
SELECTED OPINIONS

TO

Volume-IV

COMPILED BY

TECHNICAL DIRECTORATE

**THE INSTITUTE OF CHARTERED
ACCOUNTANTS OF PAKISTAN**

Introduction

This report is the fourth compilation of selected inquiries raised by the members, Corporate Law Authority and other agencies and replies issued by the Technical Advisory Committees during the period May 1996 to June 1997 for the general guidance of the members of the Institute. Volume I, II and III 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.

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1. ACCOUNTING

1.1 ACCOUNTING RECORDS - DEFINED AND THE PERIOD TO KEEP THEM

Inquiry: How should the accounting records be defined?

Opinion: Section 230 of the, Companies Ordinance, 1984 lists the books of accounts and the records required to be maintained by an entity. Sub-section 3 thereof lays down as under:-

.... proper books of accounts shall not be deemed to be kept ... if there are not kept such books as are necessary to give a true and fair view of the state of affairs of the company or the branch office, as the case may be and to explain its transactions.

The accounting records may therefore be defined as under:-

Without prejudice to the requirements with respect of the detailed books of account etc., imposed by Section 230 of the Companies Ordinance, 1984, the "Accounting Records" mean all those books of accounts, vouchers, receipts, invoices, bills, stores issue/receipt records/challans and other such papers etc., as are necessary to be kept and maintained to explain the transactions recorded in the books of accounts with a view to the accounting giving a true and fair view and for auditors' verification and certification that entity's financial statements give a true and fair view of its state of affairs according to the law applicable to that enterprise as also to explain the transactions to the tax and other competent authorities of the government.

Preferably but not mandatorily, the books and record, whether prepared manually or otherwise, which are kept and maintained for the purpose of presenting the management a summarized periodical result of operation of an enterprise may also be kept for an identical period of time as prescribed for books of accounts to be kept under Section 230.

1.2 AUTHENTICATION OF DOCUMENTS - CLARIFICATION REGARDING SECTION 51 OF THE COMPANIES ORDINANCE, 1984

Inquiry: Under Section 51 of the Companies Ordinance 1984, save as expressly provided in the Ordinance, a document or proceeding requiring authentication by a company may be signed by the chief executive or a director, secretary or other authorized officer of the company, and need not be under its common seal. There can be following three different positions, namely,

Position-1

- i) Chief Executive or
- ii) A director and secretary or other authorized officer of the company.

Position-2

- i) Chief Executive or
- ii) A director or
- iii) Secretary or other authorized officer of the company

Position-3

- i) Chief Executive or a director and
- ii) Secretary or other authorized officer of the company

Clarification is sought as to which of the above three positions brings out the correct method.

If position-2 is correct, then, how would the CLA or Registrar or other persons designated in the 'Ordinance' would satisfy themselves about the authenticity of the signature of the officer authorized by the company to authenticate the requisite documents?

Further, how should the company communicate about the nominated authorized officer?

Opinion: The Committee is of view that under Section 51 of the Companies Ordinance 1984, the chief executive or a director and the secretary or authorized officer of the company are required to authenticate a document or proceeding,

Therefore, position - 3 of your query depicts the position envisaged by the Companies Ordinance, 1984 correctly.

1.3 DEPRECIATION RATES - CHANGES DUE TO BETTER USEFUL LIVES OF ASSETS

Inquiry: Previously the depreciation on building and machinery was charged @ 5% and 10% per annum respectively.

Because of the good-repair-policy of the company, the useful lives of buildings and machinery are now estimated by the management to be 50 years and 20 years respectively. Due to such upward revision of useful lives, the management intends now to depreciate buildings and machinery at the lower rate of 2% and 5%.

The revision of useful life estimates and consequent lowering down of depreciation rates is covered by IAS 16 which states that the useful life of an item of property, plant and equipment should be reviewed periodically and, if expectations are significantly different from previous estimates, the depreciation charge for the current and future periods should be adjusted (Paragraph 49).

The IAS also clarifies that though the repair and maintenance policy of the enterprise may also affect the useful life of an asset or an increase in its residual value but the adoption of such a policy does not negate the need to charge depreciation (Paragraph 51).

Kindly advise whether the company can change the rate of depreciation on buildings and machinery from 5% to 2% and from 10% to 5%. It is clarified that the rate of depreciation shall be changed from current year without any adjustment for previous years.

Opinion: The appropriate committee of the institute is of the view that mere physical existence of property, plant and equipment in a working shape or condition is not the sole criterion for determining the useful life. Useful life means the *expected utility* to the enterprise (Paragraph 44). The IAS brings forth other factors that should be taken into consideration in determining the useful life, for example, technological changes or changes in the market for the products that should be taken into consideration in determining the useful life (Paragraph 50).

The IAS lists following further factors that need to be considered individually or in combination in determining the useful life of an asset (Paragraph 43):

- (a) the expected usage of the asset by the enterprise. Usage is assessed by reference to the asset's expected capacity or physical output.
- (b) the expected physical wear and tear, which depends on operational factors such as the number of shifts for which the asset is to be used and the repair and maintenance program of the enterprise, and the care and maintenance of the asset while idle.
- (c) technical obsolescence arising from changes or improvements in production, or from a change in the market demand for the product or service output of the asset; and
- (d) legal or similar limits on the use of the asset, such as the expiry dates of related leases.

The core consideration is whether future economic benefits associated with the asset will or will not flow to the enterprise.

The IAS requires that, in any event, the carrying amount of the asset should not exceed the recoverable amount; the recoverable amount is the amount, which the enterprise expects to recover from the future use of an asset including its residual value on disposal.

The estimation of useful life of assets is a matter of judgment by the management (Paragraph 62) and, as pointed out in Paragraph 4 of AS 26, the risk of *material misstatement* is greater when accounting estimates are involved. They affect the "true and fair view."

Reviewing of the reasonableness of the accounting estimates made by a management calls for sufficient appropriate audit evidence and is to be looked into by the statutory auditors while finalizing the financial statements, (Paragraph 2 of AS 26, Audit of Accounting Estimates). In this connection reliance can be placed on an independent valuer.

The Committee would not like to commit to the reasonableness or otherwise about depreciation percentages stated in the inquiry which would have to be determined by professional valuers.

1.4 DEPRECIATION RATES - WHETHER CHANGES IN RATES SHOULD BE PROSPECTIVE OR RETROSPECTIVE

Inquiry: One of our client, which is a 'public limited company listed on the Stock Exchanges of Pakistan wants to revise its depreciation rates which were previously as per Third Schedule to the Income Tax Ordinance, 1979 which was required under Capital Issues (Continuance of Control) Act, 1947.

The other related facts of the matter are as under:

1. The Capital Issues (Continuance of Control) Act 1947 has been replaced as per Finance Act 1995.
2. International Accounting Standard 16 allows the depreciable amount of fixed assets be amortized over the useful life of fixed assets.
3. International Accounting Standard 8 allows change in accounting estimate and benchmark treatment allows giving such revision a retrospective effect.
4. Consent letter issued by Controller of Capital Issues to the company for issue of share capital contained a condition that depreciation rates should not be less than the rates specified in the Third Schedule to the Income Tax Ordinance, 1979.
5. The client has made revaluation of fixed assets in prior years.

In the present circumstances please advise us:

- a) Is there any binding condition for change in accounting policy / revision of estimates of fixed assets of the company during the period of replacement of Capital Issues (Continuance of Control) Act, 1947.
- b) If the company is allowed to change the depreciation rates, whether the effect be prospective or retrospective. The matter should be considered in conjunction with statement 5 above.
- c) If the company changed the depreciation rates in contravention to condition contained in Consent Letter issued by Controller of Capital Issues to the company for issue of share capital, whether the auditor should concur with this change or qualify his report.

Opinion: a) The Committee is of view that conditions of Capital Issues (Continuance of Control) Act, 1947 are not binding after it has been repealed.

On the other hand, the Companies Ordinance, 1984 has made it mandatory for listed companies to follow such International Accounting Standards as notified by Corporate Law Authority. IAS 16 " Property Plant and Equipment " requires that the depreciable amount of an item of property, plant and equipment should be allocated on a systematic basis over its useful life (Paragraph 41).

Therefore, the Committee is of view that the company can revise its depreciation rates in accordance with IAS-16's requirements (Paragraph 49).

b) Section 235 (4) of the Companies Ordinance, 1984 mandates that the depreciation on the revalued assets should be provided with reference to the value assigned to such assets on revaluation. A company is thus under legal obligation to depreciate the assets on the revalued basis. The Committee is therefore unable to comprehend the emphasis placed by you on the re-valuation in the past on whether the effect of changing the policy be prospective or retrospective.

The benchmark treatment in the International Accounting Standard (IAS) 8 deals with the correction of a *fundamental error and not with the change in accounting estimate* to have retrospective effect. Paragraph 23, IAS-8, defines depreciation to be an accounting estimate and Paragraph 24 clearly points out that " the revision of the estimate does not bring the adjustments within the definitions of an extraordinary item or a fundamental error ". 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 changed pattern" and " such a change in depreciation method should be accounted for as a change in accounting estimate ". Further, Paragraph 26 of IAS-8 states that the effect of a change in an accounting estimate should be included in the determination of net profit or loss in (a) the period of change, if the change affects the period only; or (b) the period of the change and future periods, if the change affects both. Paragraph 52 of IAS 16 also states that the depreciation change should be for the current and future periods. The change in useful life or the expected pattern of consumption of economic benefits of depreciable assets should therefore not be given retrospective effect.

c) Not applicable in view of response to query (a).

1.5 EXCHANGE RISK FEE - APPLICABILITY OF IASs AND TR-24 vis-à-vis SECTION 234(3) OF THE COMPANIES ORDINANCE, 1984

Inquiry: In accordance with the provisions of the above noted Section, only such Accounting Standards, which are notified by the Authority, are required to be followed by a listed company with respect to the preparation of financial statements. We understand that the Corporate Law Authority has only notified International Accounting Standards 1,2, 4 to 14 and 16 in this regard.

In the light of the above whether the International Accounting Standard 23 along with TR 24 will be required to be followed for preparation of the financial statements of a listed company for the year ended 30 June, 1996. In the event that these are not followed by the company, under what provisions do the

external auditors report deviations (on account of IAS 23 and TR-24) in their report to the members of the company.

Opinion: The complexity to this otherwise simple matter is injected due to non clarification about what exchange risk fee (ERF) is. As stated in the TR, ERF is interest. This is confirmed by F.E. Circular No. 70 dated November 18, 1986 about exchange risk cover issued by the State Bank of Pakistan, copy enclosed.

To simplify the complexity, let us assume that a company has borrowed loan in local currency for the import of plant and machinery. The repayment schedule extends in to a time frame beyond the period of commencement of the commercial production of the plant. Now, whether the payment of interest in the post commercial production period should be capitalized or expensed out? or to put it otherwise, regardless of the position whether IAS 23 exists or does not exist whether it has been notified by the competent authority or not, shall capitalization of the interest in the case after the commencement of the commercial production be in accordance with the generally accepted accounting principles?

The answer to the above is that capitalization of interest after the commencement of the commercial production shall be in conflict with the GAAP, as already advised vide TR No.1 that was approved by the Council of the Institute as long back as 1972 in its 33rd meeting.

In the event a company capitalizes interest after the commencement of commercial production, the auditors are obliged to qualify the report about the company having not acted in accordance with GAAP.

To put it in another perspectives we would have to go back to the period when neither the International Accounting Standards had been formulated nor the Institute was in existence. Did the auditors not qualify the reports in that period when a basic accounting principle was not followed. IASs are nothing except codification of GAAP. Back to 1996, do the auditors have to take shelter behind non-notification of a certain IAS or question the validity of a TR, when a basic accounting principle is involved. A dispassionate consideration of all these matters would clear all doubts.

1.6 EXCISE DUTY - NATURE OF TURNOVER TAX UNDER SECTION 80D OF INCOME TAX ORDINANCE, 1979 vis-à-vis TR-19

Inquiry: i. According to Institute's TR-19, the excise duty is to be debited to the cost of goods. As minimum tax under Section 80D is now payable in relation to the gross turnover, the issue requires attention.

ii. Excise duty is an indirect tax and is recoverable from the purchasers of the goods, either by means of including the duty in the sales price or specifically mentioning it on the invoices and relevant record of the seller. In the former case, the gross turnover of the company includes the recovered excise duty and in the latter case, it represents a turnover exclusive of the excise duty,

iii. In sugar industry, the sugar is sold generally to persons who do not maintain any record. They do not "bother for invoices" and consequently the turnover in the sellers books is recorded inclusive of the excise duty recovered from the purchaser. ICAP's TR-1 9 also provides this accounting treatment.

iv. Besides, this treatment of recording aggregate turnover is also necessitated by the fact that the amount of excise duty is not fixed; it varies from time to time depending upon the sugar policy of the government, for instance, (a) there is no excise duty on exported sugar and (b) duty rebate is admissible if production is in excess of average production of the last three years.

v. After the enforcement of minimum tax under Section 80D if excise duty is included in sales, the tax is calculated with reference to such turnover. This is wrong as tax on the turnover is a direct tax and cannot be recovered from the purchaser whereas the excise duty is an indirect tax and is recovered from the purchaser; also, direct tax cannot be based on any indirect tax already payable to government.

vi. The Central Board of Revenue has recently issued a Circular providing relief to the cases where the excise duty is not included in the turnover provided that sales vouchers, sales book and ledger accounts show sales tax and excise duty separately from the sales price. This contradicts TR-1 9.

vii. The above treatment by the CBR discriminates against those who are presenting the turnover inclusive of the excise duty for above reasons as well as in compliance with TR-19.

viii. The chartered accountants firms are also treating excise duty as receivable from their clients and not as cost. They recover excise duty from their clients and deposit it in the treasury and thus do not affect the turnover.

ix. The following accounting treatment of turnover is proposed: -

	Exclusive of excise duty	Inclusive of excise duty
Sales	Rs. 200,000	Rs.225,000
Less Excise Duty	-----	25, 000
Net Sales	<u>Rs. 200,000</u>	<u>Rs. 200,000</u>
Less Cost of Sales	150,000	150,000
Profit	<u>Rs. 50,000</u>	<u>Rs. 50,000</u>

CBR CIRCULAR No. 3 OF 1996 (INCOME TAX)

Subject: RECOVERIES OF MINIMUM TAX UNDER SECTION 80D OF THE INCOME TAX ORDINANCE 1979 - IN THE CASE OF TAX PAYERS WHOSE SALES CONSIST OF EXCISE DUTY, SALES TAX

1. An issue had been raised that turnover, if taken inclusive of sales tax/excise duty, causes hardship where excise duty/sales tax constitute a predominant share of receipts. Keeping that in view, directions were issued by the Board, vide its Circular No. 4(33)TP-I/92 dated 8th August, 1992, that where sales tax and/or excise duty constitutes more than 50% of turnover, the provisions of section 80D shall not be applied in such cases to such portion of the turnover as represents such duties.

2. Representations have now been received that this limit is arbitrary and those with a very heavy sales tax/excise duty element, though less than 50% are hard hit as they have to pay minimum tax on their total turnover in spite of the fact that their vouchers and books of accounts clearly show the elements of duties and sales.

3. The turnover has been explained in sub-section (2) of section 80D. It means the gross receipts exclusive of the trade discount shown on invoices or bills, derived from the sale of goods or from rendering, giving, or supplying services or benefits or from execution of contracts. Keeping in view this spirit and the fact that in Pakistan it is a well established convention and principle in accounting profession that "turnover" is supposed not to include sales tax and central excise, it has been decided to modify the existing instructions referred to in paragraph 1 ante. The turnover will be exclusive of sales tax and excise duty charged, if these two taxes are mentioned on invoices, separately from the sales price. In other words if the sales vouchers, sales book and the ledger accounts clearly show these three things separately, the "turnover" will not include the two levies. However, if the sales voucher, sales book etc., show only one figure of sales price which is inclusive of these taxes, the "turnover" will consist of that one figure and these will not be segregated or split up on the basis of any formula, the entire amount will be treated as turnover for the purposes of section 80D.

4. In other words it will not be the quantum of sales tax and central excise in the total sales figures that will determine its exclusion or inclusion in the turnover but the factotum of their being so shown in the vouchers and books of accounts and their payment to the government.

ICAP's TR-19, Excise Duty-Accounting Treatment

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4.

5. Excise duty is a necessary cost, which must be incurred to bring the goods to the location and condition in which they can be sold or used in the manufacturing process. Such duty is an element of manufacturing cost and like other production overheads, the cost of inventories should include a systematic allocation of excise duty.

6. Excise duty expense should be reported as an element of cost of sales.

7. Provision should be made for excise duty liability chargeable to goods manufactured and held in stocks. Such provision should be estimated on the basis of past experience considering any expected future changes. Adequate disclosure should be made if the liability cannot be reasonably estimated.

Opinion: In view of the lengthy details, it seems advisable to distill the core issue as also to encapsulate the various sub-issues.

Core Issue

TR-19 requires excise duty expense should be reported as an element of cost of sales. So doing with would entail sales revenue to be reflected inclusive of excise duty recovered from customers which will in turn be attracting income tax levy under Section 80D even on component of excise duty and therefore TR-19 may be suitably reviewed.

Sub-Issues

What is excise duty? Is its recovery from purchaser an essential characteristic of the excise duty?

When does excise duty become due? Is the point of time at which the excise duty is collected material?

Is it possible to evolve some acceptable-to-all general formula to generate the precise amount of the excise duty to be included in sales, if sales are presented inclusive of the duty?

TR-19 only clarifies, stresses and draws attention to the fact that, owing to its very nature, the excise duty should be reckoned as a component of cost in accordance with paragraph 7 of IAS-2, Inventories, which states:-

"The cost of inventories should comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition," The rationale for it is presently explained hereunder.

The TR does neither prohibit nor it bars from maintaining of any supporting, ancillary, analytical record and books of accounts.

The Supreme Court of India has held that the taxable event with respect to a duty of excise is "manufacture" or "production" and not "consumption". (Jiyajirao Cotton Mills Ltd., vs. State of Madhya Pradesh: AIR 1963 SC 414).

According to settled case law the primary and fundamental meaning of an excise duty is that it is a tax on articles produced and manufactured (Chhotabhai Jethabhai Patel & Co. Vs Union of India AIR 1962 SC 1006 & re The Central Provinces of Behar Act, 1938: AIR 1939 FC 1 PTCL 1986 FC 33).

The duties of excise are levied on the manufacturer or the producer in respect of the commodity manufactured or produced and not on the consumer (Madras Province vs. Boddu Paidanna : AIR 1942 FC 330 PTCL 1986 FC 127).

In Abdul Khadir vs. State of Kerala (AIR 1962 SC 922) it was held by the Supreme Court of India that it may, therefore, be accepted that a duty of excise is a tax on goods, produced or manufactured in the taxing territory. It may also be accepted that generally speaking the tax is on the manufacturer or producer, though it cannot be denied that laws are to be found which impose a duty of excise at stages subsequent to manufacture or production.

It is a tax on goods and not on sale or the proceeds of the sale of goods. (AIR 1945 PC 98 PTCL 1986 FC 127 & 1979 SMCR 640 + PDL 1980 Lah 377).

It was held that the duty of excise could be levied on the manufacturer retrospectively even after he had parted with the goods and he would have no opportunity, to include the excise duty in the price of the goods, which he had already sold. The incidence of the excise duty is on the manufacturer or the producer and not on the person to whom the manufacturer or the producer sells the goods in as much as a purchaser is in a position of a consumer vis-à-vis the manufacturer (1972 Tax LR 1771).

According to the economists, it is an indirect tax which is demanded from a person in the expectation and intention that he shall indemnify himself at the expense of another that is - capable of being passed on to the consumer as part of the price, yet the mere passing on of such tax is not its essential characteristics (AIR, 1962 S.C. 1006).

There may be marked conditions where the supply outstrips the demand, or due to market competitive forces, the excise duty may not be passable to the purchaser, for example, in the case of recent increase in the excise duty on cement, the manufacturers have not been able to pass it on fully to the purchaser.

It has been held by the Courts that goods for the purpose of the excise duty refer to an article, which could ordinarily come to the market to be bought and sold (Union of India Vs Delhi Cloth & General Mills: AIR 1963 SC 791).

The excise duty is attracted on goods having become vendible. Again, as per settled case law, the method of collection is only an accident of administration, it is not the essence of duty of excise, which is attracted by manufacture itself. (PLD 1964 SC 113)

In the given conditions, no formula would generate precise figures because the figures of sale would include sale of sugar exported as well as the quantity produced in excess of average of last 3 years on which excise duty rebate is admissible. Any formula, including the one adopted in the cited example, could suffer from the identical malady of arbitrariness and give rise to controversy similar to that raised by the concerned quarters in the case of earlier 'arbitrary'

percentage fixes by CBR, which the CBR's circular under reference now seeks to rectify.

The Committee is of the view that keeping of the detailed ancillary, itemized record, books and ledger account does not conflict with TR 19.

The CBR Circular under reference does not appear to add any extra record/book-keeping; such itemized record is already kept, for example, with respect to trade discounts allowed received and is also necessary for auditor's verification of itemized details too. The Committee is also of the view that the presentation of excise duty in the accounts would not in any way alter the relief allowed by CBR Circular No. 3 of 1996.

In the light of the above, TR-19 does not call for any revision and is required to be followed.

1.7 EXPORT FINANCING & OTHER WORKING CAPITAL -ACCOUNTING FOR

Inquiry: Normally the banks are lending to the companies for export financing and for other circulating capital requirements against the charges by way of hypothecation of their fixed assets and current assets, for the period of one year. These facilities are of revolving (not involving) nature and are never being adjusted in practice. These facilities are regularly renewed on fulfilling certain laid down conditions.

The industry specially "Textile" is in severe crisis and has sustained huge losses during the last 4 years. Although the recovery has started, but most of the units are still facing difficulty in complying with prudential regulations issued by the State Bank of Pakistan.

Though this financial assistance is legally adjustable on the completion of one year but practically this gets never adjusted. I am, therefore, of the opinion that like other transactions, such as finance leases which are reflected in financial statements according to economic realities rather than their strict legal form, such loans of revolving nature may be reflected as long term loans in the financial statements.

Opinion: Two issues are involved:-

- ◆ If due to severe crisis and continued huge losses of an industry; a part of it or an individual entity, is unable to pay back the short term financing and the bank therefore rolls it over for another short term, does such roll over tend to change the economic reality of the transaction from short term to long term transaction?
- ◆ In the stated situation, does the roll over of working capital requirements year after year become a long term loan instead of short term financing?

The Committee is of the view that it is implicit in the stated situation that the roll over of the facility is made for another 12 months period. Thus both the

economic reality and the legal form of the transaction make it a short term financing.

According to paragraph 12A and 12B (ia) of Part II of the Fourth Schedule to the Companies Ordinance, 1984 and paragraph 15 of IAS-13, Presentation of Current Assets and Current Liabilities, the transaction is a current liability.

Further, due to the admitted fact that the transaction under reference is a facility for working capital finance, and bank extends it due to very special reasons for another limited period of 12 months, both the economic reality and the legal form establish it to be a short term liability and not a long term loan.

Para 36 of the Framework to the International Accounting Standards states that to be reliable, the information contained in financial statements must be neutral, that is, free from bias. Financial statements are not neutral if, by the selection or presentation of information, they influence the making of a decision or judgment in order to achieve a predetermined result or outcome.

1.8 FINANCE LEASE - DOES THE TREATMENT OF FINANCE LEASE AS OPERATING LEASE BY THE INCOME TAX DEPARTMENT GIVE RISE TO TIMING DIFFERENCES AS DEFINED IN IAS-12

Inquiry: In Pakistan, the tax laws do not recognize the concept of finance lease, and the whole amount of rentals received is treated as income of the lessor. Accordingly the lessor provides the depreciation allowance (as an admissible expense), in accordance with the provisions of the Third Schedule of the Income Tax Ordinance, 1979. In financial statements, however, the lessor does not recognize the principal recoveries and depreciation as its income and expense and the accounting is done as provided for the "finance lease" by IAS-17 Accounting for Leases.

Does the treatment followed by the Income Tax Authority generate timing differences as defined in the IAS 12 "Accounting for Taxes on Income"?

Opinion: The appropriate Committee of the Institute is of the view that your inquiry whether timing differences arise as a result of the tax treatment accorded to the leasing transactions in the books of the lessor arises from the difference between the accounting treatment of lease transactions in the books of the lessor and the tax treatment accorded under tax laws i.e:-

(a) in the books of the lessor the lease rentals are recognized as income for the period being the, finance charge and adjustment of principal outstanding; and

(b) such finance charge as income for the period is totally disregarded while computing taxable income as gross lease rentals are taken as income for the period and tax depreciation as allowed there against.

In Committee's views, the inquiry in essence is whether or not timing differences arise as a result of the above two different treatments accorded in the books of the lessor.

The appropriate Committee of the Institute is of the view that in view of the revised IAS 12 issued in 1996, timing differences do arise in respect of the aforesaid transaction as tax expense based on accounting treatment is different in each of the year the income is recognized in the books, as compared to the taxable income as clearly demonstrated in the enclosed example. Based, on tax treatment there does not arise any taxable income in the first year due to accelerated tax depreciation allowable in the first year as against the taxes of Rs.16,800/- based on accounting income, However, large tax liability arises in the second year.

Considering the above vehicle of deferred tax account is used to bridge the differences stated above. Through the instrument of deferred tax based on accounting income, tax provision is to be created whereas there is no taxable income in this year. Accordingly, in the second year huge tax liability arises against which provision created in the previous year will be utilized and current year's charge will also be made on the basis of accounting income. Also in the last year there is negative taxable income. Tax timing differences thus arise in the initial year, which are reversed in the subsequent, year(s).

BASIC FACTS ABOUT TRANSACTION

Lease period	3 years
Lease amount	Rs.340,000
Total repayment	Rs.432,000
Lease rental	Rs. 12,000 p.m.
Security deposit 10%	Rs. 34,000

	<u>YEAR I</u> Rs.	<u>YEAR II</u> Rs.	<u>YEAR III</u> Rs.	<u>TOTAL TAX</u> Rs.
ACCOUNTING INCOME				
Accounting Income	42,000	30,000	20,000	
Tax on above @40%	16,800	12,000	8,000	36,800
TAXABLE INCOME				
Accounting Income	42,000	30,000	20,000	
Less: Finance Charges	(42,000)	(30,000)	(20,000)	
Add: Lease rentals	144,000	144,000	144,000	
Add: Depreciation				
Initial 25%	85,000			
Normal 10%	34,000	18,700	0	
Extra 10%	<u>34,000</u>	<u>18,700</u>	<u>0</u>	
	153,000	37,400	0	
W.D.V (340,000 - 190,400)			149,600	

Unabsorbed Tax Dep. C/F		(9,000)		
Total Income	(9,000)	97,600	(5,600)	
Tax on Taxable Income	0	39,040	(2,240)	36,800

1.9 INTEREST - CAPITALIZATION OF

Inquiry: Our company had acquired Plant and Machinery through fixed assets financing in the year 1988. The company came into commercial production in August 1989. The company was not able to repay the said loan and mark-up thereon from 1993 to 1995 and later approached the bank to reschedule the loan. The bank honoured the company's request and rescheduled/restructured the installments after capitalizing the mark-up due on the same.

Now the management of the company intends to capitalize the mark-up freezed to the cost of plant and machinery.

Opinion: According to TR-1 issued by the Institute of Chartered Accountants of Pakistan "once the commercial production has been started the interest should be treated as revenue expenditure. The capitalization of interest on loans and debentures from the date a company goes into production would be a deviation from the generally accepted accounting principles."

Moreover the deferment of interest payment by restructuring does not change the basic nature of expense and it should not be capitalized.

Further, the mark-up under consideration relates to the period 1993 to 1995, which has already been charged to the Profit and loss Accounts of the relevant years. Hence, its reversal to income will be required which will result in credit to the current years income. This reversal will distort the results of the respective years. Also future profits will be burdened.

1.10 LEASED ASSET - CAPITALIZATION OF FINANCE CHARGES IN THE LEASED RENTALS

Inquiry: A company has acquired asset on finance lease. The cost of asset is Rs.6 million. During installation period, the leasing company has charged lease finance charges of Rs.0.5 million. The company intends to capitalize the lease finance charges in the cost of leased asset on the basis of paragraph 11 and 5(2) of IAS 23-Borrowing Costs.

Is the capitalization of the lease finance charges during the installation period in accordance with Pakistan's generally accepted accounting principles and International Accounting Standard 17, Accounting for Leases.

Opinion: International Accounting Standard 23, Borrowing Costs, in paragraph 5(d) clarifies that the borrowing costs may include finance charges in respect of finance leases recognized in accordance with International Accounting Standard 17, Accounting for Leases.

According to paragraph 13 of IAS 23 the borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made.

According to paragraph 11, borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalized as part of the cost of that asset.

Capitalization of the borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete. (IAS 23.25)

Therefore the lease finance charges of Rs. 0.5 million during the installation period should be capitalized if they meet the criteria of paragraph 11 13 and 25 of IAS 23 as stated above.

1.11 LEASES - ACCOUNTING FOR - CLARIFICATION REGARDING IAS-17

Inquiry: ICAP Circular dated January 11, 1997 regarding Clarification to IAS-17, Accounting for Leases

1 Paragraph 2.0 Definitions - Residual Value

IAS 17 is silent about the definition of residual value; it defines only unguaranteed residual value. Please advise the correct status of residual value.

2. Paragraph 3.0-3.1 Net Investment in Finance Leases

Should gross residual value or unguaranteed residual value portion of the leased asset should be considered?

3. Down payment - mentioned in Schedule I & II

Said schedules show the working of periodical allocation of unearned finance income. If consider down payment Rs.110,000/- then the periodic finance income will be different and consequently the amount of principal repayment shall also be different. Please let me know whether the down payment in both the schedules is nil or Rs.110,000/-

Opinion:

1. The status of residual value in the context of IAS-17 is the mutual agreed value of the asset at which the latter would be transferred to the lessee at the termination of lease agreement.
2. International Accounting Standard 17 "Accounting for Leases" through definition of the terms "Minimum Lease Payment", "Gross Investment in Lease" and "Net Investment in Lease" covers the accounting methods of Guaranteed and Unguaranteed Residual Values.

3. It may also be noted that International Accounting Standard No. 17 "Accounting for Leases" states that income included in monthly rentals should be allocated either on the basis of Net Investment Outstanding or Net Cash Investment Outstanding in the lease. You may also note that the former method assumes recovery of guaranteed residual value and payment of lease key money at end of a lease term contrary to the latter method, which assumes the same at the time of lease execution. You will appreciate that as majority of leasing companies in Pakistan follow the former method of income allocation therefore, to make income allocation basis in conformity with the industry practice, mark up in both the schedules is allocated on the basis of Net Investment Outstanding in the lease.

The down payment in the Schedules is Rs.110,000/-.

1.12 LEASES - ACCOUNTING FOR - FURTHER CLARIFICATION REGARDING IAS-17

Inquiry: ICAP Circular dated January 11, 1997 regarding Clarification to IAS-17, Accounting for Leases

1. In both schedules the per month markup rate is computed simply by dividing the annual rate of markup by 12, which is not correct according to the concept of discounting involved with monthly repayments. The correct rate of monthly markup is 1.67% and 1.60% in the case of schedule I and II respectively.
2. In working out the markup included in each installment, the time difference involved in the down payment at the outset of lease arrangement and its adjustment against residual value or refund at the time termination of lease has been ignored. The correct approach would have been to start on 1st January 1996 with principal of Rs.990,000/- for computing the markup and principal components of the installments.

The above errors are of conceptual nature and need to be corrected.

Opinion: 1. It may be noted though monthly rate of mark up is mentioned in the schedules, allocation of markup included in monthly installments is allocated in conformity with discounting concept i.e. by applying the annualized markup rate to the principal outstanding. The following illustration may clarify the situation:

<u>Principal Outstanding</u>	<u>Monthly Markup @ 22.00%</u>	<u>Monthly Markup @1.83 %</u>
1,100,000/-	20,167/-	20,130/-
1,086,960/-	19,928/-	19,892/-
1,073,680/-	19,684/-	19,648/-

2. It may also be noted that International Accounting Standard No.17 "Accounting for Leases" states that income included in monthly rentals should be allocated either on the basis of Net Investment Outstanding or Net Cash Investment Outstanding in the lease. You may also note that the former method assumes recovery of guaranteed residual value and payment of lease key money at end of a lease term contrary to the latter method, which assumes the same at the time of lease execution. You will appreciate that as majority of leasing companies in Pakistan follow the former method of income allocation therefore, to make income allocation basis in conformity with the industry practice Mark up in both the schedules is allocated on the basis of Net Investment Outstanding in the lease.

1.13 OBSOLETE ITEMS - PROVISIONS FOR (REFERENCE FROM MINISTRY OF INDUSTRIES AND PRODUCTION GOVERNMENT OF PAKISTAN)

Inquiry: A public sector company makes provision for obsolete items consisting of raw materials and components lying in company ware-house, bonded ware-house and in transit annually under the caption "Stock in Trade". What is the legal position?

Opinion: Inventory obsolescence is not outside the parameters of the accepted accounting practice.

On the facts of the specific case as referred it does not necessarily follow that obsolescence is actually provided on stock in bonded warehouse or in transit but it may as well be on company's stocks in its warehouse.

It does occasionally happen that the cost of inventories may not be recoverable when those inventories are damaged, become wholly or partially obsolete, or when their selling prices decline. The cost of inventories may also not be recoverable when the estimated costs of completion or the estimated costs to be incurred to make the sale increase. The accepted accounting practice is to write down inventories in such cases to net realizable value so that assets should be carried at amounts expected to be realized from their sale or use.

Inventories are usually written down to net realizable value on an item by item basis. In some circumstances, however, it may be appropriate to group similar or related items. This may be the case with items of inventory relating to the same product line that have similar purpose or end uses, are produced and marketed in the same geographical area, and cannot be practicably evaluated separately from other items in that product line. It is however not appropriate to write down inventories based on a classification of inventory, for example, finished goods, or all the inventories in a particular industry or geographical segment.

As for estimates of net realizable value these are based on the most reliable evidence available at the time the estimates are made as to the amount the inventories are expected to realize. These estimates should take into consideration fluctuations of price or cost directly relating to events occurring

after the end of the period to the extent that such events confirm conditions existing at the end of the period.

Such estimates of net realizable value also take into consideration the purpose for which the inventory is held. For example, the net realizable value of the quantity of inventory held to satisfy firm sales or service contracts is based on the contract price. If the sales contracts are for less than the inventory quantities held, the net realizable value of the excess is based on general selling prices. Contingent losses on firm sales contracts in excess of inventory quantities held and contingent losses on firm purchase contracts need to be treated in accordance with its separate related Accounting Standard.

As concerns, materials and other supplies held for use in the production of inventories these are written down to net realizable value, when a decline in the price of materials indicates that the cost of the finished products will exceed net realizable value. In such circumstances, the replacement cost of the materials may be the best available measure of their realizable value.

A new assessment is made of net realizable value in each subsequent period. When the circumstances, which previously caused inventories to be written down below, cost no longer exist, the amount of the write down is reversed so that the new carrying amount is the lower of the cost and the revised net realizable value. This may occur, for example, when an item of inventory, which is carried at net realizable value because its selling price has declined, is still on hand in a subsequent period and its selling price has increased.

The relevant Accounting Standard states: -

When inventories are sold, the carrying amount of those inventories should be recognized as an expense in the period in which the related revenue is recognized. The amount of any write-down of inventories to net realizable value and all losses of inventories should be recognized as an expense in the period the write-down or loss occurs. The amount of any reversal of any write-down of inventories, arising from an increase in net realizable value, should be recognized as a reduction in the amount of inventories recognized as an expense in the period in which the reversal occurs (IAS 2.31).

The Accounting Standard also provides for the disclosure of the following in the financial statements:-

- a) the accounting policies adopted in measuring inventories, including the cost formula used;
- b) the total carrying amount of inventories and the carrying amount in classifications appropriate to the enterprise;
- c) the carrying amount of inventories carried at net realizable value;

- d) the amount of any reversal of any write-down that is recognized as income in the period;
- e) the circumstances or events that led to the reversal of a write down of inventories; and
- f) the carrying amount of inventories pledged as security for liabilities (IAS 2.34).

Note: The net realizable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

1.14 RETIREMENT BENEFITS - ON TRANSFER OF SERVICES IN A GROUP OF COMPANIES

Inquiry: The group comprises various limited companies having same retirement benefit plans for their employees. The transfer of employment of employees is common from one company to another company. The problem is that the "X" number of employees of " Company A" have been transferred to "Company B" and their benefits to "Company B". It means that the service of employment is transferred from one company without any break of length of service.

A) Whether it is correct to transfer the service of an employee from one company to another without any break in length of service (i.e., resigned, retirement etc.) and, if yes, what disclosure should be made in financial statements of both the companies.

B) In above case one employee's length of service is 20 years in Company A " when his service is transferred along with retirement benefits to "Company B", and the life of "Company B" is only 10 years. So is it correct to transfer the service of that employee and retirement benefits to "Company B" which has a shorter life span as compared to the length of service of the employee.

Opinion: The appropriate Committee of the Institute has considered the matters raised by you whether or not it is correct to inter-transfer employees within the group companies. The Committee has considered the matter from the point of view of the employer as well as from the standpoint of rights of the employees in the transferee company. The Committee is of the view that it is the right of the employer to transfer employees from one company within the group to another company with continuity of retirement benefits which comprise provident fund, pension and gratuity scheme which may be funded or unfunded. In the case of a provident fund if the provident fund rules of the transferee company provide for acceptance of new member from within the group company with continuity of service, then it shall be in order to transfer such balances at the time of transfer of employee from the group company to another.

With respect to the matter (b) the Committee is of the view that if the length of service of the incoming member is greater than the life of the transferee company itself, it would not have an adverse affect on the employees of the

transferee company as the existing members of the fund are compensated in the form of return on a proportionate basis in relation to the available total fund in the pool. As the incoming member also brings huge funds into the pool, hence he will be proportionately remunerated in accordance with the rules of the fund.

As regards transfer of the employee into transferee company which operates funded or unfunded pension or gratuity schemes, the Committee is of the view that the burden shall not be on the existing members of the pension or gratuity funds as the requirement of keeping sufficient funds in the company relating to the pension or gratuity liability of the incoming member shall be on the company and company's contribution will have to be accordingly enhanced after the induction of the employee into the transferee company.

1.15 REVALUATION SURPLUS OF FIXED –ASSETS PRESENTATION IN FINANCIAL STATEMENTS

Inquiry: A. Currently the Balance Sheets show the Surplus, after the Equity, as a separate head as shown:

Equity

Paid up Capital	100,000
Accumulated loss	<u>175,000</u>
	(75,000)
Revaluation surplus	100,000

Can we present it as under

B. Equity

Paid up capital	100,000
Revaluation sur.	100,000
Accmtd Loss	<u>175,000</u>
	25,000

Equity

Paid up capital	100,000
or Accumulated Loss	<u>175,000</u>
	(75,000)
Revaluation Sur.	<u>100,000</u>
	25,000

Can the revaluation surplus be grouped with the equity above the accumulated loss (profit) as shown in B above?

2. Basis of Revaluation & Charge of Depreciation

The basis of Revaluation is Net Book value as on Revaluation date, please confirm. Further, what will be the depreciation charge for that year, provided:-

Date of revaluation is - during the year, and
- at year end.

My viewpoint regarding above is:-

- i) If revaluation is done during the year (say half year).
 - a) Depreciation be charged upto half year on original net book value Rs. xxxx
 - b) Deprecation be charged on revalued amount (NBV at half year+surplus) for the next six months Rs. xxxx

Rs. xxxx
- ii) If the revaluation is done at year-end, then the depreciation be charged on original NBV at year end and the revaluation surplus should not be added for the purpose of depreciation.

3. *Tax Depreciation*

In the above case, whether the tax depreciation schedule for the year 1995 be based on the WDV of 1994 or the revaluation surplus be also taken as addition for the purposes of Income tax calculations.

- i) As per paragraph 37 of IAS 16 the increase in carrying amounts of assets is credited directly to shareholders interest as revaluation surplus.
- ii) According to paragraph 31 of IAS 12, the substituted amounts do not form the basis of taxes payable. The IAS suggests following two approaches regarding tax relating to the increase in assets value.
 - a) Pare 31 :- The difference be transferred to Deferred Tax balance.
 - b) Potential tax effect be disclosed in the notes and revised every subsequent year.

Copy from a British book on Revaluation surplus and its accounting treatment is also enclosed. In my view this is more rational than the one, which is currently practiced in Pakistan.

Opinion:

1. Revaluation of Fixed Assets

Section 235(1) of the Companies Ordinance, 1984, provides that "surplus on revaluation of fixed assets account" should be shown in the balance sheet of the company after capital and reserves. Sub-section 2 further prescribes that such surplus shall not be applied to set off or reduce any deficit or loss. The revaluation surplus cannot therefore be shown and boxed with Capital and Reserves.

The presentation in "A" (in the query) is therefore mandatory; the boxing up/grouping of the revaluation surplus as in "B" is, therefore, not permissible and in conflict with sub-section 2 as cited above.

2. Basis of Valuation & Charge of Depreciation

We agree that the basis of valuation is net book value as on revaluation date.

As regards charge for depreciation we agree with the treatment suggested by you. However the Committee is of the opinion that as the revaluation is the cumulative result of many past years, it will be preferable if the depreciation is charged for the full year.

No, it would not be correct to charge depreciation on periodic basis if a unit is closed for a certain period during the year. The depreciation charge of an item of property, plant and equipment should be allocated on a systematic basis over its useful life. The charge cannot be whimsical and increased or decreased at will.

3. Tax Depreciation

The tax depreciation schedule for the year 1995 will be based on the tax WDV of 1994. Revaluation surplus cannot be taken as addition for the purpose of tax depreciation calculations in accordance with the Third Schedule of the Income Tax Ordinance, 1979.

As regards the copy of the article "Financial Reporting in Practice" published in England, two aspects need to be noted. First, the article was published with reference to a certain exposure draft issued by Accounting Standards Board of England. Whether or not it was finalized or if finalized, with what provisions it was issued by the Accounting Standard Board of England, is not stated in the inquiry. It may be that the accounting regulatory body of England did not agree to the authors' suggestions in which case its consideration is of no functional utility. Second, ICAP has adopted IASs. Accounting practices in Pakistan are therefore regulated by the provisions of the IASs and Companies Ordinance, 1984.

1.16 SALE AND LEASE BACK TRANSACTIONS UNDER FINANCE LEASE AGREEMENTS

- Inquiry:**
- (a) Whether sale and lease back transaction under finance leases agreement is an actual sale of the assets? and,
 - (b) whether such a sale would attract provision of 80C of the Income Tax Ordinance, 1979 in the hands of the seller of such assets.

Opinion: The appropriate Committee of the Institute is of the view that the inquiry in (b) has been raised in the context of question (a) above that if the sale and lease back transaction is considered an actual sale then whether or not the provisions

of Section 80C of the Income Tax Ordinance 1979 would be attracted upon sale of assets to the leasing company in the first place in the hands of the seller.

The appropriate Committee of the Institute has considered the provision of the International Accounting Standard 17 and the provision of Income Tax Ordinance 1979 and the position is:

INTERNATIONAL ACCOUNTING STANDARD 17

Leasing transactions are undertaken as operating leases or as finance leases. Under the operating lease the title does not transfer to the lessee at the outset of the lease or at the expiry of the lease period but the lessee uses the asset for its intended purposes. Whereas, under the Finance Lease transaction title still does not transfer to the lessee but an intention exists between the lessee and lessor to transfer the title of the leased assets to the lessee upon termination of the lease period.

It is also customary in practice that an entity, which owns any assets and due to its financial requirements would like to raise finances from such assets, enters into a transaction, which is termed as SALE AND LEASE BACK transaction. Apparently, it appears that the transaction in question is purely in the nature of financing transaction but in effect the transaction entails the following:

- a) the owner sells the assets in question to the leasing company under duly executed valid agreement;
- b) the consideration for the sale is determined between the seller and the leasing company;
- c) the leasing company becomes the owner of such assets and holds title on such assets; and
- d) all the conditions of the sale under the Sale of Goods Act are met but actual possession is not transferred which is still held by the seller. It is pertinent to mention here that non-transfer of possession does not render transaction of sale invalid.
- e) the leasing company is not intending to repossess the assets except as a security against default. The lessee is intended to continue to enjoy the benefit of use and even ownership after end of the lease.

Simultaneously, another agreement is executed between the leasing company and its client who is the "lessee" who had in the first place sold the same assets to the leasing company. As a result of this transaction:

- a) a lease agreement is written between leasing company as lessor and the lessee who agrees to take the assets owned by the lessor against consideration of lease payments;
- b) lease deposit money is paid by the lessee in favour of the lessor;
- c) lease payments are made through mutually agreed amounts under the agreement; and
- d) in case of default by lessee the assets are retrieved by the lessor as he owns the title on such assets.

From the above, it would appear that the transaction of sale in the first place and lease back of the same assets are undertaken as two separate transactions and under the separate independent agreements, hence these are two independent transactions in the eyes of the law. Also, at the,, same time, the title of assets transfers from the seller to the leasing, company, hence actual sale takes place in accordance with the provision of IAS 17.

THE INCOME TAX ORDINANCE, 1979

With respect to the question whether or not under the various provisions of Income Tax Ordinance, 1979 the transaction of sale and lease back is to be considered as " actual sales "

The appropriate Committee of the institute is of the view that the under the provisions of the Income Tax Ordinance, 1979 the assets would be considered as sold upon signing on agreement with the leasing company in the books of the seller. The difference between the tax written down values and the sale price under the agreement would be to tax profit which will be included in the taxable income of the seller under the provisions of Third Schedule to the Income Tax Ordinance 1979.

As regards your question whether the provision of Section 80C would be attracted in case the sale is said to have taken place, based on the given information, the Committee expresses its inability to express any opinion, whether or not the provision of 80C would be attracted. The applicability of Section 80C to any company largely depends upon on facts of every case. This would depend whether the relevant company is opting to offer its income under presumptive tax regime or under the net income basis.

Nonetheless, the sale would attract resultant taxation and also in issues, such as determination of fair market value may also be invoked by the assessing officer, which may require appropriate contestation at the appellate forums.

1.17 SCRAP - ACCOUNTING FOR

Inquiry: A company is engaged in manufacturing goods from imported raw material. This involves sequential processing of raw material through remainder of processes.

In the first process, raw material is sheared in different sizes (i.e. cutting process) for further processing. During first process residual parts of raw material are collected, which are sold in the open market being useless for further processing. This is the on-going practice throughout the year. The sale proceeds received from the disposal of these residual parts of raw material consist of following percentages as compared to total sale and total raw material consumed during the period.

	<u>% TO SALES</u>	<u>% TO RAW MATERIAL</u>
1. Case	10%	15%
2. Case	18%	23%

3. Case

22%

27%

What would be the correct presentation of sale proceeds of residual raw material in the financial statements of the company as per Companies Ordinance, 1984 and IAS.

- A) Scrap Sales - Other income
- B) Net off against raw material consumed.
- C) Sales of scrap shown along with sales of finished goods.

Opinion: Though the indicated scrap percentages are significantly high but the Committee is of the view that alternative B and C are acceptable provided there is a separate disclosure as an item of the trading account.

1.18 SHUT DOWN PERIOD - DEFERRAL OF EXPENSES FOR

Inquiry: Can the manufacturing and operating expenses for shut down period be transferred to deferred cost for allocation to P & L account in future?

Opinion: A plant can be shut down for a short period as well as for a long period due to strike, lock-out, shortage of raw material, over stocking of finished products and the mechanical problems etc. All the foregoing incidents are part of operating cycle and risk of any enterprise. The deferral of manufacturing and operation expenses would not only distort the current profit or loss it would also burden the subsequent period results for no reason.

1.19 TAX DEDUCTION AT SOURCE - ON GROSS VALUE OF INVOICE INCLUDING SALES TAX UNDER SECTION 50(4) OF THE INCOME TAX ORDINANCE 1979

Inquiry: Since the levy of Sales Tax from July 1, 1996 some problems have been created while deducting tax at source u/s 50(4) particularly in case of purchase of raw cotton.

The payment procedures which have been agreed between ginners and Central Board of Revenue have been advised as under (Reference CBR-ST Wing No. C. No. 3(59)STP/96 dated 28th August, 1996):-

"When a supply of ginned cotton is made by a ginner, Sales Tax chargeable thereon may be paid by the buyer by means of a pay order or certified cheque which shall be payable to the Government of Pakistan. The buyer shall deliver the pay order to the ginner at the time of supply of ginned cotton.

The ginner shall deposit the payorder or certified cheque so received by him from the buyer vwithin 7 days of its receipt in the designated branch of National Bank of Pakistan under the relevant head of account".

You are kindly requested to clarify as soon as possible the position for deduction of tax at source u/s 50(4) of the Income Tax Ordinance, 1979.

- 1 . The ginners insist that tax should be deducted before levy of Sales Tax and not on the total invoice value including Sales Tax; and
2. The opinion prevailing in cotton mills is more or less to deduct tax on total payment to the ginners i.e. cost of cotton plus Sales Tax.

Opinion: After due consideration of the issue involved, the Committee is of the view that the tax at source under Section. 50(4) of the IT Ordinance, 1979 should be deducted on the total amount of the invoice inclusive of sales tax.

The Committee, however, taking cognizance of the problem facing the industry because of sale tax levy have moved the CBR for the clarification on the issue and appropriate relief.

1.20 TRIAL RUN LOSS/PROFIT - TREATMENT OF - UNDER IAS 16, PROPERTY, PLANT AND EQUIPMENT

Inquiry: Paragraph 18 of IAS-16 reads as under:-

Administration and other general overhead costs are not a component of the cost of property, plant and equipment unless they can be directly attributed to the acquisition of the asset or bringing the asset to its working condition. Similarly, start-up and similar pre-production costs do not form part of the cost of an asset unless they are necessary to bring the asset to its working condition. Initial operating losses incurred prior to an asset achieving planned performance are recognized as an expense.

The underlined sentence in the paragraph is a new addition in IAS-16 (Revised 1993).

Advice is sought as to whether, in the light of this new addition, the trial run loss/profit can be capitalized?

In that reference, also advise the status of TR-20 and TR-21.

Opinion: Any start up and similar pre-production costs, which includes loss or profit on trial runs, which brings the asset to its working condition, is allowed to be capitalized. However, where the plant starts producing commercially feasible quantities but is not able to achieve its rated capacity (planned performance), any loss due to failure to achieve rated capacity cannot be capitalized and will have to be treated as an expense.

All costs required to bring an asset into working condition should be recorded as part of the cost of the asset. Examples of such costs include custom duties, sales tax, freight costs, site preparation and other installation costs, and setup costs. Thus, any reasonable cost incurred prior to using the asset in actual production involved in bringing the asset to the buyer is capitalized. These costs are not to be expensed in the period in which they are incurred, as they are deemed to add value to the asset and indeed were necessary expenditures to obtain the asset.

In certain cases, other costs will be incurred during the initial break-in period; these may, alternatively, be referred to as start up or pre-production costs. Under the provisions of IAS 16, these costs are not to be added to the amount recorded for the asset unless they are absolutely necessary to bring the asset to a workable condition. On the other hand, losses incurred in the early stages of actually employing the asset in its intended use cannot be capitalized but must be charged to expense as incurred, as these are not assets (i.e., these do not represent economic benefits that will later be received by the entity).

TR-20 and TR-21 are quite clear on the subject and do not need any revision.

1.21 WORKERS WELFARE FUND - ACCOUNTING TREATMENT OF

Inquiry: Under mentioned error is being made in the presentation of the financial statements of almost every tax payee industrial entity in Pakistan.

Under IAS-12, tax expenses for a period are to be determined on the basis of tax effect accounting. This is generally followed in providing for tax liabilities.

This principle is however not being followed for the purpose of calculation of charge for workers welfare fund (WWF) contribution, though on following reasons accounting treatment of WWF should be as that for deferred tax.

I. Charge for WWF, just like tax charge, is based upon tax adjusted profit and not upon accounting profit.

II. Rule of matching costs with revenue which is the underlying principle of tax effect accounting (resulting in deferred taxation) is clearly impugned if charge for WWF is based on tax adjusted profit.

III. As no adjustment is made for deferred charge / credit for WWF, the position for WWF may be very disproportionate to the accounting profit.

IV. Charge for WWF is exactly similar to taxation except for that fact that WWF is a deductible charge for calculation of taxable income.

To illustrate I would like to quote an example where there was accounting profit before tax of Rs.1.9 billion and tax loss of Rs.1.8 billion (due to initial depreciation) but there was no charge for WWF.

In my opinion, adjustments should be made in the financial statements to account for the deferred liability / asset for WWF in a way similar to the adjustments made for deferred taxation.

Opinion: The appropriate Committee of the Institute agrees that deferred charge / credit should be provided for WWF liability, if any.

2. GUIDANCE FOR MEMBERS IN PRACTICE

2.1 ADDITIONAL TAX LIABILITY - AUDITORS'REPORT

Inquiry: Annual accounts of x Leasing Company Ltd., for the period ended June 30, 1996 carry the following note:-

Note 23. TAXATION

" The income tax assessments of the Company have been finalized up to and including assessment year 1995-96. The assessment for assessment year 1993-94 has been set aside by the Commissioner of Income Tax (Appeals). The company has preferred appeals against certain disallowances for the assessment year 1994-95 and 1995-96. In case of an adverse decision in appeals an additional tax liability of Rs.4.723 million would arise which has not been provided in the accounts, as the management expects a favorable outcome of appeals."

The note neither states auditors concurrence with the management's expectation nor does it state its disagreement. If, for instance, implied concurrence of the auditors with the management expectation is assumed, then, the phrase " as the management expects a favorable outcome of appeals " appears superfluous.

Opinion: The appropriate Committee of the Institute is of the view that it is the responsibility of the auditor of the company to express his opinion on the financial statements being audited that they reflect a true and fair view of the state of company's affairs. In the process of expressing his opinion, if he encounters circumstances, which lead him to believe that true and fair view is not being reflected in the financial statements, then he may ask his client to rectify the fault and pass appropriate adjustments in the books of accounts in order to enable financial statements to reflect true and fair position. When the matter raised by the auditor is not satisfactorily resolved then auditor raises qualification in his report identifying the matter and expressing his qualification.

When such a qualification is not made by auditors it is understood that he is satisfied about the accounting treatments adopted by his client.

In the above perspective in the case referred to the Institute by you, the Appropriate Committee is of the considered view that when no qualification has been raised by the auditor in his report on the taxation matter disclosed in note 23 of the audited accounts of the company, it is clear that the auditor is of the view that in his opinion no provision was required to be created. Hence he did not disagree with the management for not creating provision against the tax matters in appeal.

You should remember that the notes to the financial statements belong to the company. Under the Companies Ordinance, 1984 as well as applicable International Accounting Standards it is the responsibility of the management of the company to prepare notes and include therein explanations that are required to be placed for better understanding of the information contained in such

financial statements. You must bear in mind that the notes to the financial statements are not the relevant place for auditors to express their agreement or disagreement with management. It is only the management, which gives its own point of view with respect to financial information. Auditor's disagreements appear in his report to the members.

Therefore, considering the wordings of the note 23 of the audited accounts of the company, the concern raised by you about the validity of the auditors opinion or as to the fair presentation of tax liability and profit for the period is considered not well founded by the Committee of the Institute. The auditors may not have felt that the liability will be confirmed in appeal based on the appellate decision of the assessment year 1993-94, which assessment was set-aside. Hence, on the same ground and argument the dis-allowances in his opinion would also not withstand the test of appeal for the future years i.e. 1994-95 and 1995-96.

2.2 APPOINTMENT OF LIQUIDATOR - CLARIFICATION

Inquiry: Kindly clarify whether:-

1. an auditor can act as a liquidator of the same company simultaneously?
2. where there are only two shareholders of a private company and one of them happens to be a chief executive can he be appointed as a liquidator?

Opinion:

1. Section 297 of the Companies Ordinance, 1984, envisages following three different modalities of a company's liquidation, namely:-
 - i) by the court; or
 - ii) voluntary; or
 - iii) subject to supervision of court.

The modalities of appointment, duties and functions of the liquidator are prescribed in the Companies Ordinance, 1984.

On appointment of the liquidator, the management of the company as per Companies Ordinance, 1984 comes to be vested in the liquidator. If the auditor is simultaneously appointed as a liquidator the situation would lead to a conflict of interest and shall or shall be seen to impair the objectivity as an auditor.

Hence the Committee is of the view that an auditor can be the Liquidator of the company provided he does not remain as auditor after his appointment as Liquidator in any of the situation stated above.

WHETHER SHAREHOLDER BE A LIQUIDATOR

2. With respect to your other query the Committee is of the view that the Ordinance prima-facie does not place any bar in respect of appointment if

any member of the company, whether a director or chief executive, to be appointed as a Liquidator. Therefore, if the members in the general meeting appoint any member amongst themselves as a Liquidator, the same shall not be contrary to the provisions of Section 364 of the Companies Ordinance, 1984.

2.3 AUDIT REPORT - SIGNING OF AUDIT REPORTS IN THE NEW NAME

Inquiry: Signing of audit reports in the new name where appointment was made in the individual firm's name before merger.

ABC Co.	5 partners
DEF Co.	5 partners

All 5 partners of ABC Co., and 2 of DEF Co. and one other join hands to form a new firm XYZ Co., consisting of 8 partners from January 01, 1997.

ABC Co., with 5 partners continued.

2 partners of DEF Co. continued to practice as DEF Co. under a new agreement as other 3 partners gave notice to dissolve the firm.

Can we (ABC Co and DEF Co.) sign the audit report in the new name (XYZ Co.) although appointment was made in the individual firm name before merger.

This scenario is not covered in ATR 11 & 12.

Opinion: It is noted that both ABC Co. and DEF Co. continue to exist in their names. They would therefore continue to be the auditors of the entities where they had been appointed in the above name(s) until the next AGM. (It is presumed that the entities under inquiry are the companies incorporated under the Companies Ordinance, 1984.)

The new firm, XYZ Co., cannot sign the audit report where ABC Co. and DEF Co. have been appointed auditors.

In this connection, in scenario (c i & ii) of ATR-12 may be referred to.

2.4 AUDIT WORKING PAPERS - RETENTION OF

Inquiry: As per your direction audit working papers or files are to be retained for a given period. If it is not kept safe and is allowed to be taken away by the client, shall the member be liable for action by the Institute, if reported.

Opinion: SAP-4 requires that the auditor should adopt reasonable procedures for safe custody and confidentiality of his working papers and should retain them for a period of time sufficient to meet the needs of his practice and satisfy any pertinent legal or professional requirements in respect of records retention.

The Committee is of the view that ICAP may not initiate any action on this matter at its own initiative but if any investigation is commenced against the member concerned, the member may not be able to defend himself in the inquiry as he would not be able to substantiate report or his findings in the absence of documentary evidence available with him. Thus he would be incapacitated to defend himself.

2.5 AUDITOR - APPOINTMENT OF A MEMBER OF CLUB AS

Inquiry: I am a member of club and its few members are interested in suggesting, my name for the appointment as auditor of the club without any remuneration. The existing auditors are getting remuneration. I am however not eligible for remuneration because the Articles of the Association of the Club state:-

"No member of the Association shall be appointed to any salaried office or any office paid by fees, and no remuneration shall be given to any member of the Executive Committee or any other member except repayment of out of pocket expenses and interest on money lent".

In the light of above circumstances should I be appointed as auditor of the said club without remuneration.

Is there any violation of Bye-Laws of the Institute because as per Institute rules no member of the ICAP can accept any assignment at lower remuneration than the existing auditors getting already. But in this case situation is different because the institution is not for profit and furthermore I will not accept the assignment for profit purpose rather I will render services without remuneration for the benefit of the Club.

Opinion: In case you are a member of any committee or sub-committee responsible for the management of the club, then there shall be a clash of interest and you should not assume the functions of audit.

However if you are an ordinary member of the club, there is prima-facie no bar in accepting the position of auditor.

Accepting the position of the auditor without remuneration when the retiring auditor held the position with remuneration would, in the opinion of the Committee, tantamount to undercutting. However in the special situation since there is a disability in accepting the remuneration, not receiving the remuneration by the incoming auditor would not tantamount to under cutting.

In any case, it would be ensured that the guidelines issued by the Institute in ATR-2 and its clarification are strictly followed.

2.6 AUDITORS - COMMUNICATION BETWEEN

Inquiry: Please advise us to the mode of communication that shall be considered proper, out of the following and or any other:

- | | | | |
|-----|--------------|----|-------------------------------|
| 1 . | Telephone: | a) | Engaged |
| | | b) | No response |
| | | c) | talk to staff |
| | | d) | talk to member (employee) |
| | | a) | talk to principal / partner |
| 2. | Telegram: | a) | Ordinary |
| | | b) | Urgent |
| | | c) | Reply paid |
| 3. | Faxes/E-Mail | | |
| 4. | letter | a) | By simple post |
| | | b) | Urgent Mail Service |
| | | c) | Urgent certificate of posting |
| | | d) | Registered |
| | | e) | Registered Acknowledgment due |

Opinion: Paragraph 13 of Clarification to ATR-2, Communication - Statement on the Explanation of the Word, states as under:

The communication by the incoming auditor to the existing auditor should be sent in a manner which, in case of a dispute, should conclusively establish the fact of mailing, e.g. post office receipt for registered / registered ack mail or receipt of courier company or fax printout for transmitting the communication by fax.

2.7 AUDITORS - COMMUNICATION BETWEEN

Inquiry: On taking up of a new assignment/appointment as auditors, is it necessary for members of the Institute in practice to ascertain if there was a CA firm previously engaged for the same work or other professional works in the same organization?

Opinion: Comprehensive guidelines are already given in ATR-2, Communication Statement on the Explanation of the Word and subsequent clarification thereof.

As regards communication in connection with professional work other than statutory audit paragraph 11 of ATR-2 states:-

Para 5 of Schedule "C" of the Bye-laws refers only to the position of auditor. Chartered Accountants in practice perform varied functions and a reference is invited to bye-law 115. Is communication also necessary for appointment or changes in appointment concerning such other functions besides the position of auditor? It would be a healthy tradition and in the best interest of relations with fellow practitioners if the practice of communication is followed in every case. Accordingly it is recommended that members of the Institute should also follow this practice in all cases of appointments or changes in appointment concerning any function other than that of auditor.

2.8 AUDITORS - COMMUNICATION BETWEEN MEMBERS IN ALL CASES OF APPOINTMENT

Inquiry: Experience shows that courier-service-messengers some times deliver letters without obtaining receiver's signature and some times write the name of the recipient themselves.

It has also been experienced that due to some technical fault, while a fax has not passed through to the destination, the fax print-out shows its delivery status to be OK.

As such it is submitted that the Committee should approve registered / registered- AD letters to be the only means of communication on change of auditors.

Opinion: The Committee wishes to invite reference to paragraph 13 of the clarification to ATR-2 that states as under:

The communication by the incoming auditor to the existing auditor should be sent in a manner which in case of a dispute, *should conclusively establish the fact of mailing*, e.g. post office receipt for registered registered ack. due mail or receipt of courier company or fax printout for transmitting the communication by fax

In view of the candidness vide above cited italicized portion the Committee is of the view that further clarification is not necessary.

2.9 AWARDS & DONATIONS - CAN A FIRM OF CHARTERED ACCOUNTANTS GIVE AWARDS &. DONATIONS FOR OUTSTANDING PERFORMANCE BY STUDENTS?

Inquiry: Whether a practicing firm of chartered accountants can institute awards and give donations for outstanding performance by students of educational institutions in the field of commerce.

Opinion: The Committee appreciates the spirit but is of the view that the institution of award and giving of donations in the name of the practicing firm of Chartered Accountants shall tend to be an indirect advertisement of the firm. The award/donations can however be made in the personal name of the members of the Institute.

2.10 CONSULTANCY FIRM - WHETHER A MEMBER CAN ADVERTISE

Inquiry: Banks and financial institutions advertise in newspapers, their accomplishment of financing deals, such as those relating to acquisition, takeover of corporations, companies etc. Such advertisement explicitly states that it appears as a matter of record only (an illustrative, advertisement appearing in the Press is attached for your ready reference) It is usual for banks to include the names of the brokerage house, corporate finance company, providing financial services / advice for the subject deal / transaction.

With reference to the above, we request you to issue your opinion as to the following matters:-

- 1 . Whether a consultancy firm, which is run by a member of the Institute of Chartered Accountants of Pakistan, can issue such advertisement where it has helped a client to consummate an acquisition or a financing transaction.
2. Can the aforesaid firm have its name included in such an advertisement, placed by some bank or financial institution?

Opinion: The Committee is of the view that the answer to inquiry No. 1 is in the negative.

With regard to inquiry No. 2, the Committee is of the view that a practicing member cannot have its name included in such an advertisement placed by a bank or financial institution. However if the client of the practicing member who is the beneficiary of the services decides to place an advertisement then the name of such practicing member can be included in such advertisement provided the noted below directive of the Council is kept in view.

Revised Council Directive 6.02, Publicity and Advertising by Members paragraph 9 :-

When a client proposes to publish a report by a practicing member dealing with the client's existing business affairs or in connection with the establishment of a new business venture the practicing member should take steps to ensure that the context in which the report is published is not such as might result in the public being misled as to the nature and meaning of the report. In these circumstances the practicing member should advise the client that permission should first be obtained before publication of the document.

Similar consideration should be given to other documents proposed to be issued by a client containing the name of a practicing member acting in an independent professional capacity. This does not preclude the inclusion of the name of a practicing member in the annual report of a client.

2.11 GOING CONCERN - AUDITOR'S RESPONSIBILITIES

Inquiry: In the case of a company, for the last four years the auditors state that the company is no more a going concern, yet the accounts continue to be prepared on the basis of going concern. Is it enough for the auditors to state as they have done?

Opinion: The parameters for audit are laid down in International Standards on Auditing. Paragraphs 15, 16, and 18 of Auditing Standard 23, Going Concern provide:-

Paragraph 15

If, in the auditor's judgment, the going concern question is not satisfactorily resolved, the auditor would consider whether the financial statements:-

- a) adequately describe the principal conditions that raise substantial, doubt about the entity's ability to continue in operation for the foreseeable future.,
- b) state that there is significant uncertainty that the entity will be able to continue as a going concern and, therefore, as appropriate may be unable to realize its assets and discharge its liabilities in the normal course of business; and
- c) state that the financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts or to amounts and classification of liabilities that may be necessary if the entity is unable to continue as a going concern.

Provided the disclosure is considered adequate, the auditor would not express a qualified or adverse opinion.

Paragraph 16

If adequate disclosure is made in the financial statements, the auditor should ordinarily express an unqualified opinion and modify the auditor's report by adding an emphasis of a matter paragraph that highlights the going concern problem by drawing attention to the note paragraph 15. The following is an example of such a paragraph:-

"Without qualifying our opinion we draw attention to Note X in the financial statements. The Company incurred a net loss of XXX during the year ended December 31, 19XI, and, as of that date, the Company's current liabilities exceeded its current assets by XXX. These factors, along with other matters as set forth in Note X, raise substantial doubt that the Company will be able to continue as a going concern".

The auditor is not precluded from expressing a disclaimer of opinion for going concern uncertainty.

Paragraph 18

If, on the basis of the additional procedures carried out and the information obtained, including the effect of mitigating circumstances, the auditor's judgment is that the entity will not be able to continue in operation for the foreseeable future, the auditor would conclude that the going concern assumption used in the preparation of the financial statements is inappropriate. If the result of the inappropriate assumption used in the preparation of the financial statements is so material and pervasive as to make the financial statements misleading, the auditor should express an adverse opinion.

2.12 INDEBTEDNESS OF AN AUDITOR AND HIS APPOINTMENT UNDER SECTION 254(3) OF THE COMPANIES ORDINANCE, 1984

Inquiry: Section 254(3)(d) of the Companies Ordinance, 1984 requires that a firm indebted to a company will not qualify to be appointed auditors of the company.

Will a firm be considered indebted to a commercial bank or a leasing company in case the firm has borrowed from the bank or entered into a finance lease arrangement with the leasing company? Can such firm be appointed auditors of the bank or the leasing company, as the case may be?

Opinion: The qualities of objectivity, independence and absence of conflict of interest have not only to be there in reality but have to be perceived as such by an unbiased observer. The test is that an observer knowing the facts of the case shall or shall not consider an auditor to be objective, independent and free of conflict of interest. In the given situation, the stated qualities appear to be affected.

Para 8.3c of Part B, Section 8 of Ethics of IFAC Handbook 1996 states that the financial involvement, e.g., loans to or from a client, officer, director or principal shareholder of a client company affects independence and may lead a reasonable observer to conclude that it has been impaired.

The Companies Ordinance, 1984, does not put any ceiling regarding the indebtedness; Section 226 of the Indian Companies Act quantifies the indebtedness at rupees one thousand.

The Committee is of the view that in the stated situation, the appointment as statutory auditor should not be accepted.

2.13 N.O.C. - NECESSITY OF SEEKING

Inquiry: We have been appointed auditors by XYZ Society, which is a society, registered for religious and charitable purposes. Following set of books with three different auditors are there on record:-

1. Anjuman
2. Hospital, getting funds, loans & grants to and from the Anjuman
3. Madarasa having no transaction with the Anjuman or Hospital but the management is the same.

Please advise if we should seek NOC from all the three separately or only from Anjuman auditors (being the main concern and same management).

Opinion: The Committee is of the view that audit is of two categories, namely, where it is a statutory obligation and where the management of an entity engages for audit a professional accountant in its discretion without any legal obligation as such. As for the statutory audit, an incoming auditor is obliged to communicate with as many number of auditors as the entity may have had. ATR-2 and its Clarification encourages the members to communicate (not NOC) with fellow members only,

wherever there is change in auditor. Therefore in the present case it would be desirable that you communicate with all the three previous auditors if they are members of the Institute.

2.14 SOFTWARE COMPANY ESTABLISHING - WHETHER A PRACTISING MEMBER CAN SET UP A SEPARATE COMPANY

- Inquiry:***
- (a) whether a member of the Institute in practice as a Chartered Accountant being a partner of a firm and also being a director and or shareholder in a management consultancy company allowed to set up a separate company for computer software exports pursuant to the aforesaid SRO No. 1152(I)/95 dated November 6, 1995 by becoming a director and or shareholder of such company;
 - (b) whether a separate software company as aforesaid would be deemed to be a "management consultancy company" within the meaning of the ICAP policy and/or regulations; and
 - (c) whether under ICAP regulations, it would be mandatory for a separate software company as explained above to describe itself as a "management consultancy company".

- Opinion:***
1. As regards (a) above, the Committee is of the view that a member who is a partner in a firm and already a director or member in a limited liability company engaged in the business of management consultancy may also become a director or a member in another limited liability company which is exclusively formed to undertake business of software development. The bye laws do not lay any specific restriction for such a member that he can only be a member or director of one limited liability company. In this connection your attention is drawn towards Clause 10 of Part 1 and Clause 5 of the Part 2 of Schedule 1 to the Chartered Accountants Ordinance, 1961 x. which are reproduced below.-

Part - 1

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

- (10) 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 dis-entitle 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.

Part - 1

A member of Institute engaged in management consultancy shall be deemed to be guilty of professional misconduct, if he-

- (5) adopts a name or associates himself as a partner or director of a firm or a company whose name is indicative of its activities.

The regulations regarding " management consultancy " do not place limit on member in practice to restrict his consultancy services through one management consultancy company only but while selecting a name of a company the member must ensure that the name selected does not announce nature of services rendered. He has to comply with other conditions of Part 2 of Schedule 1 also.

Therefore, if the aforesaid conditions are met, there exists no restriction on any member to be a director or a member in more than one company.

With respect to matters (b) and (c) above, the Committee is of the opinion that the software business falls within the ambit of management consultancy. Unless the business of software is carried out as part of management consultancy, it would constitute a separate business for which express permission is required by the member from the Council of the Institute as stated in Clause 10 of the Part 1 referred to above, Therefore, the software business is to be carried out as part of management consultancy business but registered as a separate company for forming management consultancy company to avail tax concession. The registration requirement under the ICAP Rules will have to be followed for the separate company.

3. CORPORATE & OTHER LAWS

3.1 PRUDENTIAL REGULATION # 8 - NBFIs AND BANKS - WHETHER SEEKING FINANCIAL ASSISTANCE FALL UNDER THE PURVIEW OF

Inquiry: Reference rule 8 of the NBFIs Regulation No. 1 dated December 5, 1991. The said rule requires NBFIs to ensure that debt equity ratio of the borrower is in accordance with the aforesaid rule prior to sanctioning credit facility.

The NBFIs Regulations neither define the word borrower which also includes banks and similar financial institutions, nor provide exemption from the aforesaid rule to banks and similar financial institutions. However, NBFIs and Commercial Banks Prudential Regulations prescribe debt to equity ratio for NBFIs and Banks.

You are requested to give your considered opinion, as to whether the NBFIs and the Banks, seeking financial assistance fall under the purview of the aforesaid rule.

Opinion: The Committee has considered your query and is of the view that NBFI Regulations apply to all borrowers including those, which are NBFIs.

However, the Committee also feels that, in cases where the borrower is a NBFI, the Rule 8(b) of NBFI Regulations requiring the borrower to maintain a Debt/Equity ratio of 60:40 would not apply 'as it would be covered by its own regulations which allows an NBFI to leverage up to 10 times of its equity.

3.2 TREASURY STOCK (REFERENCE FROM CLA)

Inquiry: You are aware that the concept of Treasury Stock is quite common and popular in some of the developed countries, particularly in USA. There is a feeling at certain quarters that Treasury Stock may be introduced in Pakistan also, in view of some inherent benefits of this type of stock and having regard of the prevailing depressed market conditions in the country. It has been claimed that if companies are allowed to purchase their own shares to resell, these may (i) absorb their surplus liquidity which may support the market price of the shares; (ii) the earning per share will increase; (iii) help the companies in meeting their obligations under an approved employees stock option plan and also under the Workers (Participation of Profits) Funds and (iv) the acquisitions will be facilitated, etc. etc.

The existing position of the Company law is that purchase by company of its own shares is prohibited and tantamounts to reduction of share capital. If the concept of Treasury Stock is introduced in Pakistan, as in vogue in USA and some other countries, some significant changes in the accounting systems, in the Companies Ordinance and in some other corporate laws will be mandatory. The new system may have direct and indirect impact on stock market. The issue is, therefore, to be examined very carefully having regard of our own circumstances and conditions. Karachi Stock Exchange has prepared a concept paper on Treasury Stock, a copy of which is enclosed for examination and reference.

Relevant Extracts from the Karachi Stock Exchange Concept Paper(CP) on Treasury Stock are as follows:-

'Section 95 of the Companies Ordinance, 1984 will have to be repealed and in its place the following section shall have to be inserted:-

'95. A company may purchase its *own* shares in the manner laid *down* in the rules enacted by the Corporate Law Authority. Such shares, known as Treasury Stock, shall not be entitled to dividends and voting rights. The company may subsequently re-sell the shares it has acquired for Treasury Stock in the manner laid down in the rules enacted by the Corporate law Authority. The re-sold shares shall become reactivated and be entitled to dividends and voting rights'.

Changes will also have to be affected in the Companies Profits (Workers Participation), Act in order to cater to the suggested amendments in the Companies Ordinance, 1984. Section 3(1) (b) shall have to be amended to read as under:

'(b) subject to adjustments, if any, pay every year to the Fund not later than nine months after the close of that year five per cent, of its profits during such year in the form of cash or treasury stock which shall, where the accounts have been audited by an auditor appointed under Section 23-B of the Industrial Relations Ordinance, 1969 (XXI of 1969), be assessed on the basis of such audit;

POWER OF COMPANY TO PURCHASE ITS OWN SHARES

Subject to the provisions of this chapter, a company limited by shares may, if authorized, by a special resolution purchase its own shares.

A company may not under this section purchase its own shares if as a result of the purchase there would no longer be any members of the company holding shares.

CHAPTER-IV

ACCOUNTING FOR TREASURY STOCK

When a company purchases its own shares these shares become frozen and are not entitled to dividends and voting rights. Accounting for Treasury Stock must reflect this reality.

Treasury Stock is treated always as reduction in paid-up outstanding. the Accounting entries would be:-

Treasury Stock
(Acquisition Cost)

Cash in Bank
(Cost of Treasury Stock)

This will be reflected in the Capital Account as follows

Paid up Capital	X
Less Treasury Stock (N shares at cost)	Y
Outstanding paid up Capital	$X - Y$
Retained Earnings	Z
Total Share Holders Equity	$(X - Y) + Z$

Opinion:

1. As a lot of research is required to comment on the introduction of the 'Treasury Stock (TS) concept in Pakistan. The Institute's views are restricted only to the amendments suggested by the Karachi Stock Exchange Concept Paper (CP) in the Companies Ordinance, 1984 (Ordinance) and accounting of TS.
2. The CP in chapter II has proposed an across the board replacement of Section 95 of the 'Ordinance' by the new section mentioned in it. This appears to be fraught with serious odds. The scope of existing section includes in its ambit non-listed public limited companies as well. The proposed amended section would entitle non-listed public limited companies also to TS operation. On the other hand, in chapter II.2, the details of procedural mechanism contain instructions with respect to listed companies only.
3. The procedural mechanism to regulate and control the operation with regard to employees stock option plan, contribution to employees pension funds and to Workers Participation in Profits Fund would need to be evolved in detail.
4. In sub-section ii, Chapter III, the CP states that the purchase of own shares may not be permissible if there would no longer be any member of the company holding shares. A situation in which a company shall have no member holding the shares is difficult to visualize as the "Ordinance" mandates minimum number of members.
5. The Institute is of the considered view that in order to eliminate malpractices, prior to seeking CLA's permission to undertake TS operations, the company should be legally obliged to attach with the permission request a special auditor's certificate to the effect that:-
 - a) the company has not resorted to borrowings to meet its working capital requirements in the last three years;
 - b) break-up value of company's shares is not less than 1.5 times of the face value of the shares;

- c) the company has declared dividends in each of the last three preceding years that were not less than the going borrowing rate and
 - d) the company after the TS operations would be able to meet its present and long term obligations.
6. In the USA, there are generally two standard accounting methods to handle the treasury stock. These are 'cost method' and 'par value method'. Our understanding is that in the USA, any deficiency on re-issue of treasury shares is charged to retained earnings. The accounting method suggested in the CP is cost method. Under this method the treasury stock account is debited for the cost of the shares acquired and is credited upon re-issuance for the same cost in a manner similar to that used in an inventory account. The Institute does not subscribe to this view theoretically; the Institute favors the Par value method. Under this method the acquisition cost is compared with the amount received at the time of their original issue and the TS is debited for the par value of the shares and a pro rata amount of any excess over par on original issuance is charged to TS Premium Account. Any excess of the acquisition cost over the original issue price is charged to retained earnings. If however the original issue price exceeds the acquisition price of the treasury stock, this difference is credited to 'TS Premium Account'. This accounting treatment offsets through the use of contra account all original capital balances identifiable with the treasury shares. If the treasury shares are re-issued the accounting treatment is similar to the one on an original issuance of the shares. Any balance in 'TS Premium Account' is reduced by any reissuance of treasury stock at less than par value; when that balance is exhausted, Retained Earnings would be debited.

