SELECTED OPINIONS

Volume - V

COMPILED BY

TECHNICAL SERVICES DIRECTORATE

OF

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF PAKISTAN

Introduction

This report is the fifth compilation of selected inquiries raised by the members, Corporate Law Authority (now Securities and Exchange Commission of Pakistan) and other agencies and replies issued by the Technical Advisory Committees during the period July 1997 to June 2000 for the general guidance of the members of the Institute. Volume I, II, III and IV were published earlier. This volume has been put on ICAP Website instead of being published.

The opinions contained in this compilation are of the competent Committees constituted by the Council of the Institute and are of operational nature and not on issues on which relevant laws and rules are not explicit. These "Selected Opinions" are not a compendium of "legal advice".

The opinions issued by the Committees to the members are arrived at on the basis of the facts and circumstances of each individual query and are issued at that particular point in time, it may change if the facts and the circumstances change. An opinion may change also due to subsequent development in law, pronouncements made by the Institute and other relevant changes. The Institute and the Committees will have no liability in connection with such opinion.

In every case the members have to take their own decisions in the light of facts and circumstances in accordance with related laws and rules etc., applicable to the issue under decision at that point in time.

Syed Sajid Ali
Director Technical Services

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1. ACCOUNTING

1.1 CONTINGENT LIABILITY

Enquiry We seek your technical opinion on matter relating to one of our client. Details of the case are as under: -

Our client, which is a co-operative society registered under the Co-operative Societies Act, 1925, engaged in assisting the transporters and their drivers to discharge their obligations under the Qisas and Diyat Ordinance, 1990 and Motor Vehicle Ordinance, 1965 for payment of liability in case of accidents.

The Society is in practice of receiving subscription from its members at different rates and issuing certificates of guarantee against the liability, which ranges from Rs.100, 000 to Rs.250, 000/- annually depending upon the amount of rate of subscription as per pro forma attached.

Kindly advise us whether the guarantee issued against the subscription received should be shown as Contingent Liability on the face of the balance sheet as a footnote. It is clarified that the Society is not registered as Insurance Company and has never shown such amount as contingent liability in the past. Total number of regular members is in the range of 7,000 to 7,500.

Opinion The Committee wishes to clarify that its views are limited to the issue of Contingent Liabilities.

TR-5, Council's Statement on Applicability of International Accounting Standards directs all members of the Institute to ensure that in accordance with the obligations undertaken by the Institute to International Accounting Standards Committee, the auditor, while expressing an opinion on published financial statements of an enterprise should satisfy himself that they do comply with IASs in all material respects and that in the event of any departure from or inconsistency with such standards, the auditors' report should contain suitable qualification.

Paragraph 10 of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* defines a contingent liability as "a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise ".

Paragraph 86 of the same IAS requires disclosure of each class of contingent liability as under: -

> Unless the possibility of any outflow in settlement is remote, an enterprise should disclose for each class of contingent liability at the balance sheet date a brief description of the nature of the contingent liability and, where practicable:
>
> (a) an estimate of its financial effect, measured under paragraphs 36-52;

(b) an indication of the uncertainties relating to the amount or timing of an outflow; and

(c) the possibility of any reimbursement.

The Committee is, therefore, of the opinion that the outstanding total mount of Certificates of Guarantees should be shown on the face of balance sheet of the Co-operative Society as a contingent liability to comply with IAS 37.

1.2 DEDUCTION OF TAX AT SOURCE - APPLICATION OF SECTION 50(4) OF THE INCOME TAX ORDINANCE, 1979

Inquiry Your professional opinion is sought regarding application of the following provisions to Islamic Commerce Educational Society being registered society under Societies Registration Act, 1860 (if we give status of AOP): -

a) Payment exceeding Rs.500.00 in cash without any limit as per Finance Bill 1998/99 (Clause 5(ff)

b) Application of Section 50(4) for deduction of income tax on supplies exceeding Rs.25,000.00 and in case of services exceeding Rs.10,000.00 in the financial year, 1998-99

c) Payments through crossed cheque of an individual expense account exceeding Rs.50,000.00 in lump sum or in the whole year to avoid add back and levy of tax treating it as taxable income.

Opinion Your queries in paragraph (a) and (c) above relate to the recent amendments in section 24. In the Committee's opinion as the Society is covered under clause 86 of the Second Schedule to the Income Tax Ordinance, 1979 and is not claiming any expenditure, clause (ff) is not applicable to it.

Regarding your query in paragraph (b) the Committee is of the opinion that the societies registered under the Societies Registration Act, 1860 are not a body corporate and hence not required to deduct tax under section 50(4) of the Income Tax Ordinance, 1979.

However, the Committee is also of the opinion that the above provisions of the Income Tax Ordinance have been introduced from time to time to encourage documentation of the economy. As such, we, the professional accountants, should advise our clients to follow these provisions and not take shelter behind legal niceties.

1.3 DEFERRED TAX LIABILITY IN CASE OF MODARABA

Inquiry Income of a Modaraba is exempted from tax according to clause (102E) of Second Schedule to the Income Tax Ordinance, 1979: -

> Any income, not being income from trading activity, of a Modaraba registered under the Modaraba Companies and Modaraba (Floatation and Control) Ordinance 1980, for any assessment year commencing on or after the first day of July 1999:

Provided that not less than ninety percent of its total profits in a year are distributed to its certificate holders.

- A Modaraba earns profits and distributes 90% of its profits to certificate holders and no tax liability arises for current taxation. What about the deferred tax liability if the management gives representation that they will keep on distributing 90% profits in future years also? What will happen to the provision for deferred taxation that already exists in the books?

- The same Modaraba earns profits in the next year but does not distribute profits to certificate holders in that year?

- The same Modaraba suffers accounting loss in the next year and is not able to distribute profits to certificate holders but will have a tax profit?

Opinion The matter was deliberated by the Committee at length and the members were of the opinion that the objective of deferred taxation is embedded deeply in the concept of proper matching of cost with revenue. It is generally accepted that the purpose of deferred taxation accounting is basically to achieve a proper inter-period tax allocation. The underlying principle being that deferred tax needs to be provided to the extent that it is probable that a liability or asset will crystallize. The income of Modaraba being tax free in a particular year gives rise to a "permanent difference" between taxable and book profits as opposed to a "timing difference". "Permanent difference" is such difference that originates in the current period and does not reverse in the subsequent periods. The objective of IAS-12 is to deal with a situation which gives rise to timing differences only and, therefore, should there not be a timing difference in a particular year no provision for deferred tax would be necessary.

The exemption to income of a Modaraba is a question of fact related to a particular year and the said benefit cannot be deferred or passed on to any future year. In any case the legislature while granting exemption has used the words "total profits" as opposed to "total income". Any tinkering with "total profits" would impair the ability of the Modaraba to meet the qualifying condition of distribution of ninety percent profits. It is for this reason also no provision for a presumed deferred tax should be made in the accounts.

Based on the above analysis the response to the specific questions raised by you is given below: -

a) Since the income for the year would enjoy tax concession, there will be no tax and accordingly no deferred tax provision would be required. The provisions for deferred taxation already existing in the books in respect of the past will have to be viewed independently.

b) There will be a tax charge, which will be accounted for, and any tax deferred due to "timing differences" will have to be provided for

(c) The response would be same as in paragraph (b) above

1.4 DEFERRED TAX LIABILITY ON LEASED ASSETS

Inquiry IAS-12 provides for the accounting for taxes of income, which includes provisions for deferred taxation arising from timing differences and permanent differences.

Your attention is invited to the treatment of financial leases for determination of deferred tax liability. The accounting income is determined after deducting rentals payable on leases whereas for income tax purposes the total amount of instalments paid under leasing arrangements are deducted while determining the taxable income. As such the taxable income will always be less than the accounting income where asset subject to financial leases have been acquired and such liability is being shown on the date of a balance sheet. Our contention is that while determining deferred taxation due to timing difference the effect for the different treatment of leases should be considered and deferred tax liability be reduced to that extent.

Opinion The appropriate Committee of the Institute has examined the above issue and is of the opinion that due to timing differences the deferred tax liability will start reducing only after the expiry of lease and will exhaust on the full accounting depreciation of relevant asset.

1.5 DIVIDEND INCOME - RECOGNITION

Inquiry IAS – 18, Revenue states that:

- Dividends should be recognized when the shareholders' right to receive payment is established (Paragraph 30(c)).

  Contrary to above, some of the listed companies have adopted a policy for recognizing dividend income on receipt basis; for instance, the published financial statements of a listed company disclose the revenue recognition policy as under: -

Revenue Recognition

- Dividend income is recognized on receipt basis

Kindly clarify the following: -

i) Whether recognizing dividend income on receipt basis is consistent with the requirements of the International Accounting Standard No. 18.

ii) If not, whether the dividend income should be recognized.

   (a) when it is declared / announced or,

   (b) when the dividend warrants are received.

Opinion The appropriate Committee of the Institute is of the opinion that the policy of recognizing dividend income on receipt basis does not accord with paragraph 30 of IAS 18, *Revenue*, that requires that "dividends should be recognized when the shareholder's right to receive payment is established". The Committee would like to add that the right to receive dividend is established when the following parameters laid down in the explanation to section 251 of the Companies Ordinance, 1984 are fulfilled :-

> Dividend shall be deemed to have been declared on the date of the general meeting in case of a dividend declared or approved in

the general meeting and on the date of commencement of closing of share transfer for purposes of determination of entitlement of dividend in the case of an interim dividend and where register of members is not closed for such purposes, on the date on which such dividend is approved by the directors.

The Committee is also of the opinion that recognition of the dividend income when "warrants are received" means recognition on receipt basis, which would be in conflict with the IAS and the Companies Ordinance, 1984.

1.6 FINANCE LEASE AND OPERATING LEASE AND CERTIFICATES OF INVESTMENTS ETC.- TREATMENT OF

Inquiry

1. The leases are being treated inconsistently in various companies. In some cases they are being treated as finance leases and in some as operating leases. As far as I am aware there is only one company, which writes operating leases, and leases written by all other companies are finance leases as they meet one of the following criteria laid down by IAS 17.

   (a) the lease transfers ownership of the asset to the lessee by the end of the lease term;

   (b) the lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable such that, at the inception of the lease, it is reasonably certain that the option will be exercised;

   (c) the lease term is for the major part of the economic life of the asset even if title is not transferred;

   (d) at the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and

   (e) the leased assets are of a specialized nature such that only the lessee can use them without major modifications being made.

   In general although lease agreements of some companies may be silent about the clauses (a) and (b) the present value of minimum lease payments amounts to at least substantially all of the fair value of the leased asset.

   I believe ICAP should provide guidance to its practising members as to what should be done if a lease is not correctly classified as any inconsistency in classification puts the member who insists on its correct classification in an awkward position.

2. I have noted some instances where certificates of investments, deposits with investment banks and leasing companies have been included in cash and bank balances. The Companies Ordinance defines it to be balance with banks in current or deposit accounts and IAS 5 also defined it as 'cash on hand and current and other accounts with banks'.

ICAP should review this and advise whether investment banks and leasing companies can be treated as banks for this classification purposes or these amounts should be disclosed as lending.

Opinion The Committee is of the view that IAS 17 (Revised) lays down comprehensive guidance on how to distinguish between finance and operating lease.

Compliance with the IAS is obligatory for an entity and the auditor is to ensure that the leases are classified by the entity in accordance with the IAS. Where an entity shows a finance lease as an operating lease, the auditor is bound to point out that the accounts have not been prepared in accordance with the IAS and to disclose the financial effect of the departure in its report.

Certificate of investments and investments in leasing companies etc shown as Cash and Bank Balance

IAS 5 has been withdrawn by the International Accounting Standards Committee and replaced by IAS 1. Sub-para (c) of paragraph 57 and sub-para (g) of paragraph 66 of IAS 1 (revised 1997) require that cash equivalent which is not restricted in its use is to be shown on the face of the balance sheet along with cash as a line item. The test laid down by the IAS is whether or not there is any restriction on its use. Comparison of paragraph 13 of the now withdrawn IAS 5 with the revised IAS 1 would show the significant difference between the two. In that while IAS 5 clarified that cash meant cash on hand and current and other accounts with banks, IAS 1 because of radical change of including cash equivalents with cash does not do so, the details are however to be shown in notes vide paragraph 94(c).

It is clear that under the State Bank of Pakistan Act, 'bank' has a specific connotation. No entity other than that which fulfils the requisite conditions laid down in the related Act can be considered to be a 'bank'. Further, the accounts are necessarily to be prepared in accordance with the Companies Ordinance, 1984 and if the provision of an IAS is in conflict with the 'Ordinance', the latter would prevail over the IAS.

1.7 FINANCE LEASE CHARGES - ALLOCATION BY A LESSEE

Inquiry Thank you for your circular dated 10 August 1999 on the subject. Please oblige by clarifying that whether sum of digits method can be used in allocating finance lease charges by a lessee entity.

Opinion The paragraph 17 of IAS 17 *Leases* requires that the finance charge should be allocated to periods during the lease term so as to produce *a constant periodic rate* of interest on the remaining balance of the liability for each period. It would be noted that the words in italics are same as used in paragraph 30 relating to recognition of finance income by the lessors.

In this view of the requirement of the IAS, the appropriate Committee of the Institute is of the view that the sum of digits method of allocating the lease finance charges by a lessee company does not comply with the requirements of IAS - 17.

1.8 FIXED ASSETS - REVALUATION OF

Inquiry: The opinion of the technical committee is sought in respect of the following:

A company had revalued its fixed assets in December 1997 but had not incorporated the revaluation surplus in its books for the year ended June 30th, 1998. After one year, the management of the company has decided to incorporate the assets at revalued amount in the year ended June 30th, 1999.

Advice is sought on:

1. Whether the company can do so?

2. If yes, how much depreciation should be charged on revalued assets?

   i) for one year only, or
   ii) from the date of revaluation report

3. The company has sold some of the revalued assets under reference (land and machinery) at a price below the historical cost of the assets in the period from July 1, 1998 to June 30, 1999.

   i) Whether the statutory auditor may reject the upward revaluation of assets made and ask the company to revalue the assets again?
   ii) What are the disclosure requirements if the revaluation report of 1997 may be accepted as valid?

Opinion: 1. No. The company cannot do so.

2. The position regarding depreciation in the event of revaluation is clearly detailed in paragraph 35 of IAS 16, (revised 1993) as reproduced below:

   When an item of property, plant and equipment is re-valued, any accumulated depreciation at the date of the revaluation is either:

   a) restated proportionately with the change in the gross carrying amount of the asset so that the carrying amount of the asset after revaluation equals its revalued amount. This method is often used when an asset is revalued by means of an index to its depreciated replacement cost; or

   b) eliminated against the gross carrying amount of the asset and the net amount restated to the revalued amount of the asset. For example, this method is used for buildings, which are revalued to their market value.

   The amount of the adjustment arising on the restatement or elimination of accumulated depreciation forms part of the increase or decrease in carrying amount, which is dealt with in accordance with paragraphs 39 and 40.

3. Prima-facie there is a need to write down all assets keeping in view the selling price fetched by some of the assets, instead of recording any revaluation surplus.

1.9 FREEZED FOREIGN CURRENCY ACCOUNTS - PROFIT / INTEREST ON

Inquiry The validity of promulgation of the Foreign Exchange (Temporary Restrictions) Ordinance, 1998 was challenged by the account holders before the Lahore High Court. The Lahore High Court in its judgement dated 27 January 1999 has declared the Ordinance to be in violation of the rights guaranteed under the Constitution. The Federal Government had appealed to the Supreme Court of Pakistan that has upheld the judgement of the Lahore High Court.

Brief details of the above order of Supreme Court are as follows: -

"That the foreign currency account holders are entitled to receive profit / interest in foreign exchange on their deposits at the rate already agreed as per original arrangements between them and the respective banks.

That the non-resident Pakistani and foreigners maintaining foreign currency accounts as on the date of blast will be entitled to utilize the interest / profits, payable to them under the above arrangements between them and the bank concerned, in any manner including the right to remit the same abroad".

It is pertinent to state that after 28 May, 1998, the State Bank had increased foreign exchange risk cover fee from 5.5% to 7% in July 98, 8% in November 98 and to 10% in March 99. In August 99 it was reduced again to 8%. The banks had similarly reduced the interest rates payable on foreign currency deposits. Presently it is either 0% or close to this.

After the Supreme Court decision, State Bank of Pakistan did not issue any clear instructions to banks and told them to implement the court's decision. The banks in turn have sought legal opinions from their legal advisors, which are although contradictory, but main ones are as follows: -

The order of the Supreme Court of Pakistan is not binding on Banks as the banks were not a party in any of the cases, which were heard and disposed of by the Supreme Court by such order.

The terms and conditions of FCAs, generally, do not require the banks to accrue or make payment of interest on the balance in such accounts to the account holders thereof at any specified rate.

Now a review petition is being heard in the Supreme Court of Pakistan. In the hearing on 15 November 1999, the bench expressed displeasure to SBP counsel for failure of his dients to protect the deposits of expatriate Pakistanis and ensuring payment of interest to them. The Chief Justice wanted the State Bank and the Government to ensure that interest on the FCAs was regularly paid to the depositors and no increase in forward cover charges is allowed. Chief Justice further maintained that there was no justification for transferring the forward cover charges on the foreign currency deposits. The CJ observed that charging the foreign currency depositors in the name of Forward Cover Charge was unjustified. The court made it clear to the counsel for the State Bank that if the

judgement of the Court was not implemented in letter and in spirit, the court would be constrained to review its earlier order and would definitely pass a stringent order. The Chief Justice Saiduzzaman Siddiqui has warned the State Bank that if the court was forced to review its judgement in the Foreign Currency Accounts case, then it would pass a more stringent order".

The ultimate position shall be clear only after the Supreme Court judgement in this case, of which the next hearing is fixed on January 17, 2000. The financial year of the banks ends on 31 December 1999 and financial statements are to be finalized by the middle or the third week of January 2000.

Please note that in most cases foreign currency deposits formed a substantial portion of their deposit portfolio.

I shall feel grateful if with a view to have a uniform policy the issue is examined by the Technical Advisory Committee and members are advised on the likely disclosures to be made in the case and whether the auditors in their report to the shareholders would need to include an emphasis paragraph in their opinion.

Opinion

The Committee would first like to clarify that it does not have the legal expertise, nor has it any legal back-up support. The Committee's views do not therefore affect the legal consequences arising out of the judgements of the Lahore High Court and the Supreme Court of Pakistan in the case of Shaukat Ali Mian and Others versus Federation of Pakistan, more popularly known as Foreign Currency Accounts case.

The Committee has noted that the order of the Supreme Court dated June 18, 1999 declares that the foreign currency account holders are entitled to receive profits / interest in foreign exchange on their deposits at rate already agreed as per original arrangements between them and the respective banks. This suggests that there should be a certain agreed interest / profit in foreign exchange between the account holder and the bank. However, you have advised that the terms and conditions of foreign currency accounts generally do not require the banks to accrue or make payment of profit / interest in foreign currency at any specified rate. This could be true in case of current accounts but not in case of term deposits. The problem needs to be sorted out at your end by reviewing the terms and conditions in respect of various categories of accounts, that is, current account, current deposit accounts and fixed deposit accounts.

With respect to the position that the order of the Supreme Court of Pakistan is not binding on banks as they were not made a party in the case, the Committee would within the above stated limitations like to infer that the position may not be such. As is clear from your enquiry too, with respect to the foreign currency accounts the banks were operating under the guidelines issued by the State Bank of Pakistan from time to time- in fact, the present situation is indeed a result not of the banks own policy or action but due to SBP's instructions. The situation might therefore be open to remedy through SBP's instructions without impleading the banks as a party to the case.

The Committee is of the opinion that the banks are bound by the Supreme Court of Pakistan to honour their liability to accounts holders according to the terms and conditions agreed at the time of accepting the accounts. However, in view of the legal technicalities involved, the liability is not candid and clear at the moment. The liability cannot be however ignored either.

The Committee is of the opinion that the liability comes within the purview of a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the banks. In this view of the matter, the liability is to be shown as a contingent liability. The financial effect estimated in terms of the agreed rate of profit / interest, if any, and the period involved together with the indication of the uncertainties relating to the issue are also required to be disclosed as required under paragraph 86 of IAS 37, Provisions, Contingent Liabilities and Contingent Assets and paragraph 14 of Part II of the Fourth Schedule to the Companies Ordinance, 1984.

In case no disclosure about the contingent liability is made, then a qualified opinion may be expressed subject to the materiality of the amount involved.

1.10 HEAD OFFICE EXPENSES IN THE 1999 PUBLISHED FINANCIAL STATEMENTS OF A BANK - TREATMENT OF

Inquiry The annual accounts of a bank for the year ended December 31, 1999 were recently published in Daily Business Recorder, Karachi. The note 3 to the said accounts read as follows :-

> From the current year, in these financial statements, Head Office expenses have not been accounted for. This change has been made to reflect more realistic position in the financial statements. Had this change not been made, there would have been an increase in loss after taxation by Rs.246.472 million.

Whether the above treatment i.e. non-incorporation of Head Office Expenses, is an allowable treatment under the applicable International Accounting Standards (IAS) or Banking Companies Ordinance, 1962.

Further, where a bank, as per its accounting policy, has incorporated in its accounts, the Head Office Expenses, would it be treated as more realistic or otherwise and what would be the approach of the auditors in this regard.

Opinion Accounting policies are the specific principles, bases, conventions, rules and practices adopted by an enterprise in preparing and presenting the financial statements (IAS 1.21 and IAS 8.6). The appropriate Committee of the Institute is, therefore, of the opinion that the incorporation or non-incorporation of head office expenses does not fall within the definition of “accounting policy”. The Framework to the International Accounting Standards defines expenses as “decrease in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants” (Framework .70b). The Committee is of the opinion that head office expenses should be recognised as a liability in the balance sheet as “the outflow of resources” is certain (Framework .94 and .95). In Committee’s considered view, the non-recognition of the expenses in the financial statements impairs the “true and fair view” of the statements and, therefore, calls for qualified audit report.

The Committee also wishes to clarify that " inappropriate accounting treatments are not rectified either by disclosure of the accounting policies used or by notes or explanatory material" (IAS-1.12).

Though as stated earlier the incorporation or non-incorporation of head office expenses is not an accounting policy but for the sake of argument if it was accepted that it was so then the Committee also wishes to point out that as the reasons for the change have not been disclosed, the disclosure in the financial statements is insufficient. The Companies Ordinance, 1984 requires that " change in an accounting policy that has material effect in the current year or may have a material effect in the subsequent years together with reasons for the change and the financial effect of the change, if material, shall be disclosed in the financial statements {Fourth Schedule, Part I, 2(iv)}. Furthermore, the IAS also mandates a similar disclosure for the change in accounting policy (IAS-8.53).

1.11 IAS-19, *EMPLOYEE BENEFITS* (REVISED 2000) - APPLICATION TO NATIONALIZED BANKS AND LARGE PRIVATE BANKS

Inquiry

We would like to draw your attention to International Accounting Standard, 19 (IAS 19) dealing with the 'Employee Benefits', which is applicable for financial statements covering periods beginning on or after January 1, 1999. We write this letter with specific reference to the provision of the said IAS dealing with the compensated absences and other short-term employee benefits, i.e. medical benefits payable after retirement.

We would like to seek your opinion as to the application of International Accounting Standards (IAS) on the banking company on the following grounds: -

1. Section 234 of the Companies Ordinance, 1984 'Contents of Balance-Sheet', deals with the disclosure requirements and the application of International Accounting Standards. Sub-section (2) of the said section exempts banking and insurance companies from the disclosure requirements as are applicable in case of a listed or unlisted, non-banking companies. Disclosure requirements of the banking companies are exclusively governed by the second schedule, as amended by BPRD Circular No.31 dated August 13, 1997, of the Banking Companies Ordinance (BCO), 1962. Section 234(2), of the Ordinance 84 requires banking company and insurance company to follow their own laws, in preparation of accounts. Hence, IASs do not apply to Banking and Insurance Companies.

   We are therefore of the opinion that according to the provisions of the section 234 of the Companies Ordinance, 1984, banking companies are exempted from the mandatory adoption of the International Accounting Standards. The adoption of any standard or the accounting treatment prescribed by the Standard is the discretion of the management of the banking company and it is not mandatory due to the prevailing regulatory framework as applicable to banking companies.

2. Nationalised commercial banks (NCB) have been recently restructured by the Government of Pakistan (GOP) by injection of capital. While calculating the amount of capital-injection, all factors such as Voluntary Golden Handshake Scheme Cost, retirement benefits and other

provisioning shortfalls were accounted for but the charge on account of compensated absences was not contemplated at that time because such charge is being accounted for at the time of availment. Now if the banks were compelled to adopt the standard, it would severely erode the equity of banks.

Nationalised banks are being restructured and right-sized with the ultimate objective to privatise. Charging of compensated absences by banks would automatically discount the purchase consideration. The ultimate benefit of this will flow to the prospective investor as in the event of pre-mature retirement of the employees, they will not be entitled to such compensation and hence the provision will have to be written back to the benefit of the prospective investor.

Banks will have an adverse impact on their international rating and would affect the availability of credit lines. This may further lead to deterioration of sovereign ratings.

Banks would also have to bear the tax effect of such provision, as this charge will not be allowed by the tax authorities on accrual basis. No CBR SRO/Scheme exists. This will further add to the tax differences existing between tax authorities and nationalised banks. Banks are already subject to arbitrary disallowances on account of provision for bad and doubtful debts, add-backs on account of interest in suspense account and any further taxation on account of provision for compensated absences will not be sustainable, and would further deplete the TIER-1 capital of banks.

Notwithstanding our above submissions, we draw your attention to TR-13, which was to be applicable for financial years beginning after December 31, 1991. We understand, that the application of the said TR, was held in abeyance due to the practical problems faced by the large enterprises in determination of the liability and its consequent recognition in the financial statements due to the significance of the amount involved thereof.

We request you to review the implications of the specific provisions of IAS 19 on banks and suspend the application of said provisions on banks due to the uncertainty involved as to the ultimate utilisation of the liability. The financial cost of the adoption of the said provisions of the IAS 19 on the financial statements of the banks may also be considered in arriving at the decision. Institute may consider in introducing alternative provisions for the adoption of the said provisions of the Standard, whereby the banks may be required to account for the liability, which is expected to crystallise in the short term i.e. next one to two years. Such alternative provision will considerably ease the financial burden on the banks enabling them to recognise the same with reasonable certainty and accuracy.

In view of the foregoing, we request you to consider our arguments and allow exemption to banks from the provision of the IAS-19 (Revised) or recommend alternative provisions as suggested in our above arguments.

Looking forward for an early response as the due dates for finalisation of accounts as per SBP guidelines of 31 March 2000 has already passed and now time available to crystallise this important issue is extremely short.

Opinion The appropriate Committee of the Institute wishes to state that question of applicability of IASs to banks has already been examined by it in its meeting held on March 5, 1999 and its opinion was also published in the Institute's Newsletter for the month of November, 1999. However the same is reproduced below again for your information: -

" The Committee is of the considered opinion that to answer your query one has to look into section 234 of the Companies Ordinance, 1984 which has three main operating sub-sections.

Sub-section (1) requires every balance sheet and profit & loss account of a company, irrespective of the fact whether it is a listed company or any other company, to give a true and fair view of the state of affairs and profit & loss of the company.

Sub-section (2) requires listed and any other company to comply with the requirements of Fourth and Fifth Schedule respectively of the Companies Ordinance, 1984. At the same time the insurance, banking and any other class of the companies for which the requirements of balance sheet and profit & loss accounts are specified in the law regulating such class of the companies are exempted from the applicability of this sub-section.

Sub-section (3) relates to the applicability of International Accounting Standards to listed companies and it provides no exemption to the insurance, banking and any other class of companies as has been done in sub-section (2).

As the framers of the law have, as in the case of sub-section (2), not provided exemption from the applicability of the International Accounting Standards in sub-section (3), the Committee is of the considered opinion that such International Accounting Standards which are notified for the purpose in the official gazette by the Corporate Law Authority are applicable to all listed companies irrespective of the nature of their operations or specialisation."

Regarding your suggestion to grant exemption to banks from the applicability of IAS-19, the Committee is of the opinion that the Institute is not vested with the powers to exempt anybody from the applicability of the IASs. The Committee would, therefore, advise you to approach the competent authority in the matter i.e. the Securities and Exchange Commission of Pakistan.

1.12 IAS 34, *INTERIM FINANCIAL REPORTING* - ADOPTION OF AND PRESENTATION OF HALF-YEARLY ACCOUNTS

Inquiry The IAS 34, *Interim Financial Reporting* requires listed companies to publish interim financial reports for the period beginning on or after 31st December 1999.

A listed company has acquired more than 60% of the shares of a company in September 1999, and is, therefore, required to publish consolidated financial statements in accordance with IAS 27, *Consolidated Financial Statements and Accounting for Investments in Subsidiaries*.

Advice is sought on: -

Consolidated financial statements for half-year ending on 31st December 1999 are required or not?

As the consolidated comparative figures are not available, should comparative figures be shown of the single company?

Opinion The Committee is of the view that interim financial report on consolidated basis is required to be published in case the most recent financial statements were published on consolidated basis. The Committee in this regard wishes to draw attention to paragraph 14 of IAS 34 that reads as under: -

> An interim financial report is prepared on a consolidated basis if the enterprise's most recent annual financial statements were consolidated statements. *The parent's separate financial statements are not consistent or comparable with the consolidated statements in the most recent annual financial report. If an enterprise's annual financial report included the parent's separate financial statements in addition to consolidated financial statements, this Standard neither requires nor prohibits the inclusion of the parent's separate statements in the enterprise's interim financial report* (emphasis added).

In the case cited by you, interim consolidated financial statements are not required. However you may do so on your own.

With regard to the comparative figures, paragraph 6 of Part I of the Fourth Schedule to the Companies Ordinance, 1984 clarified the issue as under :-

> Except for the first financial statements laid before the company, financial statements shall also give the corresponding figures for the immediately preceding financial year. This requirement shall, in the case of companies required to prepare half-yearly financial statements shall be applicable accordingly to the immediately preceding corresponding period.

The Committee would first like to clarify that the IAS 34 as adopted by ICAP is operative for the financial statements covering periods beginning on or after January 1, 1999 and not December 31, 1999. The Committee would like to further clarify that the Securities and Exchange Commission of Pakistan has not yet gazetted the IAS 34. It will become operative for listed companies' interim financial statements covering periods beginning on or after the date of the gazette notification.

However, as and when IAS 34 becomes operative, for comparative figures, its paragraph 20 read with Appendix 1 will apply.

1.13 IAS 34, *INTERIM FINANCIAL REPORTING* - APPLICABILITY OF

Enquiry

- Has the new accounting standard IAS 34 *Interim Financial Reporting* been notified by the SECP in the official gazette for the purpose of section 234 of the Companies Ordinance, 1984;

- Although the standard has been adopted by the Institute of Chartered Accountants of Pakistan but has not been notified by the SECP, then is it mandatory for listed companies to fulfil the requirements of IAS 34; and

- It appears that section 234 deals with the annual accounts only, and for half-yearly accounts there is a separate section 245, which requires only Balance Sheet and Profit and Loss Account for the half-year. Therefore, even if SECP notifies adoption of IAS 34 in the official gazette for the purpose of section 234 then will still it be mandatory for companies to follow this IAS for the purpose of preparation of half yearly accounts.

Opinion The appropriate Committee of the Institute is of the opinion that: -

1. IAS-34, Interim Financial Reporting has not yet been notified in the official gazette, it, is, however, expected to be notified very shortly.

2. The IAS has been adopted by the Institute and its members are expected to comply with the directive of the Council as contained in TR-5, IASC Standards – Council's Statement on Applicability.

The interim financial statements comprise of the balance sheet and the profit and loss account. The balance sheet and the profit and loss account are obviously required to be prepared within certain accounting framework. The International Accounting Standards as adopted by the Institute constitute the GAAP for its members, that is, the framework for the preparation of the balance sheet and profit and loss account. The adoption of IAS-34 by the Institute provides for its members the GAAP, i.e. the framework for the preparation of interim financial reporting and hence, legal niceties apart, the members are obliged to follow it.

1.14 IAS 34, *INTERIM FINANCIAL REPORTING* and CONSOLIDATED FINANCIAL STATEMENTS

Inquiry Under SRO No.33 (1) 2000 dated January 27, 2000 issued by the Securities and Exchange Commission of Pakistan (SECP) IAS 34 Interim Financial Reporting has been adopted under Section 234(3) of the Companies Ordinance, 1984.

Para 14 of IAS-34 states that: -

> "An interim financial report is prepared on a consolidated basis if the enterprise's most recent annual financial statements were consolidated statements. The parent's separate financial statements are not consistent or comparable with the consolidated statements in the most recent annual financial report. If an enterprise's annual financial report included the parent's separate financial statements in addition to consolidated financial statements, this standard neither requires not prohibits the inclusion of the parent's separate statements in the enterprise's interim financial report".

In our country parent's separate financial statements are published as a basic requirement and consolidated financial statements are published as additional information.

In view of the above, kindly guide us as to the requirement of publication of consolidated financial statements in the half yearly report.

Opinion The Companies Ordinance, 1984 and the existing practice represent the position prior to the adoption of IAS-34, Interim Financial Reporting. The appropriate Committee of the Institute is of the opinion that the situation after the adoption of IAS-34 has changed and both separate interim financial statements of the parent company and consolidated interim financial report are required to be issued to comply with the Companies Ordinance, 1984 and IAS 34, if the most recent annual financial statements were consolidated financial statements.

1.15 INPUT TAX - CLAIM UNDER SALES TAX ACT, 1990

Inquiry Company has claimed some sales tax invoices as input tax adjustment in monthly return, which previously could not be claimed by inadvertence. Whereas these invoices were not older than a year.

Section 7(2) of Sales Tax Act, 1990 does not preclude from claiming such invoices, as reproduced hereunder: -

> "A registered person shall not be entitled to deduct input tax from out put tax unless:
>
> > in case of a claim for input tax in respect of a taxable supply made in Pakistan, he holds a tax invoice in respect of such supply for which a return is furnished;
> >
> > in case of goods imported into Pakistan, he holds the bill of entry duly cleared by the customs under section 79 or section 104 of the Customs Act, 1969 (IV of 1969)."

Section 66 says :

> " No refund of tax claimed to have been paid or over paid through inadvertence, error or misconstruction shall be allowed, unless the claim is made within one year of the date of payment."

Now in this case company holds the invoices in respect of taxable supplies made and these were claimed within one year.

Your opinion is requested to advise, what consequences are attracted in this case, and under what provisions of the Sales Tax Act.

Opinion The Committee wishes to advise you that it helps its members in the matter of interpretation of corporate laws and accounting / auditing issues. Normally the Committee does not entertain members' enquiries on tax matters.

However, regarding your enquiry dated February 17, 2000 relating to sections 7(2) and 66 of the Sales Tax Act, 1990 the Committee wishes to point out that in section 66 after the word "misconstruction", the following words were added by the Finance Act, 1998:

> "or refund on account of input adjustment not claimed within the relevant tax period".

Sales tax invoices not claimed previously would have to be claimed as a refund under section 66. These cannot be claimed in the Monthly Return as input adjustment.

1.16 LEASED FIXED ASSETS - REVALUATION OF

Inquiry With reference to above, your valuable opinion is sought on the following matters: -

1. Whether a company can revalue its fixed assets, which are held by the company through finance lease arrangements?

3. Whether additional depreciation on re-valued assets can be charged to "Surplus on revaluation of fixed assets"?

Opinion 1. Regarding revaluation of fixed assets held by the company under finance lease arrangements the Committee would like to draw your attention to paragraph 11 of IAS 17, Leases which is reproduced below: -

> A finance lease should be recognized as an asset and a liability in the balance sheet of a lessee at amounts equal at the inception of the lease to the fair value of the leased property, net of grants and tax credits receivable by the lessor or, if lower, at the present value of the minimum lease payments. In calculating the present value of the minimum lease payments the discount factor is the interest rate implicit in the lease, if this is practicable to determine; if not, the lessee's incremental borrowing rate is used.

A careful reading of the above paragraph would show that the leased asset should be recorded at its fair value at the inception of the lease, if it is less than the present value of the minimum lease payments. The IAS does not provide for any re-valuation after initial recognition during the pendency of the lease.

The additional depreciation on revalued assets cannot be charged to surplus on re-valuation of assets as it would be *ultra vires* of the provisions of section 235 of the Companies Ordinance, 1984

1.17 LOAN - SETTLEMENT OF

Inquiry Company "A" had obtained loan of certain amount from a financial institution for the purchase of machinery. As the directors were unable to manage the affairs of the company successfully, they decided to sell the project. The principal amount of re-scheduled loan outstanding on the date was Rs.3.50 million. The financial institution asked for the settlement of the entire amount of loan in lump sum prior to the change of management. After negotiations, the financial institution has agreed to the payment of Rs.1.50 million as lump sum payment in settlement of the outstanding loan.

The client desires to show the saving of Rs.2.00 million directly in the reserve without channelling it through profit and loss/ profit and loss appropriation account.

Kindly advise whether the above stated accounting treatment is correct.

It may be added that the company is a private limited company under the Companies Ordinance, 1984.

Opinion

The Committee would first like to advise that the generally accepted accounting practices do not distinguish between different legal forms of entities. The position that the company under reference happens to be a private limited company is therefore of no material importance.

The Committee has noted that no International Accounting Standard exists on the subject. Reliance therefore is to be made on international practice in the matter.

The Committee has noted that Financial Reporting Standard 4 issued by the Accounting Standards Board of UK requires that "Gains or losses arising on the repurchase or *early settlement of debt* should be recognized in the profit and loss account in the period during which the repurchase or early settlement is made" (Paragraph 32).

US FAS # 15, 91, 114, 121 and Technical Bulletin 80.2 and 81.6 also deal with the various aspects involved in the issue. FAS 15 establishes standards of financial accounting and reporting by the debtor and by the creditor for a troubled debt restructuring. As for the term "troubled debt restructuring", the FAS 15 states that "A restructuring of a debt constitutes a troubled debt restructuring for purposes of this Statement if the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to a debtor that it would not otherwise consider. Such concession either stems from an agreement between the creditor and the debtor or is imposed by court of law". For example, "the creditor may accept cash, other assets, or an equity interest in the debtor in satisfaction of the debt though the value received is less than the amount of the debt because the creditor concludes that that step will maximize recovery of its investment" (paragraph 2). It also adds that "whatever the form of concession granted by the creditor to the debtor in a troubled debt restructuring, the creditor's objective is to make the best of a difficult situation. That is, the creditor expects to obtain more cash or other value from the debtor, or to increase the probability of receipt, by granting the concession than by not granting it" (Paragraph 3).

Paragraph 13 of the FAS further requires that the difference between the debt and the payment of the debt in its lieu shall be recognized by the debtor as a gain. Such gain is to be recognized by the excess of the carrying amount of the payable settled over the fair value of the assets transferred to the creditor.

The Committee has noted that the Financial Reporting Standard 26 issued by the Institute of Chartered Accountants of New Zealand also states that " when the carrying amount of an asset given up in settlement of a debt differs from the carrying amount of the debt, the difference shall be recognized as a gain or loss (Paragraph 5.18).

The Committee has further noted that AASB 1014 issued by the Institute of Chartered Accountants of Australia also carries identical guidelines.

The Committee is, therefore, of the opinion that in view of the above stated international practice, the difference of Rs.2.00 million between the debt outstanding on the date of the settlement and the amount settled in its lieu should be accounted for as a gain in the profit and loss account.

1.18 OCEAN FREIGHT - PRESENTATION OF

Inquiry

1. According to the Part III(1)(A)(i) of the Fourth Schedule to the Companies Ordinance, 1984, the profit and loss account shall be so made out as to disclose clearly the operating results of the Company during the financial year covered by the account and shall show, arranged under the more convenient heads, the gross income and gross expenditure of the Company during the financial year disclosing every material feature and in particular the following :

   A (i) the turnover and showing as deduction therefrom :-

   (a) commission paid to sole selling agents;
   (b) commission paid to other selling agents; and
   (c) brokerage and discount on sales.

2. Under Part III (7) and (3) of the Fourth and Fifth Schedule respectively of the Companies Ordinance, 1984, the profit and loss account shall be so drawn up as to disclose separately the manufacturing, trading and operating results. In the case of manufacturing concern, the cost of goods manufactured shall also be shown. …… Value of items exported during the financial year shall also be shown provided such value exceeds twenty percent of the total turnover of the company.

3. There is no specific requirement in the International Accounting Standards for disclosure of turnover and deductions therefrom. There is a general practice in Pakistan to disclose ocean / air freight and insurance expenses as selling expense. The disclosure requirements of Companies Ordinance, 1984 require deduction of only items mentioned in para 1 above from the turnover.

4. However, because of the requirements of the Companies Ordinance, 1984 and general practice followed in Pakistan, the gross margin varies highly due to the fact that in case of CIF sale, the sale value includes freight and insurance but these costs are not deducted from sales while working out the gross margin. The deduction and the non-deduction of insurance and freight expenses from sales give lesser and higher GP rate respectively.

5. According to matching concept, relevant costs should be deducted from its income. As such ocean / airfreight and insurance relating to the sales should be deducted from sales instead of showing them as selling expenses.

6. If a company insists to deduct and disclose freight and insurance from sales, will it be a violation of the Companies Ordinance, IASs or practice followed generally?

Opinion The appropriate Committee of the Institute has considered your above-mentioned enquiry and is of the opinion that the issue concerns as to what the insurance and freight expenses in the instant case represent. The Committee is of the view that insurance and freight in the given instance represent the distribution costs. The opinion of the Committee is based on the *Dictionary of Accounting and Finance* by R. Brockington published by Pitman Publisher in which the distribution costs are defined as *"Costs associated with transferring goods from a supplier to the customer. Distribution costs would include packing and transport"*.

Paragraph 82 of IAS-1 (Revised 1997), Presentation of Financial Statements, suggests that distribution costs should not be shown as cost of sales but as separate line item after working out gross profit.

1.19 PARTNERSHIP FIRM - ACCOUNTING YEAR OF A

Inquiry The audit of one partnership firm was carried out by M/s. ABC & Co. Chartered Accountants. The accounts were prepared from 1st December, 1997 to 19th May 1998.

According to the procedure of bank, the Credit Committee while considering the request for grant of financial facilities also requires the audited statements of the clients whether limited company or partnership firm.

The members of the Credit Committee were surprised that how a firm of Chartered Accountants had certified the accounts for the odd period referred to above.

We inquired through our General Manager from the auditors regarding the accounting period. We have received a reply, copy of which is enclosed for your study. We understand that the accounts should have been prepared up to June 1998.

The above firm has also audited the accounts for odd period in one more case. Certifying of accounts for such period is not a good practice without any specific reason. We suggest that suitable action be taken at your end.

Opinion The Committee is of the opinion that unlike the companies registered under the Companies Ordinance, 1984 or other statutes that oblige a body to present financial statements at least annually, the Partnership Act does not prescribe any such condition. Hence, the Act appears to leave the period of financial statements to the discretion of the partners.

On the face of it, even in the cases of companies, the 1984 Ordinance or the International Accounting Standard 1 (revised 1997) does not limit the presentation of financial statements to annual cycle. The Ordinance and the IAS prescribe the minimum requirements and there seems to be no statutory bar or conflict with the IAS in preparing and getting the accounts audited more than once in a year if the entity so desires.

1.20 PROFESSIONAL LIABILITY INSURANCE

Inquiry Reference your letter dated 3.4.98., I beg to disagree with you that an insurance cover does not effect the standard of professional work. Insured has psychological cover of monetary loss and so it may lead him to be a bit carefree.

In case of a claim, insurance co., shall pay amount to claimant, who shall not be any more interested to refer to ICAP, to ascertain if it was a professional fault.

I demand that all such insurance covers should be recorded in ICAP and in case of a loss paid, its details should be put up to Investigation Committee.

Opinion: The appropriate Committee of the Institute wishes to inform that your apprehensions that the taking out of professional liability insurance would make one "a bit care free" may not be well founded. For example, the taking out of a life insurance cover does not make one care free about his life. Or, again, for example, by taking out comprehensive car insurance, one does not become care free about accidents to and by his car.

It shall be appreciated that the profession has achieved the high professional profile due to integrity and dedication. A professional is not expected to lower the standard of work just because of the availability of insurance cover. As already advised in our previous response, professional liability insurance is an international phenomenon. This has however not led to the lowering down of professional standards at the international level.

Another point to be noted in this regard is that insurance cover shall cost a good deal that shall go to increase with every claim.

Regarding your demand to register all professional liability insurance covers with ICAP, as the professional liability insurance cover is an international practice, the Committee requests you to advise the name(s) of the institute(s) where the desired practice is in vogue.

1.21 TECHNICAL RELEASES ISSUED BY ICAP - STATUS OF

Inquiry I have received Circular No. 07/99 of August 2, 1999 regarding summarized result of review of published financial statements of listed companies with reference to their compliance with the requirements of :

i) International Accounting Standards
ii) Technical Releases
iii) Fourth Schedule to the Companies Ordinance, 1984

In my opinion, the listed companies are required to present their financial statements in accordance with the requirements of Companies Ordinance, 1984, Under Section 234 (2)(i) of the Companies Ordinance, 1984, the listed companies are required "that the balance sheet and profit and loss account or the income and expenditure account shall comply with the requirements of Fourth Schedule so far as applicable thereto".

Further, under Section 234 (3)(i) the listed companies are required "that such International Accounting Standards and other standards shall be followed in

regard to the accounts and preparation of the balance sheet and profit and loss account as are notified for the purpose in the official Gazette by the Authority".

So far as the financial statements are required to comply with the requirements of Technical Releases issued by ICAP from time to time, I have not been able to find out any provision under the Companies Ordinance, 1984. You are, therefore requested to please guide me in the matter as to how the listed companies are obliged and required that their accounts should be complied with the technical releases issued by the ICAP.

You would appreciate that the members of ICAP cannot make technical releases issued by ICAP binding on the listed companies. At the same time, the technical releases cannot be binding by a mere fact that the member of ICAP is in the employment of a listed company.

Further, the Auditors are not supposed to prepare or modify the presentation of financial statements as they are required only to report on the financial statements.

Opinion The Technical Releases issued by the Institute are the pronouncements / statements of guidance and directives by the Council of the Institute. The non-compliance of the directives issued by the Council or any Standing Committee is deemed to be a professional misconduct in terms of clause 3 of Part 4 of Schedule I to the Chartered Accountants Ordinance, 1961. If the financial statements prepared by a company are not in accordance with a TR, the members in practice are obliged to report the non-compliance in the auditors' report to the members of the company. The members in employment are also obliged to advise the management about the necessity of compliance with TRs.

1.22 UNDERTAKING - DEFINITION / SCOPE OF THE TERM

Inquiry Section 196(3) of the Companies Ordinance, 1984 reads;

(3) The directors of a public company or of a subsidiary of a public company shall not except with the consent of the general meeting either specifically or by way of an authorization, do any of the following things, namely: -

(a) Sell, lease or otherwise dispose of the undertakings or sizeable part thereof, unless the main business of the company comprises of such selling or leasing."

Kindly advise whether 'Long-term Investments' of a public company fall under the classification of the 'undertaking'.

Please also give your comments on the definition and the scope of the term " undertaking ".

Opinion It is very strange that "long-term investments" should be considered as "undertaking".

Paragraph 4 of IAS 25, *Accounting for Investments* states that an investment is an asset held by an enterprise for the accretion of wealth through distribution (such as interest, royalties, dividends and rentals), for capital appreciation or for other benefits to the investing enterprise such as those obtained through trading

relationships. Inventories as defined in IAS 2, *Inventories*, are not investments. Property, plant and equipment as defined in IAS 16, *Property, Plant and Equipment*, (other than investment properties) are not investments.

It distinguishes current and long-term investment as under: -

> A current investment is an investment that is by its nature readily realizable and is intended to be held for not more than one year.
>
> A long-term investment is an investment other than a current investment.

It is clear from the above that investment intended to be held for a period of more than a year is a long-term investment. As explained in paragraph 5 of the IAS, enterprises hold investments for diverse reasons. For some enterprises, investment activity is a significant element of operations. Some hold investments as a store of surplus funds. For the stated reasons, the IAS in its paragraph 36 recognizes the necessity to deal with re-classification of long-term investments as current investments. Reference to paragraph 37 of the IAS under reference shall also reveal that the inter-transfer of investments between long-term and short-term is a standard norm of the investment activity.

Considering the long-term investments as "undertaking" leads to the conclusion that the transfer of long-term investments to short-term investments should also be authorized by the members in the AGM. The mere classification of investments as long-term investments does not convert it into "undertaking", it continues to be investment for the purpose of accretion of wealth. It is apparent that the Companies Ordinance, 1984 would not require a company to call general meetings of the shareholders so frequently as the investment decisions would obviously warrant.

The New Oxford Dictionary defines the word "undertaking" as *"a company or business"*.

It is clear from the context of section 2(2) of the Companies Ordinance, 1984 that the word "undertaking" that has been repeatedly used in the section does not mean mere asset or property but a business unit or enterprise in which a company may be engaged as gainful occupation. For example, each one of several factories or manufacturing plants of a company will be considered an "undertaking" from the business point of view. *"Undertaking" does not consist of mere assets or property. It is a productive organism, so to speak, signifies a going concern engaged in the production, distribution etc. of goods or services (Rustam Cavasjee Cooper V. Union of India – AIR 1970 SC 564).* Sometime it means also the entire business or organization of a company.

The Committee is, therefore, of the opinion that the word "undertaking" in section 196(3) of the Ordinance does not mean mere asset but productive organism, entire business or organization of the company.

1.23 WORKERS' PROFIT PARTICIPATION FUND – CALCULATION OF

Inquiry Please refer to the ICAP TR-8 issued on December 18, 1982 regarding subject matter.

As per the above TR-8 the ICAP recommended the calculation of direct percentage of 5% on profit, whereas as per Workers Profit Participation Fund Rules 1971, Annexure I, clause 1 it should be computed on the basis as for computing the Managing Agency Commission.

We feel that the Managing Agency Commission is to be calculated as per the method mentioned at serial No.(b) of the above TR whereas the ICAP recommended method at serial No.(a), please reconsider and clarify with reference to the Rules and the Annexure 1.

Opinion

Paragraph 1 of Annexure I to the Companies Profits (Workers' Participation) Rules, 1971 (the Rules) states that the annual profits to be considered for the purpose of the Act shall be computed on the same basis as for computing the managing agency commission. What shall be the profits in relation to a company is defined in sub-section (d) of Section 2 of the Companies Profits (Workers' Participation) Act, 1968 (the Act). For facility, sub-section (d) and Section 87C of the Companies Act, 1913 (the Repealed Act) referred to in it are reproduced below: -

Sub-section (d) of Section 2 of the Act

"profits" in relation to a company means such of the "net profits" as defined in section 87C of the Companies Act, 1913, as are attributable to its business, trade, undertakings or other operations in Pakistan.

Sub-section (3) of Section 87C of the Repealed Act

For the purposes of this section 'net profits' means the profits of the company calculated after allowing for all the usual working charges, interest on loans and advances, repairs and outgoing, depreciation, bounties or subsides received from any Government or from a public body, profits by way of premium on shares sold, profits on sale proceeds of forfeited shares, or profits from the sale of the whole or part of the undertaking of the company but without any deduction in respect of income-tax or super-tax, or any other tax or duty on income or revenue or for expenditure by way of interest on debentures or otherwise on capital account or on account of any sum which may be set aside in each year out of the profits for reserve or any other special fund.

In view of the above, it is a legal necessity to compute the net profit according to section 87C of the Repealed Act that defines it to be: -

Profits of the company after allowing:

- Usual working charges
- Interest on loans and advances
- Repairs and out-goings
- Depreciation
- Bounties or subsidies received from any government or from a public body
- Profits by way of premium on shares sold
- Profits on sale proceeds of forfeited shares
- Profits from the sale of whole or part of the undertaking of the company

But without any deduction in respect of: -

- income tax or super tax or any other tax or duty on income or revenue
- Expenditure by way of interest on debentures or other wise on capital account
- Any sum, which may be set-aside in each year after out of the profits or reserves or any other special fund.

The Committee has noted that the Rules contain following illustration of the methods of computation in its Annexure II: -

(A) Allocation of Compulsory Units in the First Year

If the profits of the company during the previous years are Rs.8 lacs, its contribution to the fund at 2-1/2% (revised to 5%) shall be Rs.20,000….

The above illustration clearly indicates that the percentage of the profit under the Act is the direct percentage of the net profits computed under Section 87C of the Repealed Act and not according to the method that used to be in vogue in relation to the calculation of managing agency commission which was laid down in the Managing Agency Agreements or Articles of the concerned companies and not in the Repealed Act.

In cases where illustrations are appended to an act, the judicial authorities have held that in the construction of an Act it was the duty of a Court of Law to accept, if that can be done, the illustrations given as being both of relevance and of value in the construction of the text. In Mohammed Syedal Ariffin v. Yeoh Ooi Gark [1916] 2 A.C. 575, 581, it has been held that "the great usefulness of the illustrations, which have, though not part of the sections, been expressly furnished by the legislature as helpful in the working and application of the statute, should not be thus impaired".

The Committee is therefore of the considered opinion that TR-8 issued by the Institute correctly advises that the computation of the workers' share of profit under the Act is to be worked out on direct percentage basis of the net profits computed under Section 87C of the Repealed Act.

1.24 WORKERS' WELFARE FUND – NON-APPLICABILITY IN CASE LOSS INCURRED IN THE PRECEDING YEAR

Inquiry A listed company has approached us to seek our opinion on the following matter: -

The Company has incurred losses in the preceding years and in the current year has accrued profit, which is mainly due to remission in total liability as a result of settlement with a commercial bank. Following is the situation based on assumed figures: -

Particulars

Operating (loss) for the year before prior period adjustments	(1,200)

Prior period adjustments	200
	(1,000)
Remission in liability due to settlement waiver allowed by Commercial bank	2,000
Profit for the year before taxation	1,000

The management of the company is of the view that profit for the year does not affect allocation of Workers' Profit Participation Fund and has sought opinion from a renowned corporate lawyer who has opined as under :-

> "the company has been incurring losses in the preceding years and remission of liability is only a wind fall which by way of priority have to be adjusted under section 3(b) of he Companies Profit (Workers' Participation) Act, 1968 which permits a company to make "adjustments" against net profits. Even it the surplus were relatable to the profits of the year, you are entitled to adjust losses. Accordingly in our opinion the company is not entitled to provide 5% of profits to the Companies Profits (Workers' Participation) Fund".

i) whether the profit from settlement waiver can be treated as "adjustment" as per section 3(b) of the said Act and can be adjusted against the losses of preceding years;

ii) whether the company would be required to make the allocation of workers' Profit Participation Fund in the situation given; and

iii) whether the auditors can rely on the opinion expressed by the corporate lawyer regarding non-applicability of WPPF in the situation given above.

Opinion It shall be appreciated that the Committee does not have the legal expertise and it does not, therefore, deal with contentious legal aspects; the Committee assists the members only in the interpretation of accounting / auditing standards and statutory provisions dealing with these matters.

The Committee is of the view that though the issue under reference appears to be a legal matter, however, it would like to give its opinion on the three queries raised by you as follows :-

i) The phrase "subject to adjustment" as used in Section 3(1)(b) of the Companies Profits (Workers' Participation) Act, 1969 (the Act) does not, in the opinion of the Committee, refer to adjustments of profits/loss relatable to preceding years but to adjustments as regards payments.

ii) Profits have to be computed with reference to Section 2(d) of the Act. In the opinion of the Committee the words "profits of the Company calculated after allowing" used in Section 87c(3) of the Companies Act, 1913 since repealed be interpreted and construed in the context of various expenses enumerated in the said section to mean that such items of the expenses are permissible to be deducted in arriving at the "net

profits" while the same words "after allowing" in the context of credits or income should by all rational interpretation mean that such items be excluded in arriving at the profits according to the term as defined. Should we follow this line of reasoning, it would not be right to say that remission of liability due to settlement waiver is not to be included in the profits for the year. The Committee feels inclined to hold the view that having considered remission of liability as being germane to the business operations of the company, the same should be construed as part of the profits of the company for all intents and purposes and accordingly, therefore, provision for workers' profit participation fund, in the opinion of the Committee, should have been made.

iii) The auditor is required to give an opinion on the financial statements he had been asked to audit. In arriving at his opinion, he may use the opinion of an expert to show due diligence on his part in reaching a conclusion. The fact that the opinion, he relied on, itself is proved to be wrong in due course would not of itself carry an adverse inference. The expression of professional opinion being primarily an exercise of professional judgement would not relieve the auditor of his responsibility by merely relying on an expert's opinion, although such reliance may tend to mitigate the burden of proof.

2. AUDITING

2.1 ADVERTISING - ICAP BYE-LAWS ON

Inquiry We do offer management training services to our clients and the general public. In order to invite nominations we are planning to place advertisements in national newspapers detailing the nature of the course, nomination procedures, and the facilitator's profile. We would like to know whether placing such an advertisement would be in line with ICAP regulations and in particular the Revised Directive 6.02, subsections 13 and 14 of the ICAP Members' Handbook.

Opinion The Committee is of the considered opinion that the Council Directive 6.02 in the Members' Handbook is exhaustive and should be professionally and fairly interpreted.

The Committee further wishes to state that the underlying intention, as spelled out in paragraph 1 of the Directive, is that the advertisement should be "in good taste both as to content and presentation and should not belittle services offered by others, whether members or not, by claiming superiority for the services of a particular member or otherwise" and that " undue prominence is not given to the name of a practising member in any booklets or documents issued in connection therewith"

2.2 AUDITORS' REPORT - ADVICE ON

Inquiry A company purchases an asset in year 1 and as all the expenditure has not been incurred in year 1, the asset is treated as capital work in progress in the financial statements for the year ended 1. The auditors of the Company could not verify the value of the asset due to non-availability of the relevant documentation. Due to this scope limitation, the auditors qualified their report in the year 1.

In year 2, the asset is capitalized. The auditors have verified that the asset is capitalized properly subject to the fact that its cost could not be verified in year 1. The auditors have also physically verified the asset and they are also aware that no claim against this asset of the Company has arisen till end of year 2.

What is obligation of the auditor in year 2? Should he qualify the report? What should be done in subsequent years? Should the qualification regarding non-verification of value of the asset be continued till the asset is finally disposed off?

CLARIFICATION SOUGHT BY ICAP

Please clarify whether the entity has failed to provide documentation for the value of capitalized asset in year 2 also?

CLARIFICATION

The situation that had prevailed in year 1 has continued in year 2 too, that is the opening balance of the cost of that asset has not been verified in year 2 as well. However, additional cost in year 2 was verified.

Opinion In the opinion of the appropriated Committee of the Institute, the original enquiry read with the clarification tends to convert the enquiry as under: -

> The auditors of the company as in year 1 have not been able to verify the value of asset in year 2 too due to non-availability of relevant documentation of the asset. Should, as in year 1, the auditors issue qualified report in year 2 as well? Also, should the qualification of non-verification of value of the asset be continued till the asset is finally disposed off?

The Committee is of the opinion that the auditors should issue a qualified report in year 2 as well and the qualification of non-verification of value of the asset be continued till the asset is finally disposed off. However, when considering any qualification, the concept of materiality as enunciated in paragraph 29 and 30 of the IASC Framework for the Preparation and Presentation of Financial Statements should be kept in mind.

2.3 COMMUNICATION - BETWEEN AUDITORS FOR NON-STATUTORY SERVICES

Inquiry An audit firm "A" is appointed as auditors of a company, on a year-to-year basis, for say 02 years i.e. Y01 and Y02. On each year's audit appointment, the firm is also appointed for each such year for the following tax related services: -

i) Tax assessments
ii) Appeals before the Commissioner of Income Tax (Appeals)
iii) Appeals before the Income Tax Appellate Tribunal

After Y02, the audit firm "A" is changed and audit firm "B" is appointed as auditors. Firm "B" is also appointed to look after the tax matters of the company as given above from Y03 onwards.

In year 04 (when Firm "B" are auditors) certain tax assessments relating to Y01 and Y02 are finalised and against some of these assessments, the company prefers appeals to the Commissioner of Income Tax (Appeals). The company requests Firm "B" (current auditors) to take up these appeals and Firm "B" accepts the appointment without contacting Firm "A".

On getting information that Firm "B" has taken up tax appeals related to Y01 and Y02 (when Firm "A" were the auditors and appointed previously for tax work related to those years), Firm "A" writes to Firm "B" of Firm "A's" apprehensions. Firm "B" responds that an appointment for tax services is not a statutory requirement and that such appointments are at the discretion of the company.

<u>Questions</u>

1. Was Firm "B" bound to write and inform Firm "A" of their appointment in relation to tax issues for which Firm "A" had already been previously appointed?

2. Was Firm "B" required to get professional clearance from Firm "A"?

3. Is there any remedy available to Firm "A" against Firm "B"?

Opinion The Committee invites attention to paragraph 11 of ATR-2 that states as under: -

> Paragraph 5 of Schedule "C" of the Byelaws refers only to the position of auditor. Chartered Accountants in practice perform varied functions and a reference is invited to byelaw 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 very 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.

The service in connection with the Income Tax affairs is a non-statutory service for which the Institute does not make the communication between out going and incoming members mandatory. In the opinion of the Committee, para-wise replies to the three questions raised above are as follows:

1. No, the Firm "B" was not bound to write and inform Firm "A", but it would have been a good practice if Firm "B" had done so.

2. No

3. No

2.4 COUNTER-SIGNING OF ACCOUNTS - IN ACCORDANCE WITH PARAGRAPH IV(I) OF THE PRUDENTIAL REGULATIONS

Inquiry Paragraph IV(I) of the Prudential Regulations issued by the State Bank of Pakistan requires that :

"Where the exposure exceeds Rs.2.0 million but does not exceed 10 million the accounts should be signed by the borrower and countersigned by the internal auditor of the bank or a Chartered Accountant".

The paragraph 5 of T.R. 25 issued by the ICAP regarding the interpretation of the above states that: -

> *"The countersigning by a chartered accountant involves responsibility of carrying out a limited review to ensure that the total borrowings availed by the borrower do not exceed 10 times of the capital and reserves of the borrower-entity at the balance sheet date. In such a case the chartered accountant should clearly state the scope of the limited review".*

In pursuance of the above stated Prudential Regulation, we have been approached by number of our Tax and Corporate clients, (who had applied for or are availing the exposure not exceeding Rs.10 million), for countersigning of their accounts. In this regard, we, as required by the above-stated T.R., require an explanation / elaboration from the ICAP in the following areas:

1. Limited Review

As per our understanding, the word limited review as stated in paragraph 5 of TR-25 means adding the capital and reserves as shown in the balance sheet

presented for counter- signing and multiplying the resultant by 10 to ensure it does not exceed the total borrowing ensuring that the accounts are duly accompanied, wherever possible, with supporting notes for e.g. fixed assets etc.

Kindly confirm that our above stated understanding of the term "limited review", as stated in the T.R. 25, is consistent with that intended by the ICAP. In case of any difference in opinion, inform us of:-

- the exact scope of work encompassed by the term "limited review"
- the extent of our responsibility and liability regarding the countersigning of accounts.

2. Scope of Limited Review

Additionally, T.R. 25 requires the chartered accountant countersigning the accounts to clearly specify the scope of limited review. In this regard, we are issuing a certificate to our clients whose accounts are countersigned by us. A specimen copy of this certificate is given below:

We have reviewed the annexed balance sheet of XYZ as at June 30, 19-- to ensure that the total accommodation applied for does not exceed 10 (Ten) times of the capital and reserves in accordance with the requirements of paragraph IV (I) of the Prudential Regulations.

Our review was conducted in accordance with paragraph 5 of the Technical Release 25 (T.R. 25) issued by the Institute of Chartered Accountants of Pakistan. The said T.R. requires us to review the Financial Statements to ensure the compliance of the above stated prudential regulation.

Based on our review of the balance sheet along with the annexed notes we certify that :

The total applied accommodation does not exceed 10 (ten) times of the capital and reserves of the XYZ as at June 30, 19---.

Kindly confirm whether it serves the purpose specified in T.R. 25. If the same is not in accordance with the manner intended, also inform us of the changes therein.

Opinion The appropriate Committee of the Institute is of the opinion that the indicated approach does not accord with the requirements of Prudential Regulations. It also does not fulfill the requirements of the Institute's Technical Release No. 25

The Prudential Regulation requires that the accounts shall be *countersigned* by a chartered accountant. The countersignature, as defined in Black's Law Dictionary (6th Edition), means "to sign in addition to the signature of another in order to *attest the authenticity ".* In other words, the countersigning is an affirmation that the information being attested is true or genuine. In this view of the matter, the person countersigning the information is required to be sure that the information being countersigned is the factual representation of the position.

The Committee has also noted that Institute's TR-25 requires a chartered accountant to state the scope of limited review. What the Institute's Technical Release means by the limited review is clarified in paragraph 9 of International Standard on Auditing on Related Services RS 1&2, Engagements to Review Financial Statements. It reads :

"*A review engagement provides a moderate level of assurance that the information subject to review is free of material misstatement, this is expressed in the form of negative assurance".*

Paragraph 3 of the ISA also clarifies that the objective of a review engagement is

"to enable an auditor to state whether, on the basis of procedures which do not provide all the evidence that would be required in an audit, anything has come to the auditor's attention that causes the auditor to believe that the financial statements are not prepared, in all material respects, in accordance with an identified financial reporting framework (negative assurance)".

The Appendix 2 of the ISA details the procedures that may be performed in this regard.

Appendix 3 of the ISA lays down the following form of Unqualified Review Report

REVIEW REPORT TO …

We have reviewed the accompanying balance sheet of ABC Company at December 31, 19XX, and the related statements of income and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to issue a report on these financial statements based on our review.

We conducted our review in accordance with the International Standard on Auditing applicable to review engagements. This Standard requires that we plan and perform the review to obtain moderate assurance as to whether the financial statements are free of material misstatement. A review is limited primarily to inquiries of company personnel and analytical procedures applied to financial data and thus provides less assurance than an audit. We have not performed an audit and, accordingly, we do not express an audit opinion.

Based on our review, nothing has come to our attention that causes us to believe that the accompanying financial statements do not give a true and fair view in accordance with International Accounting Standards.

2.5 POLICY MATTERS – DEFINITION OF

Inquiry Please let us know what exactly are the matters covered by "policy matters" as mentioned in ATR -9? Definition may be supplied.

Opinion To the best of the Committee's knowledge, the term "policy matters" has not been defined in dictionary.

According to Black's Law Dictionary, 6th Edition, the word "policy" has been defined as the general principles by which a government is guided in its management of public affairs, or the legislature in its measures. It further states that the term as applied to a law, ordinance, or rule of law, denotes its general purpose or tendency considered as directed to the welfare or prosperity of the state or community.

Based on the above definition the appropriate Committee of the Institute is of the opinion that the Chartered Accountants Ordinance, 1961, Chartered Accountants Bye-Laws, 1983, Code of Ethics for Chartered Accountants and Directives of the Council issued from time to time constitute the principles of policy of the Institute of Chartered Accountants of Pakistan, violation of which would have an adverse effect on the image of the Institute and its members.

2.6 POSITION OF AN INTERNAL AUDITOR - WHETHER SPOUSE OF A DIRECTOR OF A PUBLIC COMPANY CAN ACCEPT

Inquiry The law is clear that spouse of a director of a public company cannot be statutory auditor. We are of the view that, since internal auditor is considered as part of the management and his appointment is meant to assist the management of the company, therefore, spouse of a director can act as internal auditor of the company.

Could you kindly give ruling on this point whether our view is correct or not.

Opinion The Committee is of the view that it is a multi-layered issue.

As for the position that the Companies Ordinance, 1984 does not specify as to who can and who cannot be appointed as an internal auditor as has been done in the case of statutory audit, the Committee feels that one of the plausible reasons for it may be that the Ordinance does not deal with the internal audit aspects itself.

The Committee also feels that the core function of internal audit is to ensure that the internal operation and strategic control are in place. AS-4, Planning explains that understanding the accounting and internal control systems and risk and materiality considerations are an essential part for the development of an overall audit plan. The internal auditor has therefore to be seen by the statutory auditors as independent (within the organisational – related constrains) if the work performed by the internal auditor is to be relied upon (The Institute of Internal Auditors in the Statement of Responsibilities of the Internal Auditor states that "the Internal auditing is an independent appraisal activity within an organisation for the review of operations as a service to management. It is managerial control which functions by measuring and evaluating the effectiveness of other controls").

The internal control systems and risk and materiality considerations are related directly with the issue of corporate good governance. The recent financial failures at the international level have highlighted the significance of internal controls. As recommended by the Cadbury report on Corporate Governance in the UK and reports on the subject issued by competent organisations in other countries, most of the countries now require that the directors of the company declare that the internal controls are effective. A debate is also on as to how the auditors should

verify and report on this aspect of the statement of the representation made by the directors in their report.

Although, there may be no legal bar to the appointment of a spouse as an internal auditor but the Committee is of the opinion that in view of the important tasks clarified in ISA-10 expected to be performed by the internal auditor the appointment of a spouse as an internal auditor should be discouraged.

2.7 PRACTISING CHARTERED ACCOUNTANTS – PROVIDING PROFESSIONAL SERVICES AS LOSS ASSESSORS TO INSURANCE COMPANIES

Inquiry We would appreciate if you would advise us as to whether practising chartered accountants may also act as loss assessors – especially with respect to valuation of assets lost / damaged and loss of profit etc. If yes, kindly also intimate as to whether such work could be undertaken as part of normal professional services or certain other formalities are to be fulfilled.

Opinion The Committee is of the view that assessing of the loss with respect to the valuation of assets lost / damaged and loss of profit etc. is management consultancy work and can be undertaken by a member in practice as per paragraph 1 of the Council's Directive No. 5.01.

2.8 SAP-1, BANK REPORT FOR AUDIT PURPOSE

Inquiry The bank confirmation request prescribed under SAP-1 "Bank Reports for Audit Purposes" under paragraph 8 requires banks to disclose following contingent liabilities: -

a) Total of bills discounted for your customers, with recourse:

The auditors are required to disclose this amount as contingent liability in the audited accounts. The bills discounted by banks are due against irrevocable letters of credit drawn in favor of customers and payable by correspondent banks (buyers' banks). There is no chance of failure of receipt of this amount from the correspondent banks (buyers' banks) unless that bank is bankrupt or closed down which is a very remote possibility.

One of our client has reservations as to disclosure of this amount as contingent liability in their accounts based on very remote possibility of being contingent looking at the reputation of foreign large banks.

We request that the Technical Advisory Committee may consider the making of amendments in the format for Bank Report.

Opinion The Committee is of the view that there are two different variations of the issue. One, under IAS-10 *Contingencies and Events Occurring After the Balance Sheet Date*. Two, under IAS-37, *Provisions, Contingent Liabilities and Contingent Assets.*

According to paragraph 6 of IAS 10, "remoteness" is one of the characteristics distinguishing a contingent liability from actual liability. As this IAS is applicable to financial statements up to June 30, 1999, the disclosure of contingent liabilities up to the stated date are required to be made accordingly.

Paragraph 28 of IAS 37 has changed the above position – it requires that a contingent liability should be disclosed unless the possibility of an outflow of resources is "*remote*". In other words, if the possibility is "remote" the contingent liability need not be disclosed.

The Committee is of the opinion that there is no need of a change in SAP-1, Bank Report for Audit Purposes. The information prescribed in SAP-1 should be asked for and it is for the management and auditors to decide whether the " Total of bills discounted with recourse " should be disclosed in the financial statements keeping in view the requirements of IAS 37.

2.9 SAP-1 BANK REPORT FOR AUDIT PURPOSES

Inquiry

1. SAP 1, Bank Reports for Audit Purposes requires that standard letter of request by the auditors should reach the branch manager preferably fifteen days before the date of client's financial year-end. The auditors of Provident Fund and Workers Profit Participation Funds etc. are usually appointed after the year-end.

2. Some of the bank branches do not answer all the questions of the report or simply furnish the information regarding the cash at bank as on the date of closing. Hence, the requirement of the SAP 1 cannot be implemented.

We seek guidance in the matter.

Opinion

1. The Committee has noted that the instances of audit, namely Provident Fund and Workers Profits Participation Fund are instances of non-statutory audit and for this reason the appointment of auditors etc. cannot be regulated or enforced under any statute. Nor the literal application of SAP 1 may be feasible.

2. In case of insufficient information the auditors should follow the procedure laid down in paragraph 5.1 g) and h) for no reply. The auditor in all cases is to ensure that sufficient appropriate audit evidence in accordance with International Standards on Auditing is available with him in support of his opinion given on the information incorporation in the financial statements.

2.10 TAX AUDIT

Inquiry

1.1 You have made the following observations on the outsourcing of special audit cases to firms of chartered accountants by the income tax department.

1.1.1 Will the auditors appointed for tax audit seek N.O.C. from the original auditors.

1.1.2 Audited accounts of one professional firm will be audited again by another firm. Does it not hurt the professional vanity of the first auditor and is it not unethical.

1.2 You have also made some other observations in your letter, which are reproduced below: -

1.2.1 How will the Council re-act to the latest move by C.B.R.

1.2.2 After receiving your reply I will request to call a meeting of members to discuss this important issue.

Opinion 2.1 The Committee has deliberated the questions raised by you and has reached a unanimous conclusion that there is nothing in Section 20A read with Schedule-I of the Chartered Accountants Ordinance, 1961 (the Ordinance) which is or may be seen to be a restraint on the members to accept the tax audit being out-sourced by the income tax department. You may be aware that Section 20A read with Schedule-I of the Ordinance provides the code of professional conduct and practice which the members are expected to observe at all times. The said code is a comprehensive document, has stood the test of time and has by and large played a significant role in the development and growth of the accounting profession in Pakistan along constructive and healthy lines. It is generally perceived that enforcement of the said code has infused a sense of responsibility on the part of the members and has significantly furthered public confidence in the integrity and capability of the members of our Institute.

2.2 The Committee believes that the appointment of professional firms of chartered accountants to carry out tax audit is indeed a recognition of the profession, both, of its immense potential of providing quality professional assistance to the government in the gigantic task of resource mobilization as also of the high standards of integrity which are so very essential in carrying out such responsibilities. The Committee is of the considered view that there is nothing peculiar or sinister in carrying out tax audit as, besides external statutory audit, there are numerous occasions for practising firms to carry out special assignments with a properly laid out scope of engagement to be agreed upon with the client or the user of our report. There is, therefore, nothing illegal, unethical or inconsistent for practising firms, either in terms of the Ordinance or recognized professional practice the world over, to undertake tax audit of a company which may have got its statutory annual accounts prepared in terms of Section 233 of the Companies Ordinance, 1984, already audited by the same or another firm of auditors.

2.3 The Committee would also like to draw your attention to International Standards on Auditing and Related Services codified by the International Federation of Accountants (IFAC) which has issued *inter-alia* the following ISAs and Pronouncements: -

800 – The Auditor's Report on Special Purpose Audit Engagements
910 – Engagements to Review Financial Statements
920 – Engagements to Perform Agreed-Upon Procedures Regarding Financial Information
930 – Engagements to Compile Financial Information

2.4 In the context of the aforesaid ISAs and Pronouncements, it would be noted that a professional accountant, who may or may not be the statutory auditor of an entity, may be engaged to carry out any of the assignments covered by the said standards etc. and IFAC as a global body, duly recognizes the same and nothing therein even remotely

suggests that such assignment could be viewed unethical or inconsistent with the professional role of a statutory auditor.

2.5 It needs to be appreciated that the financial statements prepared pursuant to Section 233 of the Companies Ordinance, 1984 can be subject to statutory audit only once by a statutory auditor appointed under Section 252 of the said Ordinance. It is only in this context it may be reasonable to hold a view that there could not be another statutory auditor for the same company and in respect of the same set of financial statements duly audited. There is, however, nothing to preclude the same auditor or any other firm of professional accountants to carry out a special audit of any nature and with any other terms of reference. Indeed, when any company is proceeded against under Section 263 of the Companies Ordinance, 1984, the Inspector so appointed may, subject to his terms of reference; subject duly audited financial statements to a review, scrutiny or any other form of examination required by the terms of reference governing such assignment.

2.6 Apart from the Companies Ordinance, 1984, there are other instances under various corporate regulatory frameworks where the practising firms carry out special audits or assignments required under the relevant statutes or regulations. The most common examples that of are special audits under Section 12A of the Insurance Act, 1938, which has been in practice for decades, special audit of modarabas, special audit of NBFIs etc. You could therefore, appreciate that an audit carried out for the purposes of compliance with the provisions of any tax law – income tax or sales tax, while commonly construed as a “tax audit” is nothing but a special audit which is totally distinguishable from the statutory audit as contemplated by the Companies Ordinance, 1984. There is therefore, hardly any room whatsoever to construe or perceive such audit as being illegal or unethical.

The Committee, therefore, would like to suggest to you in conclusion to understand the issue in its proper perspective and not to miss out the opportunity offered to the profession as a whole to demonstrate its potential for competence, integrity and higher ideals for professional standards. Any conduct on the part of the profession at this stage to demonstrate otherwise and shirk the challenge shall kill an enormous opportunity to render service to the society for all times to come, which would be regrettably detrimental to the interests of the profession. It is hoped that you would give the matter your most dispassionate consideration.

Lastly the members before accepting any audit have to keep in mind the requirements of ATR-2 and its Clarification issued by the Council.

3. CORPORATE & OTHER LAWS

3.1 CONSULTANCY CHARGES - CAPITALIZATION OF

Inquiry While examining the annual accounts of ABC Limited for the period ended on 30-9-1998 it was noticed that the company disclosed an amount of Rs.1.357 million which were spent on account of "Consultancy Charges" (Note 22 of the accounts). On calling its details, the company informed that Rs.0.3 million were paid to Consultants in connection with the expansion of the plant from the capacity of 4500 TCD to 5500 TCD. The company was advised that as the expenditure was of a capital nature, it should have been amortised over a period of more than one year. The company however, took the plea that as the amount was not material it was charged to revenue account. The comments of the auditors of the company were also called, who also took the same plea that as the amount was not material it was rightly charged to profit and loss account of the said period. The auditors further took the plea that as the consultants were engaged on permanent basis to look after the existing plant as well as the extended capacity, hence the cost was not directly attributable to any specific asset and therefore, as per paragraph 11 and 13 of IAS 16, such cost was charged to "revenue accounts".

2. The matter has been examined and the SECP feels that the plea taken by the company and its auditors does not appear correct and the expenses being of capital nature should have been deferred and amortised. The ICAP is requested to examine the matter and may advise the Commission about the correct treatment of this expense.

3. The relevant copies of the correspondence exchanged with the company and the auditors of the company are enclosed. Also is enclosed a copy of Annual Accounts of the Company for the period ended on 30-9-1998.

Opinion: The objective of financial statements is to provide information about the financial position, performance and changes in financial position of the enterprise for assessing the stewardship of management and for making economic decisions. The capital work-in-progress as shown in the financial statements amounts to Rs.24.821 million and judged against this base, the amount under reference being Rs.0.3 million represents a little over one percent of the capital work-in-progress. The Committee is of the opinion that expensing out of the expenditure, i.e., considering it as revenue expenditure does not affect the true and fair view or alter the significance of the information to influence any meaningful decision making process of the stakeholders.

The appropriate Committee of the Institute has also examined the correspondence of the enterprise as well as of the auditors addressed to you in the matter. The Committee has reservations about the contents and various references to IAS made in the correspondence; it however agrees with the spirit of the clarification that the item is not very material and does not tend to affect the information content of the financial statements.

3.2 FINANCIAL STATEMENTS - PRESENTATION OF

Inquiry As you are aware International Accounting Standard (IAS 1) was revised and the revised Standard was made effective for financial statements covering periods beginning on or after July 1, 1998. The revised Standard requires that an enterprise should present as a separate component of its financial statements a Statement of Changes in Equity showing:

a) the net profit or loss for the period;

b) each item of income and expense, gain or loss which, as required by other Standards, is recognized directly in equity, and the total of these items; and

c) the cumulative effect of changes in accounting policy and the correction of fundamental errors dealt with under the Benchmark treatments in IAS 8.

In addition, an enterprise should present, either within this statement or in the notes:

d) capital transactions with owners and distributions to owners;

e) the balance of accumulated profit or loss at the beginning of the period and at the balance sheet date, and the movements for the period; and

f) a reconciliation between the carrying amount of each class of equity capital, share premium and each reserve at the beginning and the end of the period, separately disclosing each movement.

In the illustrations given in the Standard, the Income Statement concludes with the "Net profit for the period" and all the appropriation movements therein such as transfers to reserves, dividends etc. are shown in the Statement of Changes in Equity. Copies of the illustrations are attached.

Under Paragraph 1H of Part III of the Fourth Schedule to the Companies Ordinance, 1984, appropriation to reserves and dividends are required to be shown in the Profit and Loss Account.

There are two schools of thought on the issue. One view is that the appropriations should not be the shown in the Profit and Loss Account as required by the Standard since this will lead to duplication of information and will also be confusing for a reader of financial statements. The second view is that the appropriations should be shown in both statements as otherwise the provisions of paragraph 1H of Part III would not be met.

Paragraph 8 of Part I of the Fourth Schedule and Paragraph 6 of Part I of the Fifth Schedule states that any information required to be given in respect of any of items in the financial statements shall, if it cannot be included in such statements, be furnished in a separate note, schedule or statement to be attached to and which shall be deemed to form an integral part of, the financial statements.

Keeping in view the provisions of the above Paragraphs 8 and 6, we believe that showing the appropriations etc. in the Statement of Changes in Equity as required by the Standard rather than in the profit and loss account will be appropriate and be in compliance with the Companies Ordinance which through SRO 777(I)/86 dated August 6, 1986 also requires listed companies to follow IAS 1.

Opinion The appropriate Committee of the Institute is of the opinion that there are two issues involved in the matter.

Firstly whether there should be separate Statement of Changes in Equity. Section 255(3) of the Companies Ordinance, 1984 and Form 35A (Auditors' Report to the Members) define the financial statements to comprise of three components, namely, balance sheet, profit & loss account and statement of changes in the financial statements (cash flow statement). The IAS under reference has however expanded the definition of the financial statements and added in it a Statement of Changes in Equity.

The Committee is of the opinion that in order to maintain uniformity in the presentation of information; the changes in equity should not be included in a separate statement as required by the IAS but should be shown in the notes to the accounts.

The Institute has already issued Circular No. 15/99 dated November 20, 1999 to its members on the basis of above-mentioned opinion.

Secondly whether the appropriation to reserve and dividends be shown in the profit and loss account or in the notes relating to changes in equity, the Committee is of the opinion that appropriation should be shown in profit and loss account to comply with the requirements of Fourth and Fifth Schedules.

The Committee is also of the opinion that changes in Form 35A, which may be necessitated due to revised IAS 1, may be taken up at a later stage after the finalization of changes already under process.

3.3 REVALUATION UNDER SECTION 235 OF THE COMPANIES ORDINANCE, 1984 - WHETHER LAND CAN BE EXCLUDED FROM ASSETS FOR THE PURPOSE OF

Inquiry **Substance of Reference**

Sub-section (4) of section 235 of the Companies Ordinance, 1984 states that after re-valuation, depreciation on the assets so re-valued shall be provided with reference to the value assigned to such assets on re-valuation.

Land is a non-depreciable asset. In this view of the matter, can land be re-valued under the section?

The published financial statements of ABC Limited for the year ended June 30, 1999 show that the leasehold land has been re-valued and on which no depreciation has been provided.

Opinion The Committee has noted that sub-section (I) of section 235 of the Companies Ordinance, 1984 (the " Ordinance") states that "where a company re-values its

fixed assets …..". The Committee is of the view that issue under reference hinges on whether the Ordinance and the International Accounting Standards treat land as "fixed asset" or not.

Reference to paragraph 2(A)(i) of Part II of the Fourth Schedule to the Ordinance indicates that land is considered as a tangible fixed asset. According to paragraph 35 of IAS 16, *Property, Plant and Equipment,* a class of property, plant and equipment is a grouping of assets of a similar nature and used in an enterprise's operations. According to International Accounting Standards "land" comes within the definition of asset as defined in paragraph 56 of the Framework for the Preparation and Presentation of Financial Statements and in paragraph 7 of IAS-38, *Intangible Assets* and is accordingly included in the grouping of assets under paragraph 35(a) of IAS 16.

The Committee has noted that Black's Law Dictionary, 6th Edition defines "assets" to mean "property of all kinds, real and personal, tangible and intangible; the entire property of a person, association, corporation, or estate that is applicable or subject to the payment of his or her or its debts ". The Dictionary also defines "fixed assets" as "assets of a permanent or long term nature used in operation of business and not intended for sale ; e.g. property, plant, equipment".

The Committee is of the view that provisions in sub-section (4) of section 235 of the Ordinance to the effect that depreciation on re-valued assets shall be provided with reference to the value assigned to such assets on revaluation, read together with the above definitions and the International Accounting Standards would go to include land in the definition of assets ; land needs to be grouped as asset.

However, the Committee is of the opinion that the revalued amount of the leasehold land should be amortized over the remaining period of the lease.