
SELECTED **O**PINIONS

TECHNICAL ADVISORY COMMITTEE

Volume-III

COMPILED BY

TECHNICAL DIRECTORATE

**THE INSTITUTE OF CHARTERED
ACCOUNTANTS OF PAKISTAN**

Introduction

This report is the third compilation of selected inquiries raised by the members, Corporate Law Authority and other agencies and replies issued by the Technical Advisory Committees during 1995 and upto April 1996 for the general guidance of the members of the Institute. Volume I, and II were published earlier.

The opinions contained in this publication 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 are arrived at on the basis of the facts and circumstances of each individual query and are issued at that particular point in time, it may change if the facts and the circumstances change. An opinion may change also due to subsequent development 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.

Syed Sajid Ali
Director Technical Services

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1. ACCOUNTING

1.1 CUSTOM REBATE & C.C.1 & E REBATE-ACCOUNTING TREATMENT

Inquiry: How the rebate allowed by Custom and, C.C.1 & E be dealt with in accounts/presented in the audited accounts.

Opinion: With the abolition of import licence fee the C.C.1 & E rebate has been withdrawn by the Government and does not exist presently.

Section 37 of the "Act " states that where it appears to the Board that in respect of goods of any class or description manufactured in Pakistan and exported to any place outside Pakistan, a drawback of customs-duties should be allowed on any imported goods of a class or description used in the manufacture of such exported goods, the Board may, by notification in the official Gazette, direct that drawback shall be allowed in respect of such imported goods to such extent and subject to such condition as may be provided in the rules.

Section 40 of the ' Act ' mandates that the payment of duty drawback shall not be made until the vessel carrying the goods has put out to sea or other conveyance has left Pakistan.

There is a time lag in the date on which a duty drawback becomes due to the exporter and the physical receipt of the duty drawback. There is therefore a likelihood of holding an opinion that the accounting of the duty drawback should be postponed till its physical receipt from the government. Such opinion or view however being in conflict with the fundamental concept of " accrual accounting " is erroneous. The amount of the duty drawback be computed in accordance with the relevant provisions of the " Act ", accrued in full and accounted for as ' Duty Drawback Receivable from Government when, as stated in **paragraph 14 of IAS 18 Revenue**, amongst other factors enumerated therein, **the enterprise has transferred to the buyer the significant risks and rewards of ownership of the goods.**

The amount admissible as duty drawback as per claim lodged with the competent authority should be shown as a deduction from cost of sales.

1.2 DEPRECIATION-CHARGE OF - AS PER REQUIREMENTS OF INCOME TAX ORDINANCE 1979

Inquiry: A listed company used to charge depreciation as per requirement of the Third Schedule of Income Tax-Ordinance 1979 without making its own estimates of the useful life of the asset. The company now considers it to be a 'fundamental error' and has decided to estimate the useful life of the asset with the help of experts. The company has also decided to change its depreciation method from declining method to sum of units method.

Three queries made are:-

1. Can this be done? Particularly with respect to reversal of excess depreciation of prior years?
2. How the reversal of prior years' amount be presented in the Profit and Loss Account?
3. What is auditors' responsibility in this respect?

Opinion:

- 1&2 The depreciation does not fall within the category of fundamental error', the fundamental error is defined in IAS-8 as under:-

“ Fundamental errors are errors discovered in the current period that are of such significance that the financial statements of one or more prior periods can no longer be considered to have been reliable at the date of their issue.”

As per Pare 23 of IAS-8, the depreciation is an accounting estimate: the paragraph states 'estimates may be required, for example, of the useful lives or expected pattern of consumption of economic benefits of depreciable assets'. Also, paragraph 52 of IAS 16 states that if there has been a significant change in the expected pattern of economic benefits from the assets, the (depreciation) method should be changed to reflect the change pattern and "such a change in depreciation method should be accounted for as a change in accounting estimate

ISA 26, Audit of Accounting Estimates also shows the provisions to allocate the cost of fixed asset over their estimated useful lives as an accounting estimate.

The International Accounting Standards do not bar the change in the depreciation method if a significant change in the expected pattern of economic benefits is foreseen by the management.

According to paragraph 26 of IAS-8 “the effect of a change in accounting estimate should be included in the period of change and future period”, if the change affects both. Also, paragraph 52 of IAS 16 states that when a change in the depreciation method is necessary, the depreciation charge for the current and future periods should be adjusted.

IASs do not refer to previous years reversal in current year; they all refer to 'current and future period'. The depreciation charged in the previous years cannot therefore be reversed.

3. The Auditors' responsibility with respect to the audit of accounting estimates is comprehensively stated in the ISA and need not therefore be stated again.

1.3

EXCHANGE RISK FEE (TR-24) - ACCOUNTING TREATMENT

Inquiry: TR-24, Exchange Risk Fee-Accounting Treatment, advocates that the "fee" paid after the start of the commercial operation should be charged off.

ISSUE

Whether or not the auditors should qualify the report when a company insists on capitalization of exchange risk fee as an exchange loss as allowed by the Companies Ordinance, 1984. In such an event, whether the Companies Ordinance, 1984 or the TRs issued by the Institute should be followed?

Opinion: 1. The words used in clause 2(D) of Part II of the Fourth Schedule to the Companies Ordinance, 1984 are "may be added to or deducted from" and not "shall". As such it is not obligatory to adjust Exchange Risk Fee from the value of the respective assets.

2. Moreover TR 24 has to be read in the light of IAS-4, Depreciation Accounting, IAS-16, Property, Plant & Equipment and IAS-21, Accounting for the Effects of Changes in Foreign Exchange Rates, which are not in conflict with the TR issued by the Institute. You are aware that the three IASs have been notified by CLA under Section 234 of the Companies Ordinance, 1984.

3. Therefore if the client insists on capitalization of Exchange Risk Fee the auditors' report may be qualified suitably.

1.4 GAIN ON SALE OF FIXED ASSETS- ACCOUNTING TREATMENT

Inquiry: Whether realized gain on sale of land is a capital reserve or is it a revenue reserve?

Opinion: The Committee has noted that para 7 (A) (ii) of the Fourth Schedule to the Companies Ordinance 1984 defines "Capital Reserve" as under:

'Capital reserves shall include capital redemption reserve, share premium account, profit prior to incorporation or any reserve not regarded free for distribution by way of dividend (to be specified).'

The Committee has also noted that Para 1 (A) (vii) of Part III of the same Schedule, Requirements as to Profit and Loss Account, provides for 'Profit on Sale of Fixed Assets' to be Included in the Profit and Loss Account.

Further, paragraph 56 of IAS-16 Property, Plant and Equipment provides that "Gains or losses arising from the retirement or disposal of an item of property, plant and equipment should be determined as the difference between the estimated net disposal proceeds and the carrying amount of the asset and should be recognized as income or expense in the income statement.

The Committee is of the opinion that, based on the above, profit on sale of land cannot be accounted for as a "Capital Reserve".

However, the board of directors of the company if they so choose may resolve to appropriate such gain towards undistributable surplus in which case a transfer can be made to a capital reserve account with appropriate disclosure.

1.5 GIFT OF SHARES OF PUBLIC LIMITED COMPANIES TO A PRIVATE LIMITED COMPANY-ACCOUNTING TREATMENT

Inquiry: A private limited company has received shares (duly transferred in its name) of a public limited company as a gift from somebody. These shares have been accounted for as investment by credit to Capital Reserve.

ISSUE

1. Can an individual gift (free of cost) shares of a public company to a private company?
2. Is the stated accounting correct and,
3. If the stated accounting is not correct, what would be the correct recording of the shares?

Opinion: i) Whether or not the shares can be gifted, not being an accounting or auditing matter, advice may have to be sought from an attorney-at-law.

ii & iii) How to treat the gift in the company accounts depends upon the terms of the gift deed. However, assuming that a gift can legally be made and that the gift has not been made with any special condition(s) and the company is free to deal with the shares in any manner deemed fit by it, the accounting as an investment is all right.

As to the value to be assigned to these shares the Committee is of the opinion that the same should be at market value in case of quoted shares and break-up value in other cases. The Committee is further of the opinion that the value of gift would be a revenue receipt and accordingly should be taken to profit and loss account.

1.6 HALF YEAR ACCOUNTS- PUBLICATION OF

Inquiry: 1. Do those companies which have opted to close their accounts for a period of eighteen months, that is, January 1, 1995 to June 30, 1996 and have issued half yearly (audited) accounts for January 1, 1995 to June 30, 1995 have to issue second half yearly accounts for the period July 1, 1995 to December 31, 1995 under section 245 of the Companies Ordinance, 1984.

2. If such accounts have to be issued, then which period's comparative half yearly figures should be given as accounts for July 1, 1994 to December 31, 1994 were not prepared/issued.

- Opinion:**
1. Section 245 of the Companies Ordinance, 1984 (the Ordinance) obliges every listed company to prepare and transmit to its members a profit and loss account and balance sheet as at the close of the first half of its year of account. Since the year of accounts in the case cited by you encompasses a period of eighteen months (1 January 1995 to 30 June 1996), the underlying objective of the law would seem to have been served if the accounts are prepared for the period 1 January 1995 to 30 June 1995 and circulated to the members within the stipulated time. On, however, a more literal interpretation of the said provisions, it may be argued that 'first half of the year of account' should in the instant case be 1 January 1995 to 30 September 1995. While this apparently may appear to be the legal connotation in relation to a 'year', the change over of the accounting year this time is in any case not an ordinary situation contemplated by law. Accordingly, therefore, it would be advisable to adhere to the original purport of the law by adopting the first six months as the 'first half year of account.'
 2. The Committee also considered the provisions of Section 246 to the Ordinance, which empowers Corporate Law Authority to require companies, either by a general order or a special order to prepare and send to the members periodical statement of accounts in such form and manner as may be specified. Should the company in the instant case receive such an order specifically or be made subject to a general order, it shall have to prepare and circulate accounts covering the period of six months between 1 July 1995 to 31 December 1995.
 3. As regards your enquiry relating to comparative figures in such six monthly accounts, the Committee is of the opinion that the comparative figures should cover the same period in the preceding year e.g., for 1 July 1995 to 31 December 1995 the comparative figures should be for 1 July 1994 to 31 December 1994.

1.7 INVESTMENT - VALUATION OF

- Inquiry:**
1. IAS 25, Accounting for Investment, requires that the current investments should be valued at either the market rate or the lower of cost or market rate determined either on an aggregate portfolio basis in total or by category of investment or individual investment basis. The market value is generally considered to be the rate ruling at the last date of the financial year.

On the basis of "Prudence" when the investments are disposed off at a lower rate than the rate at the date of the balance sheet, should not provision be made on the basis of the date of disposal rather than on the basis of the rate at the balance sheet date? and, if the investments are disposed off at the higher rate than the rate ruling at the balance sheet date is there may need for providing for the fall in the market value at the balance sheet date?

As per IAS 25 'Accounting for Investments', 'Market value' is the amount obtainable from the sale of an investment in an active market. It does not mean market rate at the date of balance sheet.

ISSUE

Is the practice correct?

Opinion: VALUATION OF INVESTMENTS

Paragraph 29 and 33 of IAS-10, Contingencies and Events Occurring after the Balance Sheet Date state:

Paragraph 29

"Adjustments to assets and liabilities are not appropriate for events occurring after the balance sheet date, if such events do not relate to conditions existing at the balance sheet date. An example is the decline in market value of investments between the balance sheet date and the date on which the financial statements are authorized for issue. The fall in market value does not normally relate to the condition of the investments at the balance sheet date, but reflects circumstances, which have occurred in the following period. However, disclosure is generally made of events in subsequent periods that represent unusual changes to the condition of assets or liabilities at the balance sheet date; for example, the destruction of a major production plant by a fire after the balance sheet date".

Paragraph 33

" If disclosure of events occurring after the balance sheet date is required by paragraph 28 of this Standard, the following information should be provided:

- (a) the nature of the event; and
- (b) an estimate of the financial effect, or a statement that such an estimate cannot be made".

On the basis of the above, in case the investments are held as current investments and the market value of such investments on the balance sheet date is lower than cost but between the balance sheet date and the date on which the accounts are authorized for issue, the market value of such investments rises above cost, the investments should be carried in the balance sheet at market value (being lower than cost) at the balance sheet date.

As for paragraph 3 of your query the Committee would like to clarify that it has been assumed that the active market is a place where securities/shares are exchanged i.e. registered Stock Exchange in Pakistan. Further in this active market rates differ on day to day basis. Therefore, for the purpose of determining the market value the rate prevalent at the date of balance sheet is relevant.

1.8 LAND LEASE FOR 99 YEARS-AMORTIZATION OF

Inquiry: The lease-hold land is held on a specific maximum period of 99 years. Some entities charge off lease cost over the period of the lease; some entities do not do so. According to IAS 17, Accounting for Leases, such land leases are required to be classified as operating lease, whereas all the business concerns show it as fixed asset.

ISSUE

Is the showing of lease hold land as fixed asset in accordance with IAS-17, Accounting for Leases?

Opinion: As in the case of leasehold land the risks and rewards are not transferred to the lessee, the leasehold land as per International Accounting Standard No.17, Accounting for Leases, is classified as an operating lease. However, in Pakistan, Paragraph 2(A) (i) (a) of Part II of the Fourth Schedule to the Companies Ordinance, 1984, requires that the leasehold land should be classified under fixed assets and as the Companies Ordinance, 1984 prevails over International Accounting Standards, the leasehold land is accounted for as part of fixed assets and not as an operating lease. It is to be noted that in majority of leases, the lease costs, where the government is lessor, are immaterial. The published accounts of different companies show that where the lease costs are considered to be material by the Management, these are being amortized and in the opinion of the Committee these should be amortized.

2. AUDITING

2.1 AUDIT DELAYED - MANDATORY QUALIFICATION OF REPORT OR NOT

Inquiry: Should not the Auditors' Report be qualified when there is an inordinate delay in audit

Opinion: In paragraph 12 of AS 1 - Objective and General Principles Governing an Audit of Financial Statements it is clearly stated as follows:

Paragraph 12- 'While the auditor is responsible for forming and expressing an opinion on the financial statements, the responsibility for preparing and presenting the financial statements is that of the management of the entity. The audit of the financial statements does not relieve management of its responsibilities.'

Moreover the Companies Ordinance has laid down a strict time frame in which annual accounts should be prepared by the directors and laid before shareholders.

In view of the above stated position the Committee is of the opinion that there is no need for a mandatory qualification of the Auditors' Report if there is a delay in audit beyond a certain period after closing of books.

2.2 ACCEPTING POSITION OF DIRECTOR IN A COMPANY WITH WHICH THE FIRM HAS RETAINERSHIP ARRANGEMENTS

Inquiry: A practicing firm has a retainership arrangement with the company. One of the partners has been offered the position of a director "on the board"?

ISSUE

Can the partner accept the offer and hold the position of a director?

Opinion: Clause (10) of Part 1 of Schedule I of the Chartered Accountants Ordinance, 1961 as provides as under:-

A Chartered Accountant in practice shall be deemed to be guilty of professional misconduct if he-

Engages in any business or occupation other than the profession of chartered accountants unless permitted by the Council so to engage:

Provided that nothing contained herein shall disentitle a chartered accountant from being a director of a company, unless he or any of his partners is interested in such company as an auditor.

As such the Committee is of the opinion that the position of director of the company can be accepted provided the firm are also not the statutory auditors.

2.3 ACCEPTANCE OF APPOINTMENT IN CASE OUT GOING AUDITOR RAISES OBJECTIONS

Inquiry: If the out going auditor raises an objection or point, is it binding on the incoming auditor to attend to it before accepting the audit or not?

Opinion: The major reason for 'communication' is to enable the incoming auditor to ascertain why the change is contemplated by the management, that is why ' the incoming auditor must be fully informed ', as stated in paragraph 6 of ATR-2 ' to enable him to decide for himself whether or not, it is professionally desirable for him to accept the nomination.'

Explaining why communication is essential, sub-para (b) of para 8 of ATR-2 states:-

"The interest of the incoming auditor has to be safeguarded".

The purpose of communication between the existing and the incoming auditors is to ensure that all relevant facts are known to the incoming auditor and to determine whether, in the given circumstances, it would be proper for him to accept the assignment as well as to ensure that by accepting the appointment he does not unwittingly become the means by which any unsatisfactory practice of the company or any impropriety in the conduct may be enabled to continue or may be concealed from shareholders or other legitimately interested persons.

2.4 AUDITOR'S APPOINTMENT AT AGM TO CARRY OUT AUDIT OF ACCOUNTS OF MORE THAN ONE FINANCIAL YEAR IF SUCH ACCOUNTS HAVE NOT YET BEEN AUDITED

Inquiry: Inquiry No. 2.3 in Volume II of the Selected Opinions issued by the Institute, which is reproduced below, needs clarifications:-

Inquiry: We have been appointed statutory auditors of a private limited company for the year 1993. The audit for the year 1991 and 1992 is still pending. We have already communicated to the existing auditor In respect of the proposed appointment. We shall appreciate if you would please guide us that since we are auditors for the year 1993, can we also issue our report for the year 1991 and 1992 or not?

Opinion: Regarding appointment of auditors the Institute has Issued ATR 11 on July 10, 1992. ATR 11 states:-

'An auditor has to be appointed in an annual general meeting and he holds office till the next annual general meeting. Such appointment is not related to the accounting year of the company. In other words if more than one year's accounts of the company are in arrears for audit purposes the auditor appointed in the last annual general meeting could audit all the pending accounts till the next annual general meeting when he would cease to hold office as the auditor unless re-appointed'.

In the opinion of the Committee, therefore, accounts for 1991 and 1992 can be audited if such accounts have not yet been audited.

Section 158 of the Companies Ordinance 1984 states that an Annual General Meeting (AGM) is to be held within eighteen months from the date of incorporation and thereafter once at least in every calendar year within a period of six months following the close of its financial year and not more than fifteen months after the holding of its last preceding AGM.

Section 233 which deals with the annual accounts and balance sheet states that the directors of the company will lay before the company in AGM a balance sheet and profit and loss account made upto a date not earlier than the date of the meeting by more than six months. The period of accounts shall not exceed twelve months and shall be audited by the auditor of the company. It further states that a copy of the balance sheet and profit and loss accounts so audited with the auditors' and directors' report shall be sent to every member of the company. Section 252 provides that an auditor is appointed at each AGM to hold office till conclusion of the next AGM, when either the retiring auditor is re-appointed or new auditor is appointed.

ISSUE

- i) How could the auditor for the year 1993 be appointed if an AGM was not held?
- ii) Assuming that an AGM was held and audited accounts were not presented, however, an auditor was appointed for audit of the year 1993. How can he audit accounts for 1991 and 1992 when another auditor had been appointed by the shareholders for audit of 1991 and 1992?

Opinion: According to sub-section 1 of Section 252 of the Companies Ordinance, 1984:-

"Every company shall at each annual general meeting appoint an auditor or auditors 'to hold office from the conclusion of that meeting until the conclusion of the next annual general meeting".

And according sub section 3 of Section 255 of the Companies Ordinance 1984:-

3) , The auditors shall make a report to the members of the company on the accounts and books of accounts of the company 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 during his tenure of office. and the report shall state.....

As such if an auditor had been appointed to audit accounts for 1991 and 1992 and, he had not carried out those audits for whatever reasons, his appointment

will cease at the conclusion of next annual general meeting. Two auditors cannot hold appointment at the same time to carry out audits of different years.

We are therefore of the opinion that the opinion of the Committee at 2.3 in Volume II of Selected Opinions does not require any modification and is quite clear on the subject.

2.5 AUDITORS' REPORT AS PER FORM XI OF THE MODARABA COMPANIES AND MODARABA RULES, 1981

Inquiry: As per Form XI of the Modaraba Companies and Modaraba Rules, 1981 the contents of the auditors' report include certification that the business conducted, investments made and expenditure incurred by the Modaraba are in accordance with the objects, terms and conditions of the Modaraba. The modarabas are required to comply with the following:-

- i. Modaraba Companies and Modaraba (Floatation and Control) Ordinance, 1980.
- ii. Modaraba Companies and Modaraba Rules 1981.
- iii. NBFIs Regulations promulgated by SBP.
- iv. Guidelines issued by CLA.
- v. Authorization certificate issued by Modaraba Registrar

ISSUE

1. Is the audit opinion to be confined to i and ii; or,
2. Is the auditor required to ensure that the modaraba has also adequately complied with other requirements as mentioned in iii to v as well;
3. If the answer to issue No. 2 is in affirmative, specific clauses requiring the auditor to do so may be identified; and,
4. Should the audit report be qualified in the event of noncompliance of requirements mentioned in iii to v.

Opinion: The auditor is required to express his opinion on the financial statements of the Modaraba in the format prescribed in Form XI of the Modaraba Companies and Modaraba Rules 1981. Paragraph c(i) of the Format requires the auditor to determine whether the Financial Statements exhibit a true and fair view of the state of the Modaraba's affairs.

Paragraph 29 of AS -1 relating to Objective and Basic Principles Governing an Audit, (1993) states as follows:-

"The auditor should review and assess the conclusions drawn from the audit evidence obtained as the basis for the expression of an opinion on the financial information. This review and assessment involves considering whether:-

- the financial information has been prepared using acceptable accounting policies, which have been consistently applied;
- the financial information complies with regulations and statutory requirements relating to the preparation of financial statements;
- the view presented by the financial information as a whole is consistent with the auditor's knowledge of the business of the entity; and
- there is adequate disclosure of all material matters relevant to the proper presentation of the financial Information".

Keeping in view the relevant provisions of AS-1 as reproduced above the auditor's opinion on financial statements of Modaraba should not be only confined to:-

- the 'objects, terms and conditions' given in the Modaraba's prospectus,
- Modarabas Companies and Modaraba (Floatation and Control) Ordinance 1980 and
- Modaraba Companies and Modaraba Rules, 1981, and,

the auditor is also required to verify compliance of various regulations and statutory requirements, which may include the following:

- State Bank of Pakistan Non-Banking Financial Institutions Regulations.
- Guidelines issued by the Corporate Law Authority.
- Registrar of Modarabas' Authorization Certificate.
- Consent Order of Controller of Capital Issues.

While expressing his opinion on the financial statements the auditor in accordance with AS-1, is required to verify compliance with all the relevant rules, regulations and statutory requirements.

The auditor should use his judgment to determine whether noncompliance of any particular rule or regulation is material which could affect the true and fair view of the financial statements of Modaraba and then decide accordingly whether he should qualify his audit report or not.

2.6

AUDITORS' REPORT : FORM IN RESPECT OF CHARITABLE INSTITUTIONS/ CLUBS/SCHOOLS AND RELIGIOUS INSTITUTIONS

Inquiry: Has the Institute prescribed a standard form of auditor's report in respect of charitable institutions/clubs/schools and religious institutions etc.?

Opinion: The Institute has not prescribed any specific form of Auditor's Report for Charitable Institutions, etc.

The Institute has adopted International Standard on Auditing No.13, The Auditor's Report on Financial Statements and No. 24, The Auditors' Report on Special Purpose Audit Engagement and the requirements of both the Standards are required to be complied with in every case.

2.7 AUDITOR'S RESPONSIBILITY IN CASE OF GOVERNMENT ORGANIZATIONS INCURRING LOSSES DUE TO MISAPPROPRIATION OF ASSETS

Inquiry: In the case of government organizations huge losses are suffered by such organizations due to misappropriation of assets and illegal use of authorities and positions. In normal practice auditors emphasize that financial statements should reflect true and fair view of the affairs of the concern and its assets should be reflected not higher than their realizable value. Therefore, they emphasize on writing off debts which are not collectable or making provision for bad debts if they are doubtful. Through such emphasis of auditors further support is being provided to concealment of thefts and illegal use of government resources. Kindly advise whether auditors have any responsibility for reporting of such fact in the audited financial statements or there is any other way through which auditors can discharge their responsibility.

Opinion: The Committee has considered the query in depth and is of the opinion that where auditor reaches the conclusion that misappropriation of assets has taken place the auditor is under obligation to extend his audit procedures till the time either he dispels or confirms his suspicion. Guidance has to be taken from AS-11, Fraud and Error. In the event of confirmation of his suspicion auditor has a responsibility to ensure that the misappropriation has been adjusted in the financial statements. Also a disclosure of such misappropriation is warranted as per AS 11. By complying with these procedures the illegal act is brought to the attention of the beneficial owner, in this case, government.

However, in the event an adjustment of misappropriation is not made the auditor should qualify his report. In the event the adjustment of misappropriation is made but not disclosed in the financial statements it would require qualification in the auditors' report that adequate disclosure has not been made.

2.8 COMMUNICATION BETWEEN MEMBERS IN CASE THERE IS A BIG GAP BETWEEN AUDITS

Inquiry: The audit of an entity was conducted by a C.A firm "several years ago". In the period after "several years ago" the entity was audited by a body other than a Chartered Accountant. Subsequently, audit was undertaken by a C.A. firm. The

inquiry is whether the incoming auditors were obliged to communicate with the C.A firm who had audited accounts 'several years ago'?

Opinion: It is abundantly clear from the inquiry that the system is such that its audit does not fall within the purview of the Companies Ordinance, 1984. It is also clear that the audit of the system was arranged by the management from a body other than a Chartered Accountant and the management had the audit done for its own purpose and not as a mandatory necessity. According to the given facts the audit in the intervening years since several years ago was undertaken by a body other than a CA and when a CA firm is appointed as auditors such CA firm is not obliged to communicate, with the CA firm who had audited accounts several years ago.

2.9 COMMUNICATION: CHANGE OF AUDITORS

Inquiry: Is the communication necessary between the auditors of a taking-over company with the auditors of a merged company?

Opinion: In case the accounts of the former company have been merged in the accounts of KESC and are not being audited separately by a chartered accountant, there would be no requirement for KESC's auditors to communicate with the auditors of the former company. However, if the accounts of the former company have been kept separate from KESC's main accounts and are being audited separately by a chartered accountant, the latter has an obligation to communicate with the auditor of the former company as per clause 7 of Part 1 of Schedule I of Chartered Accountants Ordinance, 1961.

2.10 EMPLOYEE/CONSULTANT/RETAINER: HOW TO DIFFERENTIATE BETWEEN

Inquiry: What is the criteria to differentiate between an employee, consultant/retainer?

Opinion: 1. The 'consultant' in the limited context of the Institute, means a member (or members) who renders professional services other than audit that employs the practitioner's technical skills, education, observation, experience and knowledge.

2. An employee means a natural person appointed or engaged under a written or verbal contract of service, whether on a full time, part-time, permanent, casual or temporary basis, essentially creating a master-servant relationship., Other natural persons who are appointed or engaged under a contract for services and who are not subject to the direction of the employer in respect of the manner or execution of those services do not fall within the definition of an employee for this limited context.

3. A 'consultant-retainer' is one who instead of an one-off assignment holds the regular brief for the 'engager-enterprise' to employ technical skills etc. mentioned in paragraph 1 above as and when requested, on agreed financial terms and conditions.

2.11 HALF YEARLY AND ANNUAL STATEMENTS OF ACCOUNTS OF PRIVATE LIMITED COMPANIES: SUBMISSION TO CLA

- Inquiry:**
1. Is it compulsory for all Private Limited Companies to submit half yearly and annual statements of Accounts, Audited or Unaudited accounts irrespective of the amount of paid up/authorized capital, to the Corporate Law Authority?
 2. Is it the duty of Auditors (C.A) to submit Annual Balance Sheet of Private Companies to the CLA and in case of delay or default the possible action if any provided, in the statute?

Opinion: The position with respect to the specific query is that the Companies Ordinance 1984 provides for the half yearly accounts for the listed companies only and the position of accounts being unaudited applies to these half yearly accounts alone; annual accounts in respect of every company incorporated under the Companies Ordinance 1984 have necessarily to be audited as per Section 233(3) of the Companies Ordinance-1984. Section 242 of the Companies Ordinance deals with the filing of the copy of the balance sheet to the 'Registrar; whereas Section 233(5) requiring filing of accounts and other documents to the CLA and the Stock Exchange etc., are applicable to 'listed companies' only. Auditors do not have any duty or obligation in this regard.

2.12 MEMBERS' VISIT TO CLIENT

Inquiry: It is proposed that visit of a member viz., partner, principal or employee to client during audit be made compulsory.

Opinion: The existing International Standards on Auditing already envisage auditor's presence/visit to the client. For instance, besides various other references in ASs on the issue, AS-8, Audit Evidence, provides as under:

Para 13(a) Existence - an asset or a liability exists at a given date

Para 20 Inspection - Consists of examining records, Documents or tangible assets. Inspection of records and documents provides evidence of varying degrees of reliability depending on their nature and source and the effectiveness of internal controls over their processing. Three major categories of documentary audit evidence, which provide different degrees of reliability to the auditor, are:

(a) documentary audit evidence created and held by third parties;

(b) documentary audit evidence created by third parties and held by the entity; and

(c) documentary audit evidence created and held by the entity.

Inspection of tangible assets provides reliable evidence with respect to their existence but not necessarily as to their ownership or value.

Para 21 Observation - Consists of looking at a process or procedures *being performed by others*.

Para 22 Inquiry - Inquiry consists of seeking appropriate Information of *knowledgeable persons inside* or outside the entity. Inquiries may range from formal written inquiries addressed to third parties to informed *oral inquiries addressed to persons inside the entity*.

Para 5 Addendum to ISA When inventories are material to the financial statements, the auditor should obtain satisfaction as to their physical existence and condition by *attendance at stocktaking* unless this is impracticable.

2.13 MUSHARAKA FUND - TRUSTEES OF - REMUNERATION OF

Inquiry: Under clause 8.1 of the Guideline for Issue of Certificates of Musharaka for Modarabas issued by the Registrar of Modarabas, Corporate Law Authority, a practicing chartered accountant can be appointed as a trustee for which the maximum remuneration of. 0.05% per annum of the total Musharaka fund is payable quarterly to the member.

ISSUE

Whether acceptance of the remuneration violates clause 9 of Part 1 of Schedule I to the Chartered Accountants Ordinance, 1961.

Opinion: The remuneration of the trustees as stated in. Clause 8.5 of the Guidelines is not violative of the provisions of Clause (9) of Part 1 of the Schedule I of the Chartered Accountants Ordinance, 1961.

2.14 SELECTED OPINIONS: LEGAL STATUS OF

Inquiry: Statement in Introduction to Selected Opinions that 'these opinions represent the views of the members of the Committee and may not necessarily be construed as official opinions of the Council or the Institute'.

Opinion: The Introduction to Selected Opinions of Technical Advisory Committee Volume II compiled by the Technical Directorate correctly depicts the position of those opinions.

In your letter, it has been emphasized that 'Selected Opinions' are a compendium of "legal advice" by the Institute on issues where the members did not (or do not) find express provision in the Companies Ordinance and or other related laws. Reference to the publication shall however reveal that the opinions sought by the members are, by and large, of operational nature and not on issues on which the Companies Ordinance or other related laws are not explicit. Thus, the opinions contained in the publication are of the competent committee constituted by the Council of this august professional body.

The opinions issued by the Committee to the members' queries are dated. Thus, an opinion may change due to subsequent development in law, pronouncements made by the Institute and other relevant changes. Further, 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.

In view of above long known status of opinions given on members' queries, these are of advisory nature and service to members having been duly vetted by two or more committees comprising of senior members and therefore have been found useful vis-à-vis, government authorities and even third parties. In any case the querying member has to take his own decisions in the light of facts and circumstances in accordance with related laws and bye-laws etc., applicable to the issue under decision at that point in time.

2.15 TAX / BUDGET COMMENTARIES

Inquiry: Whether the Tax Budget Commentaries being issued by certain firms are in the nature of advertisements.

Opinion: The commentary on the budget, as also mentioned by you in your inquiry, is issued for 'client use only'. The commentary is in the nature of service by the auditors to their clients and is not in the nature of advertisement. In view of this position no further guidance to members appears to be warranted.

This Committee is also of the opinion that the issue of such tax/budget commentaries by the practicing members is fully covered by the Council's Directive No. 6.02 dated December 26, 1985 regarding Publicity and Advertising by Members.

3. CORPORATE & OTHER LAWS

3.1 BENEFICIAL OWNER OF THE SECURITIES - DEFINITION OF UNDER SECTION 222 OF THE COMPANIES ORDINANCE, 1984

Inquiry: Section 222 of the Companies Ordinance, 1984 requires every director, chief executive etc., to file a return if he is or has been a beneficial owner of the securities. Under the doctrine of Benami transaction an ostensible owner is merely a Benamidar while the beneficial ownership vests with the person other than the Benamidar. Section 224 of the Ordinance, which requires every director, chief executive etc., to tender the profit earned on the securities as a beneficial owner to the company also supports this view.

ISSUE

Does Section 222 need suitable modification/amendment?

Opinion: Section 222 of the Companies Ordinance, 1984 does not require any change because beneficial owner as used in this section will include an ostensible owner who may be real owner and in case where ostensible owner is a benami owner then such statement may be filed not by him but by the real owner.

3.2 BODY CORPORATE - DEFINITION OF - UNDER SECTION 2(16) OF THE INCOME TAX ORDINANCE, 1979

Inquiry: Whether a society registered under the Societies Registration Act of 1860 is a body corporate within the meaning of Section 2 (16) of the Income Tax Ordinance 1979? And, whether a society registered under the Societies Registration Act, 1860 is a body corporate and a 'company' under the provision of the Companies Ordinance 1984 as the interpretation has gained considerable importance due to the fact that a 'Company' is covered by the mischief of Section 80D of the Ordinance whereby in case no tax liability, 1/2 percent of the turnover is recovered as tax. This would mean that educational institutions, mosques and other similar organizations whose income is otherwise exempt would have to pay tax under Section 80D based on its gross revenue, since all such institutions invariably are registered under the Societies Registration Act, 1860.

Opinion: A society registered under the Societies Registration Act, 1860 is not a "body corporate" and, therefore, not a "Company" within the meaning of Section 2(16) of the Income Tax Ordinance, 1979. The term "body corporate" has not been defined in the Ordinance and in the absence of such a definition, the dictionary meaning of the term is to be relied upon. In Black's Law Dictionary the term "body corporate" has been defined as a public or private corporation. According to accepted definition a 'body corporate' cannot be one which cannot sue or be sued in its own name or which does not have a right to buy, sell, lease and mortgage in its own name. A Society registered under the Societies Registration Act, 1860 cannot sue or be sued in its own name and, therefore, it would not be a 'body corporate.'

3.3

CHIEF EXECUTIVE - PERIOD OF APPOINTMENT OF

Inquiry: Section 199(1) of the Companies Ordinance, 1984 provides for the appointment of chief executive for a period not exceeding three years from the date of appointment.

In a company XYZ limited the last election of directors was held in AGM on December 30, 1993. The next election of directors will be held on December 30, 1996, and then on December 30, 1999. The company's chief executive was appointed by the board on January 14, 1994.

The chief executive previously appointed on January 14, 1994, has resigned on November 1, 1995 and in his place new chief executive was appointed by the directors on November 2, 1995.

CLARIFICATION ASKED FOR

Whether the new chief executive appointed to fill the casual vacancy be appointed for the remainder of the period or for three years term upto November 1, 1998?

Opinion: The Committee is the facilitation forum for the interpretations or clarifications of issues pertaining to accounting or auditing matters only. The issue under reference neither relates to accounting nor to auditing; it is a question of legal interpretation, which is beyond Committee's functional scope. An attorney-at-law may have to be consulted for the definitive interpretation of the relevant provision of the 'Ordinance'.

The clarification issued by the Corporate Law Authority to whom reference has also been made should, in Committee's views, be considered to be the authoritative interpretation of the relevant section of the "Ordinance" until interpreted otherwise by the superior courts of law.

Subject to the above, the tentative observations of the Committee are as under:-

The wording of the inquiry suggest that the company's articles are modeled on Article 45 of Table A and the power to appoint the chief executive is vested not in the members in general meeting but in the board of directors.

Section 200 of the ' Ordinance ', Terms of Appointment of Chief Executive and Filling Up of Casual Vacancy, states:-

- (1) The terms and conditions of appointment of a chief executive shall be determined by the directors or the company in general meeting in accordance with the provisions in the company's articles.

Section 180(2), Term of office of directors states:-

Any casual vacancy occurring among the directors may be filled up by the directors and the person so appointed shall hold office for the remainder of the term of the director in whose place he is appointed.

Section 199(1) does not prescribe the minimum period of appointment of a chief executive; it stipulates the maximum period for the appointment. In other words, the appointment of a chief executive for a period of less than three years shall not be in conflict with the "Ordinance".

In view of the above stated provisions of the "Ordinance", the Committee is of the view that the new chief executive prima facie may be appointed to hold office for a maximum period of three years but advisedly upto December 30, 1996 to synchronise with 3 years tenure of other directors. Provisions of Section 180(2) relating to terms of office of directors regarding filling up of casual vacancy are not applicable to him.

3.4 DEBT EQUITY RATIO FOR PRUDENTIAL REGULATIONS

Inquiry: The Prudential Regulations require the Debt Equity Ratio of 60:40. The accounting of a lease as a finance lease tends to affect this ratio and the management insists on showing a lease for which there is no intention to return the asset back to the lessor as an operating lease instead of a finance lease.

ISSUE

The definition of debt calculated for the purpose of Prudential Regulations should not include the liability against assets subject to finance lease as fixed asset acquired are also shown against it.

Opinion: Regulation-V of the Prudential Regulations issued by State Bank of Pakistan, which is reproduced below, spells out the modality for long term debts:-

Extract from Regulation-V: Maintenance of Debt Equity Ratio

Current maturities of long term debt not yet due for payment may be excluded from the current liabilities for the purpose of calculating these ratios. Lease rental receivable within the next twelve months as disclosed in the notes to the annual audited accounts shall be treated as current assets for the purpose of calculating these ratios.

As such the Committee is of the opinion that long-term part of the finance lease shall have to be treated as part of debt.

3.5 DEPRECIATION ON FIXED ASSETS OF PUBLIC COMPANIES *(Reference by CLA)*

Inquiry: Under the repealed Capital Issues (Continuance of Control) Act, 1947 it was mandatory to charge depreciation at the rates not less than the rates provided in the Income tax Ordinance, 1979. After repeal of this enactment the policy regarding the depreciation is required to be settled in the best interest of shareholders/ investors.

Under the Fourth Schedule to the Companies Ordinance, 1984 the amount of depreciation charged is required to be disclosed along with method and rate charged. In case of deviation the reasons for not making it and the amount that should have been provided and quantum of arrears, if any, is to be disclosed. Any change in the accounting policy relating to depreciation that has material effect in the current year as well as subsequent years together with the reasons for the change and financial effect to the change, if material, are required to be mentioned. We have also adopted IAS No 4 requirements of which are known to you.

Since the rates of depreciation have a significant bearing on the financial position of a company and change in the depreciation rates are likely to alter profitability disclosed in the annual accounts, you are requested to examine the issue and give your considered views as to whether the matter needs regulation under policy guidelines or the companies may be given full freedom to charge depreciation in accordance with the requirements of the Companies Ordinance, 1984 and International Accounting Standard No 4.

Opinion: The regulation requiring the rate of depreciation charged in the accounts not to be less than the normal rates allowed under the tax law had lost its validity once the Institute of Chartered Accountants of Pakistan became a member of the International Accounting Standards Committee obliging its members to follow International Accounting Standards (IAS). IAS 4 and IAS 16 comprehensively deal with depreciation accounting and generally apply to all depreciable assets. You may be aware that Section 234(3) of the Companies Ordinance, 1984 makes it obligatory on every listed company to follow IAS 4 and IAS 16 amongst other IASs in preparing financial statements. The accounting profession is now of the opinion that the company's right to adopt a method of arriving at a fair charge based on International Accounting Standards should not be infringed with in any way.

3.6 DEPRECIATION - CHARGE OF - AT LESS THAN PRESCRIBED RATES (Reference by CLA)

Inquiry: 1. A company was granted permission, vide consent order dated 25.10.1992 to issue capital subject to the condition (condition No. 13 of the consent order) that depreciation shall be charged at rates not less than the rates of depreciation as admissible under Income Tax Law.

2. On examination of the annual accounts of the company for the year ended 30.9.1994 it was noticed that the company without obtaining prior exemption from the Controller of Capital Issues has charged depreciation on its plant and machinery on unit of production method instead of charging the same at the rates prescribed in the Income Tax Act, 1922, in contravention of condition No.13 of the Controller of Capital Issues consent order dated 25.10.1992. With this change in depreciation method, the company has charged less depreciation on its plant and machinery amounting to Rs.13.198 million in its annual accounts ended on 30.9.94.

The matter was taken up with the company's auditors to explain/clarify that they being auditors of the company as to how the company has charged depreciation on its plant and machinery on unit of production method, instead of charging it at a rate not less than the rate of depreciation as admissible under Income Tax Law whereas the company has not been permitted by the Controller of Capital Issues for change of depreciation policy.

In view of the position explained above you are requested to furnish your considered views/comments in the matter.

Opinion: 1. According to paragraph 9 of AS-31, Consideration of Laws and Regulations in an Audit of Financial Statements issued by the International Federation of Accountants:

It is management's responsibility to ensure that the entity's operations are conducted in accordance with laws and regulations. The responsibility for the prevention and detection of non-compliance rests with management".

2. According to paragraph 11, of the same AS:-

"The auditor is not, and cannot be held responsible for preventing non-compliance."

Moreover, as already enquired by the auditors under reference in their letter dated the 19th June, 1995 we had already conveyed our considered opinion on the Charging of Depreciation as follows:-

" In the opinion of the Committee, if the company adopts a policy in accordance with IAS the auditor need not qualify his report only on the grounds that the compliance of the CCI requirements regarding depreciation charge has not been made. The auditor should however, ensure that adequate disclosure has been made in the accounts regarding such non-compliance together with the reasons thereof and the impact on the financial statements.

In case the client refuses to make a disclosure regarding noncompliance, the auditor should include in his report a paragraph emphasizing the matter.

The Committee believes that where depreciation allocated to fixed assets on the basis of capacity utilization reflects the pattern in which the economic benefits are consumed by the enterprise, use of such method would be in order. However, a predetermined minimum charge for depreciation in each accounting period be made irrespective of the fact that the facility may not have been used at all.

In the present case the Management of Company has made full disclosures regarding the non-compliance of condition No. 13 of your consent order dated the 25th October 1992. In spite of the full disclosure the auditors have drawn the attention of the members to this non-compliance in their report dated the 28th February, 1995. Committee is of the opinion that Auditors have complied with the requirements of the Companies Ordinance, 1984, International Accounting Standards and International Standards on Auditing.

3.7 WORKERS' PROFIT PARTICIPATION FUND (WPPF) - FORMATION OF

Inquiry: Worker's Profit Participation Fund

Should a company form a Worker's Profit Participation Fund (WPPF) if:

- a) there are no permanent employees whose monthly emoluments are below Rs. 3,000 (Rupees three thousand); and
- b) all workers in the factory are under contract; and
- c) the company is:
 - local or
 - multinational

ISSUES

1. If the company has to contribute to WPPF and there are no permanent employees with monthly emoluments below Rs. 3,000, should the payments be transferred to Worker's Welfare Fund as stated by the Companies Profits (Worker's Participation) Act, 1968 in sub-clause (d) of clause 4 of its schedule.
2. Is the company liable for payment to either of the two funds?
3. If such a situation arises should a provision of liability be created or not?

Opinion: 1&2 The Committee is the facilitation forum for the interpretations or clarifications of issues pertaining to accounting or auditing matters only. The issue under reference neither relates to accounting nor to auditing; it is a question of legal interpretation, which is beyond Committee's functional scope. An attorney-at-law/labour law attorney may be consulted in the matter.

3. As stated in para 91 of the Framework of International Accounting Standards, a liability is recognized in the balance sheet when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably.

