control. Other factors like contractual arrangements and circumstances discussed above may also require judgment and need to be considered. |
| | | IFRS 10 includes a number of application examples to illustrate the analysis that is required and the Committee would recommend referring them for guidance purposes. |

3. **Company 'A' holds, owns or directly controls quite less than 50 percent of the shares of another company 'B' but both the companies have majority of the board members in common, and the total number of shares of company 'B' are held by all the common directors and company 'A', in aggregate, constitute a collective holding of more than 50 percent shares of company 'B'.**

Refer case no. 2 above.

***Note of Caution:***

The Committee would like to highlight here that the above views are based purely on theoretical scenarios presented. Therefore, application of views presented above based on these theoretical scenarios to actual conditions without considering all relevant underlying factors in accordance with provisions of relevant applicable standards may not be appropriate.

*(*December 24, 2014*)*

## 1.5 AMORTIZATION OF INTEREST FREE LOAN UNDER IAS 39

***Enquiry:*** This is with reference to the subject matter where it has been observed that the companies are following different accounting practices as follows:

(a) No amortization of the interest free loan;

(b) Amortization of the interest free loan and accounting for the amortized gain in Profit & Loss Account (P&L); and

(c) Amortization of the interest free loan and accounting for the amortized gain in Equity.

2. In this connection, it has been noticed that when the amortized gain is credited to P&L, as per the requirements of International Accounting Standard (IAS) 39 "Financial Instruments: Recognition and Measurement", the tax authorities are treating the said income as taxable. This is one of the reasons that the companies are reluctant to follow the treatment of carrying the interest free loan on amortized cost as required under IAS 39.

3. Secondly, it has also been observed that the amortized gain is being accounted for within the equity rather than treated as income in the P&L. In this regard, your valuable opinion is solicited whether the aforesaid treatment is in line with the requirements of the IASs.

4. With regard to Para 2 above, you are requested to take up the matter with the Federal Board of Revenue on the issue of taxability of amortized gain under intimation to us, in order to streamline the accounting treatment and / or taxable issues of the subject matter.

5. Moreover with regard to Para 3 above, you are requested to confirm whether the treatment of accounting the amortized gain in equity is a valid treatment under the IASs.

***Opinion:*** The Committee considered your enquiry and its views are as follows:

The fair value of inter-company loans usually need to be estimated and the difference between fair value and loan amount then needs to be accounted for.

Where the loan is from a parent to a subsidiary, it would be inappropriate to recognise a gain or loss for the discount or premium; in substance this is an additional contribution by the parent (or a return of capital/distribution by the subsidiary). Contributions from and distributions to "equity participants" do not meet the basic definition of income or expenses (refer Framework para 70). In this case, the difference between the loan amount and the fair value (discount or premium) should be recorded as:

- an investment in the parent's financial statements (as a component of the overall investment in the subsidiary);
- a component of equity in the subsidiary's financial statements.

Subsequently, the loan should be measured at amortised cost, using the effective interest method. This involves "unwinding" the discount such that, at repayment, the carrying value of the

loan equals the amount to be repaid. The unwinding of the discount should be reported as interest income or expense.

Where the loan is between group entities other than a parent and subsidiary, the discount or premium may meet the definition of income or expense depending on whether or not, in substance, the transaction is carried out at the direction of the parent. In this case, the Committee would like to refer its Selected Opinion No. 1.9 *'Measurement of Interest Free (Low Interest Rate Loans Received/ Advanced By Companies'* of Volume XII which addresses your issue.

With regard to take up this issue with the Federal Board of Revenue (FBR), the Committee is of the view that accounting treatment of amortization of interest free loan is clear in IAS 39. If the Commission has identified the taxability issues in certain companies then the Committee suggests interested parties to take up the matter directly with the FBR.

*(*February 11, 2015*)*

## 1.6 QUERY ON TRADING RIGHT ENTITLEMENT CERTIFICATES (TREC)

***Enquiry:*** Pursuant to demutualization of the Lahore Stock Exchange (LSE) and Karachi Stock Exchange (KSE), the ownership rights in a Stock Exchange were segregated from the right to trade on an exchange. As a result of such demutualization, Trading Right Entitlement Certificates and Shares were issued by Stock Exchanges.

According to ICAP Directive, the apportionment of book value of Cards will be on the basis of fair value of Trading Right Entitlement Certificates and Shares issued by Stock Exchanges. After apportionment of book value of cards to TREC and Shares, we will determine recoverable amount of Cash Generating Units (CGU) according to IAS-36 for impairment test. Recoverable amount will be equal to higher of FV less cost of disposal and Value in Use (Para 19).

The Karachi Stock exchange has, vide its notice dated May 2013, determined the fair value of Trading Right Entitlement Certificates and Shares for the purpose of Base Minimum Capital (BMC) requirement as under:

- TREC - Rs.15,000,000
- Shares @ Rs. 9.954 per share

Currently a number of companies are showing the formal Stock Exchange card carrying value either as it is or apportioned the same between TREC and long Term Investment even if it exceeds the fair value of the TREC and Shares. For example:

The carrying value of card of KSE is around Rs. 105 M. Now either the card is being shown at Rs, 105M or this 105M is apportioned into TREC and Shares at Rs. 29M and Rs. 76M respectively. This apportionment is made on the following assumptions.

The KSE has declared the value of TREC at Rs. 15M and shares at Rs. 40M. The ratio of this value comes to 27:73. This Rs. 105M has been apportioned on the basis of this ratio.

Likewise, the carrying value of card of LSE is around Rs. 38M. Now either the card is being shown at Rs. 38M or this 38M is apportioned into TREC and Shares at Rs. 12M and Rs. 26M respectively. This apportionment is made on the following assumptions.

The LSE has declared the value of TREC at Rs. 4M and shares at Rs. 8.4M. The ratio of this value comes to 32:68. This Rs. 38M has been apportioned on the basis of this ratio.

In view of the above the clarification is required what will be the treatment of the value of cards over and above the value of TREC & Shares (Rs.15,000,000 & Rs.40,073,830) in respect of Karachi Stock Exchange and (Rs. 4,000,000 and Rs. 8,439,750) in respect of Lahore Stock Exchange.

Currently the TREC & Shares for KSE have been trading in the market at Rs.45 million approximately and TREC & Shares for LSE around Rs. 8 to Rs10M. Hence, active market is available. These transactions are being done in the form of open auction and private deals in the stock exchanges.

***Opinion:*** The Committee considered your query and would like to reproduce ICAP Selected Opinion No. 1.5 'Clarification required on ICAP Opinion on Accounting for De-Mutualization of Stock Exchanges' of Volume XIX issued on August 29, 2013:

> *"15. Any subsequent measurement of the shares and/ or TREC would only be possible where their reliable fair values can be measured. <u>This would most likely happen</u> 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".*

With regard to your query, the Committee would suggest that fair values on split off date need to be assessed and allocation of the value of card should then be done on the basis of determined fair values.

The Committee is also of the view that the apportioned carrying value would be required to be tested for impairment as per IAS 36, if any. When the management and the auditor conclude that there is no impairment, they may continue to use the apportioned carrying value. However, the Committee would like to caution you about transactions which are being done privately; care must be taken when data is not available publicly.

*(*February 11, 2015*)*

## 1.7 PRIMARY AND SECONDARY FREIGHT COSTS RELATED TO INVENTORY

**Enquiry:** **<u>Entity 1:</u>** ABC Ltd. is a trading company which imports Product A in bulk at Karachi port, which is then distributed to various of its warehouses throughout Pakistan, from where it is sold to its customers. ABC Ltd. incurs a substantial freight cost in transporting Product A from port to warehouses (Primary Freight) and also in transporting it from warehouses to the customers (Secondary Freight).

**<u>Entity 2:</u>** DEF Ltd., a sister concern of ABC Ltd., manufactures Product A at Karachi, which is then distributed to various of its warehouses throughout Pakistan, from where it is sold to its customers. DEF Ltd. also incurs a substantial freight cost in transporting Product A from port to warehouses (Primary Freight) and also in transporting it from warehouses to customers (Secondary Freight).

Both the entities expense out the entire secondary freight costs and that part of the primary freight costs which is relevant to the inventory sold, out of the total inventory transported, under Selling and Distribution expenses. For example:

Total inventory transported (Primary Freight)= 1 million units

Total inventory sold = 0.6 million

Total primary freight cost = Rs. 10 million

Primary freight cost expenses under Selling and Distribution = Rs. 6 million (0.6/1 X 10)

The remaining Rs. 4 million is shown as an asset under "Loans, advances, deposits, prepayments and other receivables" and expensed out when the related inventory is sold.

The following are some relevant paragraphs from IAS 2:

Para 10:

*Cost of inventories:*

*"The cost of inventories **shall** comprise all costs of purchase, costs of conversion and **other costs** incurred in bringing the inventories to their **present location and condition.**"*

Para 15:

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

In light of the above and any other relevant technical references, the following questions arise:

1. Should the primary freight cost be included in the cost of inventories and consequently in the Cost of Goods sold?

If the answer to question 1 is yes:

2. Would this be an optional or a necessary treatment?

3. Would this apply to both the manufacturing as well as the trading entity? (considering that there is a general belief among accountants that costs should only be included in inventory if they are necessary to bring it in "saleable condition", a term not used anywhere in IAS 2)

4. Where then would secondary freight be classified in case:

a) The risk remains with the selling entity during transport to the customer, and passes onto him when the Product reaches his premises?

b) The risk passes onto the customer during transport to him, but the transport cost is borne by the seller?

5. If the entities, in addition to the warehouses, had retail units, would it then be appropriate to include the cost of transportation from the warehouse to the retails unit in inventory?

6. In a scenario where inventory is moved from Karachi to Peshawar, for planned sales there, but due to low demand or any other extraordinary circumstances, has to be moved back to Karachi again, under which head would the cost of this return trip of inventory be classified?

If the answer to question 1 is no or the answer to question 2 is optional:

7. Is it appropriate to defer the primary freight expenses under the Head "Loans, advances, deposits, prepayments and other receivables" till the time of sale of related inventory?

8.Would the entity's pricing at different locations affect where primary freight cost is classified? If yes, where would it be classified under the following scenarios?

a) The entities charge the same price at all locations

b) The entities charge a price varying in line with primary freight costs at all locations

c) The entities charge a price directly dependent on primary freight cost at most locations, but charge lower prices at locations where they face stiff competition.

9. If the primary freight cost is to be classified under Cost of Goods Sold because the relevant revenue (the increase in price due to the freight cost incurred) is included in sales revenue, would it then be appropriate to classify secondary freight under Cost of Goods Sold if the entity charges additionally for delivery to the customer, which is part of sales revenue?

***Opinion:*** The Committee would like to refer following paragraphs of IAS 2 'Inventories':

11 The costs of purchase of inventories comprise the purchase price, import duties and other taxes (other than those subsequently recoverable by the entity from the taxing authorities), and transport, handling and other costs directly attributable to the acquisition of finished goods, materials and services. Trade discounts, rebates and other similar items are deducted in determining the costs of purchase.

16 Examples of costs excluded from the cost of inventories and recognised as expenses in the period in which they are incurred are:
(a) abnormal amounts of wasted materials, labour or other production costs;
(b) storage costs, unless those costs are necessary in the production process before a further production stage;
(c) administrative overheads that do not contribute to bringing inventories to their present location and condition; and
(d) selling costs.

The cost of inventory includes all necessary expenditures in bringing the inventory to its desired condition and location for sale or for use in the manufacturing process. For raw material and inventory that are purchased outright and not intended for further conversion, cost identification is straight forward. The cost of these inventories will include all expenditures incurred in bringing the goods to the point of sale and capable of being sold. These costs include purchase price, transportation (freight), insurance and handling cost.

Freight-in costs are part of the cost of goods purchased. The cost of goods includes all costs necessary to get an asset in place and ready for use. Freight-in costs are allocated to the products purchased and will cling to the products. Those products in inventory (items not yet sold) will include their share of the freight-in costs (as part of the inventory cost). The products that have been sold will include their share of the freight-in costs (as part of the cost of goods sold).

Freight-out i.e. Distribution costs and the costs of transporting goods to customers are not product costs and are not to be included in the cost of the inventories. However, transport and distribution costs that are necessary to get the inventory to its present location or condition for sale form part of the cost of inventory. The following are examples of costs that are allocated to inventory:

- the cost of transporting goods from the supplier;
- transport or distribution costs that are incurred at an intermediate stage in the production process; and
- transport or distribution costs to get the inventory from a central warehouse to the point of sale.

Similarly, packaging costs incurred to prepare inventory for sale are part of the cost of inventory.

*(*February 11, 2015*)*

## 1.8 TECHNICIAL OPINION - IFRIC 15 'AGREEMENTS FOR THE CONSTRUCTION OF REAL ESTATE' READ WITH IAS 18 'REVENUE'

***Enquiry:***

(i) A public unlisted company (the "Company") has principal business of development of housing projects and commercial plazas. The Company being an Economically Significant Company (ESC) has prepared its financial statements in accordance with the International Financial Reporting Standards (IFRS/IAS).

(ii) The annual audited accounts of the Company for the year ended June 30, 2012 has entered into sales agreements with large number of its customers to deliver housing units or full: developed residential/ commercial plots as per the terms and conditions agreed between the parties.

(iii) The Company has policy on **'Revenue'** as follows:

***'Revenue'*** *from sale of plots, houses commercial areas is recognized by applying stage of completion method. Revenue is recognized by the proportion that project costs incurred for work performed to date bears to the estimated total cost of the project. Unrecognized revenue represents the portion of the value of houses sold by the Company under agreement to sell to clients and would be recognized as revenue by transfer to profit or loss in subsequent years".*

The Company in response to the Commission's letter, with regard to recognition of revenue has provided a copy of specimen agreement (Copy Attached) and stated as follows:-

*"The full amount of property sold to a 'Customer' through the 'Agreement to Sell' is immediately recognized as 'Trade Debts' on the Debits side and 'Un- recognized Revenue on the credit side. The amount of Down Payment' and 'Installments' when received are adjusted against the 'Trade Debts' till the time the 'Last Installment' is received from such 'Customer' where by the balance of 'Trade Debts' for such 'Customer' becomes zero. This accounting treatment is based on the legal fact that 'Risks and Reward,' of the relevant property has transferred to the 'Customer' upon signing of the 'Agreement to Sell'. On the other hand, 'Un-recognized Revenue' is based on the 'Matching Principle' concept of accounting where only that portion of the Revenue is recognized in Income Statement of the year which pertains to the actual cost incurred on the project on the date when Income Statement and Balance Sheet are drawn. At each Balance sheet date, the estimate total cost of the 'Property '(if Single property) or the 'Project'(in case the 'Property' is a part of an integrated project which consists of large number of properties and any single property cannot be completed) is revisited and 'Stage of Completion' method is applied to determine what portion of the Revenue has been earned and therefore should be transferred to the Income Statement currently. Costs incurred on projects for unsold housing units or plots are recorded as inventory' which may include, but not limited to the purchase of land development and construction costs, etc. simultaneously, appropriate costs from the Inventory are transferred to the 'Cost of Sale' in the Income Statement of the period against the Revenue Recognized in the Income Statement of the period by applying the percentage completion method for such properties against which 'Agreement to Sell' have been signed with the 'customers'."*

While clarifying the revenue recognition principles followed in terms of International Accounting Standard (lAS) 11 'Construction Contracts' and lAS 18 'Revenue' read with IFRIC Interpretation 15 'Agreement for the Construction of Real Estate', the Company has stated as follows:~

*"The Company is engaged in construction and development of real estate projects in Pakistan. The Company has sold and delivered numerous housing and infrastructure development projects in Pakistan where the Company has entered into agreements with large number of its customers to deliver a housing unit or a fully developed residential / commercial plot as per the terms and conditions agreed between the parties. IFRIC-15 'Agreements for the construction of Real Estate' contains the detailed guidance to determine whether these agreements are within the scope of IAS 18 or IAS 11 and when the revenue from these contracts should be recognized.*

*According to Para 12 of IFRIC -15, an agreement the construction of real estate in which buyers have only limited ability to influence the design of the real estate, e.g. to select a design from a range of options specified by the entity, or to specify only minor variations to the basic design, is an agreement for the sale of good within the scope of IAS 18. The Company offers standard products to its clients whereby they can choose from a few models and sizes in terms of ground space and constructed space while no changes are accepted which are part of the approved plans from the development authorities (LDA, FDA, CDA etc.) therefore, the revenue shall be recognized within the scope of IAS 18 as sale of goods.*

*As per Para 16 and 1, IFRIC-15, if the entity is required to provide services together with construction materials in order to perform its contractual obligation to deliver the real estate to the buyer, the agreement is an agreement for the sale of goods and the criteria for recognition of revenue set out in paragraph 14 of IAS 18 apply. Simultaneously, the entity may transfer to the buyers the practical ownership control and the risks and rewards associated the ownership of the work in progress in its current state as construction progresses. In this case, if all the criteria in paragraph 14 of IAS 18 are met continuously as construction progresses, the entity shall recognize revenue by reference to the stage of completion applying the percentage of completion method. The requirements of IAS 11 are generally applicable to the recognition of revenue and the associated expenses for such transaction.*

*According to para 14 of IAS 18, Revenue from the sale of goods shall be recognized when all the following conditions have been satisfied:*

*(a) the entity has transferred to the buyer the significant risks and rewards of ownership of the goods.*
*(b) The entity retain neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;*
*(c) the amount of revenue can be measured reliably;*
*(d) it is probable that the economic benefits associated with the transaction will flow to the entity; and:*
*(e) the costs incurred or to be incurred in respect of the transaction can be measured reliability.*

*As per para 25 of IAS 11, the recognition of revenue and expenses by reference to the stage of completion of a contract is often referred to as the percentage of completion method. Under this method, contract revenue is matched with the contract costs incurred in reaching the stage of completion, resulting in the reporting of revenue, expenses and profit which can be attributed to the proportion of' work completed. This method provides useful information on the extent of contract activity and performance during a period.*

*In our case, the Company transfers all the significant risks and rewards associated with the properties sold to the customers. The customers are free to sell their properties to third parties to make gains provided that they have adhered to the other terms and conditions of the agreement. Further the Company retains neither the continuing managerial involvement to the degree usually associated with the ownership nor the effective control over the*

*properties, once these have been sold to the clients, to an extent that would preclude recognition of some or all the consideration as revenue.*

*The company transfers to the buyer control and the significant risks and rewards of ownership of the properties being sold by the company to its clients as the constructions progresses. The benefit of the increase in prices of properties as a result of development and construction activities at individual projects goes to the clients and they can make gains by selling their properties as market prevailing prices which is normally on higher side than the prices charged by the Company."*

It is observed that the Clauses of the 'Sale Agreement' indicate that risks and rewards were not fully transferred to the customers and managerial involvements of the units sold remains with the Company, Hence, this arrangement may not be considered as a valid sale; and

In this regard, ICAP is kindly requested to provide technical opinion/ input that whether the recognition of trade debts and unearned revenue at the time of signing of sales agreements is in line with the requirements of IAS 18 and IFR1C Interpretation 15, and, if not, please provide the accounting treatment in accordance with IFRS/ IAS.

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

**IAS 11 'Construction Contracts':**

**11 Contract revenue shall comprise:**

**(a) the initial amount of revenue agreed in the contract; and**
**(b) variations in contract work, claims and incentive payments:**
**(i) to the extent that it is probable that they will result in revenue; and**
**(ii) they are capable of being reliably measured.**

13 A variation is an instruction by the customer for a change in the scope of the work to be performed under the contract. A variation may lead to an increase or a decrease in contract revenue. Examples of variations are changes in the specifications or design of the asset and changes in the duration of the contract.

A variation is included in contract revenue when:

(a) it is probable that the customer will approve the variation and the amount of revenue arising from the variation; and
(b) the amount of revenue can be reliably measured.

**IAS 18 'Revenue':**

**14 Revenue from the sale of goods shall be recognised when all the following conditions have been satisfied:**

**(a) the entity has transferred to the buyer the significant risks and rewards of ownership of the goods;**
**(b) the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;**
**(c) the amount of revenue can be measured reliably;**

**(d) it is probable that the economic benefits associated with the transaction will flow to the entity; and**
**(e) the costs incurred or to be incurred in respect of the transaction can be measured reliably.**

15 The assessment of when an entity has transferred the significant risks and rewards of ownership to the buyer requires an examination of the circumstances of the transaction. In most cases, the transfer of the risks and rewards of ownership coincides with the transfer of the legal title or the passing of possession to the buyer. This is the case for most retail sales. In other cases, the transfer of risks and rewards of ownership occurs at a different time from the transfer of legal title or the passing of possession.

16 If the entity retains significant risks of ownership, the transaction is not a sale and revenue is not recognised. An entity may retain a significant risk of ownership in a number of ways…….

19 Revenue and expenses that relate to the same transaction or other event are recognised simultaneously; this process is commonly referred to as the matching of revenues and expenses. …….... However, revenue cannot be recognised when the expenses cannot be measured reliably; in such circumstances, any consideration already received for the sale of the goods is recognised as a liability.

**IFRIC 15 'Agreements for the Construction of Real Estate':**

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

*The agreement is an agreement for the sale of goods*

16 If the entity is required to provide services together with construction materials in order to perform its contractual obligation to deliver the real estate to the buyer, the agreement is an agreement for the sale of goods and the criteria for recognition of revenue set out in paragraph 14 of IAS 18 apply.

17 The entity may transfer to the buyer control and the significant risks and rewards of ownership of the work in progress in its current state as construction progresses. In this case, if all the criteria in paragraph 14 of IAS 18 are met continuously as construction progresses, the entity shall recognise revenue by reference to the stage of completion using the percentage of completion method. The requirements of IAS 11 are generally applicable to the recognition of revenue and the associated expenses for such a transaction.

18 The entity may transfer to the buyer control and the significant risks and rewards of ownership of the real estate in its entirety at a single time (e.g. at completion, upon or after delivery). In this case, the entity shall recognize revenue only when all the criteria in paragraph 14 of IAS 18 are satisfied.

The terms and conditions of Sale Agreement mentioned in clause 19, 20 and 23 state that:

- Completion of the Sale Deed of the House/ Property and registration in the name of the client will be done once all the dues have been cleared.
- This sales agreement will not create legal right, title in the property in favor of the client until a registered sales deed is executed in favor of the client.
- Client will not transfer the allotted Property until and unless prior written permission of the Company is obtained.

Based on information provided, risks and rewards are not fully transferred to the client as well as control/ managerial involvements of the units sold will remain with the Company and therefore, the requirements of para 14 (a) and (b) of IAS 18 are not being complied. Keeping in view of the requirements of para 17-18 of IFRIC 15, the Committee is of the view that the revenue from the sale of housing scheme will be recognized when all the requirements of para 14 of IAS 18 are fulfilled.

However, the Committee is also of the view that in order to record the liability, the recognition of receivable from Customers as per the payment schedule agreed in contract and unearned revenue/ advance received from customers at the time of signing of sales agreements is in line with the requirements of IAS 1.

*(*February 11, 2015*)*

## 1.9 IMPLEMENTATION OF IFRS 10 'CONSOLIDATED FINANCIAL STATEMENTS' ON MUTUAL FUNDS IN PAKISTAN

***Enquiry:*** We refer to ICAP circular 2008/01 wherein it was stated that "the matter is under consideration of the Professional Standards and Technical Advisory Committee of ICAP and joint committee of the ICAP & MUFAP, therefore, till the outcome of the decision of both the committees, members are advised not to consolidate their funds" and the recent introduction of consolidation under IFRS 10 which is creating confusion in the Industry.

The Industry's viewpoint is that IFRS 10 should not be applicable on the mutual funds industry. Asset management companies should not consolidate the funds under their management along with their financial statements, as consolidation may lead to serious distortion and volatility in the financial statements of the Management Company which will be grossly misleading.

While IASB's exception for Investment Entities clearly excludes mutual funds from consolidation, the asset management companies need to be examined on the definition of control. We have examined the same and have the view that asset management companies operating in Pakistan fall under the role of Agent and therefore should be classified as investment entities.

Consolidating mutual funds into asset management companies will create serious distortion and volatility in the financial statements of the Management Company which will be grossly misleading. That when consolidated into the management companies into their sponsor entities will lead to further distortion and as most of those sponsors are listed will mislead the investors. As explained by IASB, the fair value information is more useful for decision making than consolidated information. The consolidated information with regards to mutual funds industry will have no purpose whatsoever as mutual funds are pooled investments and the right of ownership is pari passu for all investors in the fund and not the asset management companies or their sponsors.

In this regards, a clarification/ circular similar to circular 2008/01 should be issued by ICAP that all mutual funds and asset management companies are "investment entities" and therefore consolidation under IFRS 10 will not be applicable on the industry. We are available for further

discussion in this regards so that the same can be addressed before the end of the Financial Year.

***Opinion:*** **ISSUE**

After the introduction of IFRS 10 'Consolidated Financial Statements' ("IFRS 10"), the Institute has been approached by number of practicing members for seeking opinion on whether:

- The Asset Management Companies ("AMCs") meets the definition of Investment Entity under the requirements of IFRS 10;
- AMC controls the Mutual Funds ("MFs"); and
- MF should be consolidated with the AMC under the requirements of IFRS 10.

**1. Investment Entity**

| Requirements of IFRS 10 | Yes / No | Basis of Opinion |
|---|---|---|
| *27. "…A parent shall determine whether it is an investment entity. An investment entity is an entity that:* | | When evaluating whether AMCs satisfy the definition of investment entities, first we need to understand that MFs and AMCs are two distinct and separate legal entities. The majority of investors of MFs are substantially different from the shareholders of AMCs, although the shareholders of AMCs may also invest in MFs to whom the AMCs provide asset management services.<br><br>In assessing whether the entity meets the definition of an investment entity, an entity is required to consider the requirements of paragraphs 27 and 28 and the criteria given in B 85 of IFRS 10. |
| *(a) obtains funds from one or more investors for the purpose of providing those investor(s) with investment management services;* | **No** | AMCs do not obtain funds directly on their own account but invite funds for investment schemes (MFs), which are separate legal entities. The AMCs in Pakistan do not satisfy the typical characteristics required in paragraph 28 of IFRS 10. While the investees (investment schemes) can be more than one, the shareholders of AMCs are generally very few/one who are its related parties (e.g. banks are parent companies of AMCs). Most of the AMCs operating in Pakistan are public unlisted companies which are closely held by a few investors.<br><br>As per the guidance given in paragraphs B85Q to B85S of IFRS 10, typically an investment entity would have several investors who pool their funds to gain access to investment management services and investment opportunities that they might not have access to individually. This is generally what happens in a MF but not in the case of an AMC. |
| *(b) commits to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment* | **No** | MFs commits to the unit holders that its business purpose is to invest funds in various investment portfolios solely for returns based on capital appreciation, investment income, or both. |

| Requirements of IFRS 10 | Yes / No | Basis of Opinion |
|---|---|---|
| *income, or both; and* | | This is not true in case of AMCs. AMCs primary business and principal source of income, is asset management services to MFs managed by it. AMCs (investor) may also invest surplus funds in the MFs (investee) managed by it and benefit from payout and capital appreciations. However, such investment is not its core business. |
| *(c) measures and evaluates the performance of substantially all of its investments on a fair value basis…"* | **Yes** | As per B85K of IFRS 10, an essential element of the definition of an investment entity is that it measures and evaluates the performance of substantially all of its investments on a fair value basis. In order to demonstrate that it meets the definition, an investment entity:<br><br>(a) provides investors with fair value information and measures substantially all of its investments at fair value in its financial statements; and<br><br>(b) reports fair value information internally to the entity's key management personnel (as defined in IAS 24), who use fair value as the primary measurement attribute to evaluate the performance of substantially all of its investments and to make investment decisions.<br><br>As explained above primary business of AMCs is provision of asset management services and its performance is evaluated with reference to the size of assets under its management and the fee income therefrom. However, AMCs also measure their investment at fair value.<br><br>**CONCLUSION: AMCs in Pakistan do not meet all the criteria as laid down by IFRS 10.27. Therefore, in our opinion, AMCs are not Investment Entities.**<br><br>**In our view, AMCs shall be required to consolidate those MFs under its management which meet the criteria discussed above.**<br><br>**If AMC is acting as principal then only it needs to consolidate unless exemptions under para 31 and 33 of IFRS 10 are claimed. In Pakistan majority of AMCs are subsidiaries of banks and are presented in the consolidated financial statements of the parent.** |

## 2. Control of Asset Management Company

| Requirements of IFRS 10 | Yes / No | Basis of Opinion |
|---|---|---|
| *7. "…An investor controls an investee if and only if the investor has all the following:* | | |
| *(a) power over the investee;* | **Yes** | In order to establish control, first criteria is to assess power of AMCs (investor) over schemes (investee) under its management.<br><br>Power is the current ability to direct the relevant activities. Power arises from rights, which may include:<br>- voting rights<br>- potential voting rights<br>- rights to appoint key personnel<br>- decision making rights within a management contract<br>- removal or kick-out rights<br><br>However, power does not arise from protective rights.<br><br>The AMCs in Pakistan establish market and manage a publicly regulated MF in accordance with narrowly defined parameters set out in the investment mandate governed by local laws and regulations (*Non- Banking Finance And Notified Entities Regulations, 2008*).<br><br>In Pakistan, MFs are not required to establish, and have not established, an independent board of directors.<br><br>In Pakistan, the unit holders do not hold any substantive rights that would affect the decision-making authority of the AMCs, but can redeem their interest at the NAV of that day.<br><br>Although AMCs are operating within the parameters set out in the investment mandate and in accordance with the regulatory requirements, it has decision-making rights that give it the current ability to direct the relevant activities of the MF.<br><br>*Thus, AMCs (investors) has power over the investment schemes (MFs/Investee).* |
| *(b) exposure, or rights, to variable returns from its involvement with the investee; and* | **Case-to-Case basis** | In order to establish control, second criteria is to assess whether the investor (AMC) is exposed, or has rights, to variable returns from its involvement with the scheme (investee). |

| Requirements of IFRS 10 | Yes / No | Basis of Opinion |
|---|---|---|
| | | Returns can be positive, negative or both. Example of returns include:<br>- Dividends (from direct interest in the fund either directly or potentially through certain related parties)<br>- Remuneration (as result of earning management fees and performance fees)<br><br>As per section 61 of Non- Banking Finance And Notified Entities Regulations, 2008:<br><br>"*An Asset Management Company shall be entitled to an accrued remuneration equal to an amount not exceeding three percent of the average annual net assets of the Collective Investment Scheme that has been verified by the trustee and is paid in arrears on monthly basis during the first five years of existence of the Collective Investment Scheme and thereafter of an amount equal to two per cent of such assets or such other amount as may be specified by the Commission:*<br><br>*Provided that an Asset Management Company may charge performance based or fixed fee or the combination of both which shall not exceed the limit prescribed in this Regulation and such fee structure shall be disclosed in the Offering Document."*<br><br>AMCs in Pakistan are entitled to remuneration (i.e. management fee) as per the above regulation. In addition AMCs may also invest surplus funds in units of the schemes and earn return similar to those of other unit holders of the scheme (i.e. investment return).<br><br>If the AMC has no investment return than variability of returns from the activities of the fund will be nil. Thus, second criteria for control establishment will not be met, therefore, control will not be established.<br><br>However, if the AMC is earning management fee as well as investment return, then AMC will be exposed to the variability of returns from the activities of the mutual fund.<br><br>*Thus, the assessment of exposure to variable returns will need to be assessed on case to case basis. However, considering the general practice in Pakistan, most of the AMCs are exposed to the variability of returns from the activities of the mutual fund as these AMCs have also invested in units of MFs to which it is providing management services.* |
| *(c) the ability to use its power over the investee to affect the amount of the investor's returns…"* | **Case-to-Case** | In order to establish control, third criteria is to evaluate whether the investor (AMC) has the ability to use its power to affect the returns from its involvement with the |

| Requirements of IFRS 10 | Yes / No | Basis of Opinion |
|---|---|---|
| | **basis** | investee (MFs). This criteria requires to determine whether the AMC is acting as a Principal or Agent to the unit holders of MF by considering following factors:<br><br>- scope of its decision-making authority over the fund,<br>- rights held by other parties (including removal rights),<br>- remuneration to which the fund manager are entitled in accordance with the remuneration agreement,<br>- exposure to variability from other interests that it holds in the mutual funds.<br><br>Thus AMCs in Pakistan:<br><br>- have wide scope of decision- making power over the unit holders,<br>- will be removed only if there is willful contravention of trust deed, liquidation, appointment of receiver, etc. These rights are considered to be the protective rights.<br>- are entitled to remuneration.<br>- are exposed to variability of interest through their investments, if any, in the units of MFs managed by it.<br><br>*After analyzing relevant illustrative examples of IFRS 10, it should be assumed that if AMC exposure to variability of returns is 20% or more than relationship of Principal is established with unit holders of MF.*<br><br>**CONCLUSION: In our opinion, majority of AMCs in Pakistan would meet the first two requirements of control definition that is power and exposure to variability of returns. However, keeping in mind the illustrative examples of IFRS 10 and to avoid subjectivity, if AMCs exposure to variability to returns is 20% or more then the AMCs' exposure to variability of returns from the activities of the fund is of such significance that it indicates that the AMC is a Principal to the unit holders of MF as the AMC meet all criteria laid down by IFRS 10.7 for control establishment. Therefore, parent and subsidiary relationship will be established between AMC and MF, unless it is proved that AMC is acting as an Agent to the unit holders of MF.**<br><br>**We consider that management of AMC will also have to assess on case to case basis for each MF that they manage as to whether they have control over the MF.**<br><br>(June 23, 2015) |

# AUDITING

## 2.1 SIGNING OF PREVIOUS YEAR AUDIT REPORT OF CORPORATION

***Enquiry:*** State Life Insurance Corporation of Pakistan (the corporation) is a state owned entity established and governed under Life Insurance (Nationalization) Order, 1972. The Board of Directors of the corporation was dissolved on 12 May 2013. The financial statements of the corporation for the year ended 31 December 2012 were initialed by two firms of Chartered Accountants. However, due to non-existence of Board of Directors, these financial statements remained un-approved and the Auditors' Report thereon was not issued by the auditors. One of the auditors completed his term and the other one continued. For the subsequent year ended 31 December 2013, another firm of Chartered Accountants was appointed as auditors as a replacement of the auditors ceased to continue with the approval from Ministry of Finance. Section 28 of the Life Insurance (Nationalization) Order, 1972 deals with the appointment of auditors and audit of the financial statements of the corporation.

The Board of Directors of corporation has been re-constituted during the year and the financial statements of the corporation are being approved by the Board of Directors. The auditors for the relevant year who ceased to continue are reluctant in signing the Auditor's Report as they believe that they are currently no more the auditors of the corporation as of the approval of the financial statements by the Board of Directors in current date. We write to seek your opinion as to the signing of the Auditor's Report for the year ended 31 December 2012 by the predecessor auditors in the current date.

***Opinion:*** The Committee has examined your enquiry and understand that draft audited financial statements of the Corporation for the year ended 31 December 2012 (2012 Financials) were not approved in accordance with the provisions of Life Insurance Nationalization Ordinance, 1972 (LINO) due to non-constitution of the Board by the Federal Government. Accordingly, the auditors, one of whom having completed five years tenure and due to retire (retiring auditor), also could not sign the audit report on 2012 Financials. The Federal Government prior to approval and signing of these draft audited accounts appointed a new auditor in place of retiring auditor for the audit of financial statements for the subsequent years.

This has created an anomaly as traditionally the draft audited accounts are approved by the Board and retiring auditor sign the audit report prior to appointment of new auditors. Given the fact that LINO is silent on this specific issue, the Committee consider that the retiring auditor may sign the audit report on 2012 Financials after these have been approved by the Board, to avoid any undue hardship to the Corporation.

However, for extra caution, the Corporation is advised to act under legal advise.

*(*December 02, 2014*)*

## 2.2 CLARIFICATION REGARDING SECTION 230 & AUDITORS REPORT TO THE MEMBERS

***Enquiry:*** Section 230 of the Companies Ordinance 1984 deals with “Books of Account” and has several subsections. The sub-section 6 states:

**Quote** "The books of account of every company relating to a period of not less than ten years immediately preceding the current year shall be preserved in good order" **unquote.**

And whereas

- the Auditor's Report to the members states:

**Quote** "We report that:

a} In our opinion, proper books of account have been kept by the Company as required by the Companies Ordinance 1984" **Unquote**

Similarly under para 3, line 3 states:

**Quote** "An Audit includes examining on a test basis" **Unquote**

I request clarification whether the Auditor's Report to the members confirms compliance of Section 230 including subsection 6 having been verified on test check basis by the external auditors or not?

***Opinion:*** The Committee would like to emphasis that both the above addressed matters are different. Section 230 of the Companies Ordinance 1984 deals with retention of records whereas auditor's report addresses maintenance of proper books of account which means proper accounting, properly reconciled, etc.

The Committee would like to reproduce section 255(3) of the Companies Ordinance 1984:

> (3) The auditor shall <u>make a report to the members of the company on the accounts and books of accounts of the company</u> and on every balance-sheet and profit and loss account or income and expenditure account and on every other document forming part of the balance-sheet and profit and loss account or income and expenditure account, including notes, statements or schedules appended thereto, which are laid before the company in general meeting <u>during his tenure of office</u>, and the report shall state-
>
> (a)……
>
> (b) whether or not in their opinion proper books of accounts as required by this Ordinance have been kept by the company;

An auditor is required to give an opinion that proper books of accounts have been maintained by the company for the relevant accounting period. An auditor is not required to perform extra procedures to verify whether or not books of account of last ten years have been preserved by the company.

*(*February 11, 2015*)*