SELECTED OPINIONS

Volume VI

COMPILED BY

TECHNICAL SERVICES DIRECTORATE

Of

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF PAKISTAN

INTRODUCTION

This report is the sixth compilation of selected inquiries raised by the members, and other agencies and replies issued by the Technical Advisory Committees during the period from July 2000 to June 2001 for the general guidance of the members of the Institute. Volume I, II, III and IV were published earlier. Volume V and VI have been put on the ICAP Website. Volume I to IV are also now available on the Website.

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

The opinions issued by the Committees to the members' queries are dated. Since an opinion is arrived at on the basis of the facts and circumstances of each individual query, it may change if the facts and the circumstances change. An opinion may change also due to subsequent developments in law, pronouncements made by the Institute and other relevant changes. The Institute and the Committees will have no liability in connection with such opinion.

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

Syed Sajid Ali
Director Technical Services

CONTENTS

1. ACCOUNTING

2. AUDITING

1. ACCOUNTING

1.1 AGRICULTURAL LOANS

Inquiry: It was observed during a recent quality control review that certain companies engaged in manufacture and sale of sugar and allied products procure agricultural loans from financial institutions, and disburse them to the crop growers. These loans do not appear in the accounting records of the companies as loans, but are normally shown under the heading of contingencies and commitments.

In the particular case of quality control review of the working paper files of an audit firm, it was observed that its client (sugar mill) got into agreement with various banks in respect of agri loans. The situation is that:

- The loan agreement is between banks and the sugar mill. (Actual agreement was filed in the permanent file of the audit firm)
- This loan was disbursed to various growers of sugar cane by the mill.
- The loan did not appear in the books of the sugar mill. It was shown under the heading of contingencies and commitments.
- The loan disbursed to the sugar cane growers by the mill does not appear as receivables.
- The partner incharge of the audit firm responded to my query that the normal industry practice with agri loans is that described above due to the fact that these loans are meant for growers and the sugar mills are only the means to disburse them. The recovery rate in respect of these loans is 100% as the mills have sufficient credit balances (payables) of the growers, at all times, to whom loan is disbursed.

My interpretation of the case was that:

- As the loan agreement by the bank is in the name of the sugar mill, it should be shown as a loan in financial statements of the mills.
- The amount subsequently disbursed to the growers by the sugar mills should be shown as receivables in the financial statements of the sugar mills.

Kindly give your opinion on the matter.

Opinion: The Committee is of the view that the interpretation you have mentioned above is correct as there is no legal or as well as logical ground for not including the loan as liability in the financial statements of an enterprise who has taken the loan.

The industry norm shall not be repugnant to the law and the accounting standards. Legally the Sugar mill (the borrower) is liable to pay to the banks (the lender) and in case of default bank has the right to file suit for the recovery of loan against mill, and not against those whom the borrower has disbursed the funds.

1.2 BONUS SHARES – ACCOUNTING TREATMENT UNDER TR-15 (REFORMATTED) 2000

Inquiry: What will be the Accounting Treatment in case a holder of shares having 100 shares at the start received 500 Bonus Shares but sells his original 100 shares before the physical receipt of Bonus Shares. It will result in elimination of investment Account in the Balance Sheet at the time of sales.

In case of Income Tax, if an Assessing Officer verifies the number and amount of shares with the company than what will be the situation, specially with reference to section 13 of the Income Tax Ordinance, 1979, because even if the Number of shares agree but there will be the difference in the amount.

What harm is there to record these transactions at face value in Financial Books of Accounts because it is not only an increase or decrease in Reserves or Profit or Loss Account, but an increase in Capital Account which is done only after certain legal formalities and no reductions can be made without the sanction of High Court.

Opinion: The principle of valuation of investment as enunciated by the International Accounting Standard (IAS) 25 is "the lower of cost and market value". Exception to this basic principle is allowed by the said IAS 25 as well as IAS 39 within certain defined conditions and parameters. As you may be aware, observance of IASs is mandatory by the members of the Institute and therefore, TR-15 was issued by the Institute, which follows the principle, laid down by the said IAS 25. The accounting of bonus shares received by the recipient, therefore, even "on logical grounds" cannot be at face value. The spirit of TR 15 will have to be followed even in the very remote example cited by you. The Committee is further of the view that your observation in paragraph 1 of your letter is misconceived since Section 13 of the Income Tax Ordinance, 1979 can only be invoked in case of unexplained investments while the receipt of bonus shares by the recipient is a declared and documented event and thus can always be explained.

1.3 BONUS SHARES - ISSUE OUT OF SHARE PREMIUM ACCOUNT

Inquiry: Our company is a quoted company and has been suffering losses during the past few years on account of economic turmoil and huge investment in construction of hotel at Lahore. However, our Board of Directors may consider distribution to shareholders out of Share Premium.

In this connection, we would like to seek your advice on the following issues pertaining to the application of "Free Reserve" as applicable under Rule 6 of SRO 110 (1)/96 dated 8th February 1996: -

1. Can we treat "Share Premium" as "Free Reserve" for the purposes of declaration of bonus shares?

2. Will the condition of "Free Reserve" be applicable for declaration of bonus out of share premium?

Opinion

1. Section 83 of the Companies Ordinance, 1984 clarifies that "provisions of the Ordinance relating to the reduction of the share capital apply to share premium account also. The share premium is in fact de-facto share capital. It is not "Free Reserve". Apart from it, it does not fall within the definition of 'free reserve' as it is defined in the *Explanation* to Rule 5 of the Companies (Issue of Capital) Rules, 1996. to be what is created out of "revenue or other surplus". Share premium is an independent account and not created out of 'revenue or other surplus'.

2. Subject to the provision in the Articles of Association of the Company, share premium can be utilized for issue of bonus shares as permitted by clause (d) of sub-section (2) of section 83 of the Companies Ordinance, 1984 provided the four conditions laid down in Rule 6 of the Companies (Issue of Capital) Rules, 1996 are complied with.

1.4 CONSOLIDATED FINANCIAL STATEMENTS

Inquiry: I am directed to enclose a letter dated September 10, 2000 received from a company which is subsidiary of a listed company, the contents of which are self-explanatory. Further, in this matter various proposals have also been received by the Securities and Exchange Commission of Pakistan (SECP) which are outlined below: -

Option No. 1

The holding company whose accounting year ends on 30th June 2000 may be allowed to consolidate the subsidiary's audited financial statements as on 30-9-2000. The time difference will be 3 months which shall not be violative of either the provisions of the Companies Ordinance, 1984 or the requirements of IAS 27. However in this situation the holding company may seek extension in holding of its AGM till 31-3-2001.

Option No. 2

The subsidiary's accounts for the nine months ending on 30-6-2000 duly reviewed by the auditors under ISA 910 may be allowed for consolidation purposes. In this case the period of consolidation will be nine months, however, the opening balances will be audited and the closing date shall coincide with the holding company's year-end.

Option No. 3

The subsidiary company's accounts be consolidated for the full 12 months from 1-7-1999 to 30-6-2000. However, in this situation, the opening balances will not be audited and may be qualified by the Auditors.

Please formulate your views on the above and intimate the same to the undersigned within 10 days of the receipt of this letter to enable us to deal with matter expeditiously.

Opinion:

Option No. 1

Though it is allowed in IAS and also it does not violate any section of the Companies Ordinance, 1984, but following two problems will always be faced in future: -

i) The process of elimination of inter company transactions and balances may become a bit more complicated since reciprocal accounts (e.g. sales and cost of sales) will be out of balance for any events occurring after the earlier fiscal year end but before the latter one.

ii) Seeking extension in holding AGMs every year would not be a good practice.

Option No. 2

In case of closing for nine months only, adjustments for 3 months transactions would still have to be made.

Option No. 3

In our letter dated November 29, 1999 addressed to Group Director Finance of the Holding Company, copy also endorsed to you, we had suggested that the subsidiaries who close their accounts on 30th September should make interim closing for the year ending on 30th June 2000 and get these reviewed by their statutory auditors under International Standard on Auditing on Related Services 910 regarding Engagements to Review Financial Statements. These reviewed financial statements should be consolidated with the holding company's accounts closing on 30 June 2000. In our opinion preparing audited financial statements for the year ending on 30th June 2000 will be a costly and cumbersome exercise.

1.5 DIVIDEND INCOME - RECOGNITION OF

Inquiry: Please refer to ICAP Circular No. 06/2000 dated March 30, 2000 according to which dividend income should be recognized when shareholders right to receive payment is established. The Circular further states certain parameters for recognition of dividend income laid down in the explanation to Section 251 of the Companies Ordinance, 1984

Moreover as per IAS 10 paragraph 31:

> "Dividend stated to be in respect of the period covered by the financial statements and that are proposed or declared after the balance sheet date but before approval of the financial statements should be either adjusted for or disclosed. " Therefore as per IAS 10 dividend receivable is an adjusting event.

As at 30 September, 2000 we have short term investments in AB Limited and CD Company Limited, the financial years of both companies ended on 30 June, 2000

and Directors of the investee companies have recommended final dividends on November, 2000 which was approved in the annual general meetings held on 30 December, 2000.

You are requested to kindly advise in the light of above referred ICAP Circular and IAS 10 whether we should accrue dividend income in the accounts for the year ended 30 September, 2000 or the dividends declared/approved by the investee companies after the year end of investor need not to be taken in the accounts.

Opinion: First of all we would like to state that paragraph 31 of IAS 10, which you have quoted in your inquiry, is no more valid as the whole of old IAS 10 (Reformatted 1994) has been superseded by IAS 10 'Events After the Balance Sheet Date' (revised 1999).

Moreover to the inquiry under reference IAS 10 is not applicable. It is a question of recognizing income under IAS 18 *Revenue*, paragraph 30 of which states: -

30. Revenue should be recognized on the following basis :-

(c) dividends should be recognized when the shareholder's right to receive payment is established.

Further Explanation to section 251 of the Companies Ordinance, 1984 is as follows: -

251. Period for payment of dividend. -

> ***Explanation.*** - 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 purpose, on the date on which such dividend is approved by the directors.

In the present case, dividends were approved by the shareholders of investee companies as on December 30, 2000. This is the date on which your right to receive dividend is established and which is after closing of your accounts. Hence the Committee is of the opinion that dividend should not be accrued by your company.

1.6 IAS-17, *LEASES* (REVISED 1997) – CLARIFICATION

Inquiry: With reference to the IAS 17 (revised 1997), clarification is required on the following two points.

a. Net Investment Method:

According to para-30 of the referred IAS, the finance income should be recognized following the "net investment method".

We are enclosing herewith a sample of "amortization schedule" together with related "journal entries" which we are currently following. You are requested to kindly confirm that whether this is the "net investment method"? If no, then please advise us by giving a sample of "amortization schedule" and the related "journal entries".

b. Transitional Provisions:

With reference to para-58 please advise us whether: -

- The finance income on only new disbursements (made on or after 01 January 1999) is to be recognized on the basis of "net investment method", and the income on lease disbursed earlier (till the time of their maturity) can be recognized on "net cash investment method" – being followed earlier,

Or

- The finance income on leases disbursed earlier is also to be recognized on net investment method (on or after 01 January 1999).

2. You are requested to kindly give your input on these points enabling us to understand the IAS 17 (revised 1997) fully and accordingly.

Opinion: Paragraph 30 of IAS 17 “Leases” requires lessors to recognize finance income on a pattern reflecting a constant periodic rate of return on the lessor’s net investment outstanding in respect of the finance lease. IAS 17 defines Net Investment in the Lease, Gross Investment in the Lease and Minimum Lease Payments as follows:

Net investment in the lease is the gross investment in the lease less unearned finance income.

Gross investment in the lease is the aggregate of minimum lease payments under a finance lease from the standpoint of the lessor and any un-guaranteed residual value accruing to the lessor.

Minimum Lease Payments are the payments over the lease term that the lessee is, or can be required, to make excluding contingent rent, costs for services and taxes to be paid by and reimbursed to the lessor, together with:

b) in case of the lessor, any residual value guaranteed to the lessor by either;

   i) the lessee;
   ii) a party related to the lessee; or
   iii) an independent third party financially capable of meeting this guarantee.

Note: Only relevant parts of the definitions have been reproduced.

The appropriate Committee of the Institute has reviewed your query and is of the opinion that, if security deposit received in advance is adjustable against the residual value at the end of the lease term then the receipt of security deposit falls within the definition of Minimum Lease Payments. Accordingly, the finance income should be allocated on the basis mentioned in paragraph 30 of IAS 17. However, it must be ensured that the lease agreement or other related documents should contain a clause, which permits adjustment of security deposits against residual value at the end of the lease term.

Subject to the above, recognition of income should be as per Schedule enclosed.

The appropriate Committee is also of the opinion that the finance income on only new disbursements (made on or after 01 January 1999) is to be recognized on the basis of "net investment method", and the income on lease disbursed earlier (till the time of their maturity) can be recognized on "net cash investment method" – being followed earlier.

1.7 IAS-19, *EMPLOYEE BENEFITS* (REVISED 2000) - APPLICABILITY OF

Inquiry: Is the standard applicable to all companies incorporated under Companies Ordinance, 1984, that operate defined benefit plans or, owing to the complex accounting treatment required by the standard, those companies that are suffering losses and some small companies may be exempted.

Are the assumptions which form the basis of accounting for a defined benefit plan must be made by an independent qualified actuary or such assumptions can also be made by a company's own management.

In particular, if a public (listed) company follows all the requirements of the standard except that in accounting for employees gratuity plan (which is a defined benefit plan) the assumptions are made by the management and not by a qualified actuary then what should be the effect on the auditor's report to the financial statements.

Opinion: The standard is applicable to all companies incorporated under the Companies Ordinance, 1984 that operate defined benefit plans.

It is not necessary that a qualified actuary should be involved in the measurement of all material post-employment benefit obligations. Paragraph 57 of IAS 19 states that: -

> This standard encourages, but does not require, an enterprise to involve a qualified actuary in the measurement of all material post-employment benefit obligations. For practical reasons, an enterprise may request a qualified actuary to carry out a detailed valuation of the obligation before the balance sheet date. Nevertheless, the results of that valuation are updated for any material transactions and other material changes in circumstances (including changes in market prices and interest rates) up to the balance sheet date.

The auditor should assess the assumptions made by the management and if he is satisfied with them, in all materials respects, a clean report should be issued.

1.8 IAS-30, *DISCLOSURES IN THE FINANCIAL STATEMENTS OF BANKS AND SIMILAR FINANCIAL INSTITUTIONS* - APPLICABILITY OF

Inquiry: Kindly let us have your opinion about the applicability of IAS-30, Disclosures in the Financial Statements of Banks and Similar Financial Institutions.

According to paragraph 2 of the above IAS: -

> The term "bank" includes all financial institutions, one of whose principal activities is to take deposits and borrow with the objective of lending and investing and which are within the scope of banking or similar legislation. The standard is relevant to such enterprises whether or not they have the word "bank" in their name.

Kindly let us know whether the above IAS is applicable to the following: -

- Investment Banks formed under SRO 585 (1) / 87 dated July 13, 1987.
- Modarabas formed under Modaraba Companies and Modaraba (Floatation and Control) Ordinance, 1980
- Leasing Companies formed under Leasing Companies Rules, 1996
- Mutual Fund formed under Investment Companies and Investment Advisors Rules, 1971

Please note that Banking Companies Ordinance, 1962 is not applicable to any one of the above entities.

Opinion: The appropriate Committee of the Institute has noted that as stated above paragraph 2 of IAS-30, *Disclosure in the Financial Statements of Banks and Similar Financial Institutions* defines a Bank as follows: -

> "For the purposes of this Standard the term 'bank' include all financial institutions, one of whose principal activities is to take deposits and borrow with the objective of lending and investing and which are within the scope of banking or similar legislation. This is relevant to such enterprises whether or not they have the word "bank" in their name. (Underlined for emphasis).

In paragraph A(a) of the Rules of Business contained in circular No.1 dated December 5, 1991 issued by the State Bank of Pakistan a NBFI is defined as follows: -

> "NBFI means a Non-Bank Financial Institution and includes a DFI, Modaraba, Leasing Company, Housing Finance Company, Investment Bank, Discount House and Venture Capital Company".

As such the litmus test for applying IAS 30 to an enterprise is as follows: -

> That the enterprise takes deposits and borrows with the objective of lending and investing; and
>
> that the enterprise is within the scope of banking or similar legislation.

In simple terms financial institution is one who earns income on effectively utilizing funds, obtained from external sources (i.e. deposits / borrowing) by way of advancing and investing (i.e. lease, modaraba, equity investment etc.)

Mutual Funds do not fall under the definition of "similar financial institution" as Mutual Funds do not obtain deposits in any form nor do they use their funds (capital) in other avenues except term investments in listed securities. In the same way this will not apply to a trading Modaraba.

However the users of the financial statements of a financial institution are interested in the liquidity and solvency and the risks related to the assets and liabilities recognized on its balance sheet and to its off balance sheet items.

Liquidity refers to the availability of sufficient funds to meet deposit withdrawals and other financial commitments as they fall due. Solvency refers to the excess of assets over liabilities and hence, to the adequacy of the bank's capital.

A financial institution is exposed to liquidity risk and to risks arising from currency fluctuation, interest rate movements, change in market prices and from counter party failure. These risks may be reflected in the financial statements, but users obtain a better understanding if management provides a commentary on the financial statements which describes the way it manages and controls the risks associated with the operations of the institution.

In order to streamline the disclosures made by financial institutions, the Committee is of the opinion that the additional disclosures in accordance with IAS-30 be adopted in preparation of the financial statements by leasing companies, Modarabas other than trading Modarabas and investment banks.

1.9 INTERIM FINANCIAL REPORTING

Inquiry: Refer your Circular No. 03/2001 dated January 26, 2001. Based on our understanding and interpretation of IASs, we feel the direction given in the said circular needs consideration.

In Pakistan consolidated annual financial statements are prepared as an additional information as per IAS. The financial statements of parent are the one, which form part of the basic statutory requirement and which are approved and adopted by members in the general meeting. We believe that in other countries where consolidated financial statements are prepared there is an option for preparation of parent's financial statements as an additional information.

In view of the above, in our opinion there is no requirement of preparation of interim consolidated financial statements. If a company (a parent company) prepares interim financial statements it fulfills the requirements of both Companies Ordinance, 1984 and IAS 34.

Our understanding is also based on the following extracts of IASs: -

Paragraph 7 of IAS 27 states that:

"A parent other than a parent mentioned in paragraph 8 should present consolidated financial statement" (i.e. the emphasis is on a single set of financial statements).

Further paragraph 31 of IAS 27 states that:

"In many countries separate financial statements are presented by a parent in order to meet legal or other requirement."

Thus from the above it is our understanding that IAS, keeping in view the general requirements and regulations throughout the world, requires presentation of consolidated financial statements, while it does not require or prohibit preparation of separate financial statements of parent company.

This was clarified by ICAP circular No. 3/99 dated May 8, 1999, which mentioned that to comply with the Companies Ordinance, 1984, (the local law) separate financial statements are required to be prepared and the new requirement is to present the consolidated financial statement to comply with the IASs.

Further IAS 34, paragraph 14 and your Circular no. 3/2001 dated January 26, 2001 state that:

"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".

From the above it is our interpretation that the main emphasis of IAS is on the preparation and presentation of one set of financial statements for interim financial reporting. However, our local law emphasizes on the preparation and presentation of parent's separate financial statements and the consolidated financial statement is considered as a set of additional requirement to comply with IAS.

To summarize we believe that only one set of financial statements (i.e. parent's financial statements) need to be published for interim reporting and ICAP should also recommend this, which will be in accordance with the spirit of IASs and will fully comply the local law.

Opinion: Paragraph 14 of IAS 34 requires that, if the enterprise's most recent annual financial statements were presented on a consolidated basis, then the interim financial reports in the immediate succeeding year should also be presented similarly. This is entirely in keeping with the notion of consistency of application of accounting policies. The rule does not, however, preclude or require publishing additional "parent company" interim reports.

But on the other hand section 245 of the Companies Ordinance, 1984 has made it mandatory on a listed company to publish interim financial statements as detailed therein.

As we have to comply with IAS 34 as well as with Companies Ordinance, 1984 the Committee is of the opinion that no change in Circular No. 3/2001 is required.

1.10 LEASING TRANSACTIONS – WHETHER LIABLE TO SALES TAX UNDER SALES TAX ACT, 1990

Inquiry: By virtue of Finance Ordinance, 2000, finance lease has been excluded from the definition of "Supply".

My questions are: -

i) Sale and Leaseback Transaction

Whether this kind of transaction is subject to sales tax and client (i.e. lessee) has to charge sales tax on this transaction and issue sales tax invoice under the relevant clause of Sales Tax Act, 1990.

ii) Disposal / transfer of leased asset at the end of lease term to lessee

In case of both operating lease and finance lease, leased asset is usually transferred back to the lessee in consideration of residual value at end of lease term.

And in case of termination or where lessee is not willing to purchase the leased asset, the asset is disposed off to any third person by the leasing company / modaraba / other financial institution.

Is such transfer / disposal of leased asset liable to levy of sales tax under the Sales Tax Act, 1990?

If answer is yes, will leasing companies, modarabas and other financial institutions engaged in leasing business be required to be registered under the Sales Tax Act, 1990.

Opinion: i) Sale and Leaseback Transactions

Before responding to the question, the Committee would like to convey its understanding that the "lessee" in question is not engaged in the business of supplying goods, which he intends to leaseback. In other words the "lessee" is likely to enter into sale and leaseback transaction for goods which are being used by him as fixed assets. The Committee would like to apprise you that Section 3 of the Sales Tax Act, 1990 (the Act) defines the general scheme of taxation under which sales tax is levied at the general rate of 15% on "taxable supplies" made by a "registered person" in Pakistan in the course of furtherance of any "taxable activity" or in respect of goods imported into Pakistan. The term "taxable activity" has been defined in Clause (35) of Section 2 of the Act and means any activity which is carried on by any person, whether or not for a pecuniary profit, and involves in whole or in part, the supply of goods to any other person, whether for any consideration or otherwise, and includes any activity carried on in the form of a business, trade or manufacture. You would appreciate that the basic requirement of taxable activity is a "supply of goods" whether for consideration or otherwise. The term "supply" has been defined under Clause (33) of Section 2 of the Act and inter alia includes sale, lease (excluding financial lease) or other disposition of goods in furtherance of business carried out for consideration. In the light of the foregoing overview of the scheme, you will observe that sales tax is chargeable on every supply of goods made by a registered person for

furtherance of his / its business unless the goods supplied are exempt under the Act.

Now the question is whether the selling of fixed assets consisting of plant and machinery for leasing back the same can be construed “supply of goods” in furtherance of the lessee’s business. The expression “business” connotes a wide range of meaning, which includes any set of activity carried on for the purpose of earning profits. However, whether sale of fixed assets which is integrated with and forms part of leaseback transaction would mean a supply within the meaning of Clause (33) of Section 2 of the Act would need to be considered in the perspective of the leasing transaction and the business being carried on by the lessee. You would appreciate that the sale of fixed assets would be followed by the subsequent lease transaction, which implies that the sale transaction is nothing more than a disguised security against a lease contract. The Committee is, therefore, of the opinion that the lessee who may be exclusively engaged, for instance, in manufacturing and supplying of textile goods if entering into such sale transaction of fixed assets which, in substance, do not change hand would not represent “supply” within the meaning of Clause (33) of Section 2 of the Act. Hence such sale of fixed assets may not be subject to sales tax.

The understanding of the Committee that the disposal of fixed assets cannot be termed as “supply” in furtherance of business is fortified by a decision of the Supreme Court of India in case reported as (1967) 19 STC1 (SC). For your interest, the relevant paragraph from the head notes is quoted below: -

> “In disposing of miscellaneous old and discarded items such as stores, machinery, iron scrap, cans, boxes, cotton ropes, rags, etc. the company was carrying on business of selling those items of goods. These sales were frequent and the volume was large, but it cannot be presumed that when the goods were acquired there was an intention to carry on the business in those discarded materials; nor are the discarded goods, by-products or subsidiary products of or arising in the course of the manufacturing process. They are either fixed assets of the company or are goods which are incidental to the acquisition or use of stores or commodities consumed in the factory. Those goods are sold by the company for a price which goes into the profit and loss account of the business and may indirectly be said to reduce the cost of production of the principal item, but on that account disposal of those goods cannot be said to become part of or an incident of the main business of selling textiles. In order that receipts from sale of a commodity may be included in the taxable turnover, it must be established that the assessee was carrying on business in that particular commodity. A person who sells goods which are unserviceable or unsuitable for his business does not on that account becomes a dealer in those

goods, unless he has an intention to carry on the business of selling those goods" (underlined for emphasis)

In the light of the above discussion, the Committee is of the considered opinion that the lessee would not be required to charge sales tax on such transaction of sale of fixed assets.

ii) Disposal / transfer of leased asset at the end of lease term to lessee

You would appreciate that the definition of the word "supply" has been amended by the Finance Ordinance, 2000 to exclude "financial lease" from its fold. Accordingly, the finance lease activity would remain outside the ambit of sales tax. However, disposal of an asset on maturity of lease contract in an open market in a case when a lessee is not willing to purchase the subject asset is an ancillary activity to the business of leasing hence may be construed as a "supply" of goods in furtherance of business. Accordingly such disposal of assets may be subject to sales tax under the Act. The Committee is, therefore, of the considered opinion that any person who is liable to charge / collect sales tax is required to get registration under the provisions of the Act.

1.11 LOSSES CAUSED DUE TO IRREGULARITIES, CORRUPTION / MISAPPROPRIATION AND EMBEZZLEMENT - REFLECTION IN THE ANNUAL AUDITED ACCOUNTS

Inquiry: A public sector enterprise had suffered heavy financial losses due to irregularities, corruption / misappropriation and embezzlement by the past management of that enterprise particularly in 1996 during the tenure of, Ex. Acting Chairman. As per practice in vogue only the composite losses are reflected in the accounts books on the basis of amount realised while we are of the opinion that for recovery purposes it is essential that losses occurring due to irregularities, corruption / misappropriation and embezzlement should exclusively be reflected / incorporated in the annual audited accounts.

In this regard office of the Auditor General of Pakistan was approached and advice / expert opinion was sought in the matter i.e. whether or not such losses should be reflected in the books of accounts. However, Office of the Auditor General of Pakistan showed its inability to give any advice and asked us to refer the case to you for the required opinion / advice.

You are therefore requested to kindly advice in the matter. Copies of our letter dated 19-12-2000 and Auditor General of Pakistan letter dated 18-1-2001 are enclosed.

Opinion: The appropriate Committee is of the opinion that while loss accrued to an organisation due to operational results and other factors is capable of being determined and so reflected in the financial statements, to attribute any part of such loss to causes or reasons such as irregularities and corruption, quantify it in monetary terms and account for it separately in the financial statements is generally not feasible. You would appreciate that until proved through a due process of law, such determination and its disclosure would at best remain an allegation and may not be sustainable as conclusive as of the date of the

financial statements. Accordingly, therefore, such a practice is not in vogue anywhere in the world. What is really required is for that enterprise to make concerted efforts to account for its assets and liabilities in accordance with the norms contained in the various International Accounting Standards (IASs) as applicable, particularly those relating to inventories, property, plant and equipment, impairment of assets; provisions, contingent liabilities, and contingent assets and prepare its financial statements in accordance with the same.

In preparing the financial statements in the manner stated above, the aggregate amount of losses sustained by the enterprise in a particular accounting period would be reflected. However, if it is possible to quantify in monetary terms the extent of the loss, if any, sustained by the enterprise due to misappropriation and embezzlement of funds or other assets, this may be reflected suitably in the financial statements with adequate disclosures.

1.12 POTENTIAL LEASE LOSSES - PROVISION FOR

Inquiry: Rule 14 of NBFI Rules of Business specifies the basis for determination of provision for potential lease losses.

In case of substandard, it states that:

DETERMINANT	**PROVISION TO BE MADE**
Where installment of principal or mark-up is overdue by one year or more.	Provision of 20% of the difference resulting from the outstanding balance of principal less the amount of liquid assets realizable without recourse to a Court of Law and forced sale value of mortgaged / pledged assets as valued by valuers fulfilling prescribed eligibility criteria.

My queries are:

1. While calculating provision for potential lease losses, rate of provision is applied on outstanding balance of principal or principal portion of overdue rentals.

2. In case of leasing company, assets are in the name of company. Realizable value of securities to be taken or not as they are not mortgaged or pledged.

3. An illustration is given below, give your opinion which treatment is according to rule 14.

Lease amount	Rupees 10,000,000
Principal received	Rupees 2,000,000
Outstanding balance	Rupees 8,000,000
Rentals are overdue by	16 monthly installments
Principal portion of overdue rentals	Rupees 3,000,000
Provision for potential lease losses	i)Rupees 8,000,000x20%=Rupees1, 600,000;or ii) Rupees 3,000,000x20% =Rupees 600,000

Give me your opinion as soon as possible.

***Opinion**:* The appropriate Committees of the Institute wish to point out that where mark up / interest or principal is overdue by one year or more it is classified as doubtful. Further the words "outstanding balance of principal less the amount of liquid asset " means, in your example, the outstanding balance of Rs.8,000,000.00. In Committees' views provision for potential leased losses should be made @ 20%. Realizable value of securities is to be taken into account.

1.13 PROFITS AFTER TAX – MEANING OF

Inquiry: With reference to above kindly take the opinion of Technical Committee on the following issue:

1. Back ground of the case

We are a public limited company listed on stock exchange engaged in manufacturing and export of cotton yarn. The export sales of the company were 45% for the year ended September 1999. The company is filing return under the normal law.

The Finance Act, 1999 introduced a new provision of law under section 12 (9A) of the Income Tax Ordinance, 1979 which requires a public limited company, other than a scheduled bank or a Modaraba, which derives profits for any income year but does not distribute cash dividend up to 40% of its after tax profit then the reserves which are in excess of 50% of the paid up capital will be taxed @ 10% under the above provisions of law. The company is paying dividends since 18 years.

The company did not provide deferred tax in the previous years now intends to provide deferred tax for all timing differences.

2. Question arises

2.1 Whether the term after tax profit used in section 12 (9A) of the Income Tax Ordinance, 1979 (read with clause 59 Part IV of the Second Schedule to the Income Tax Ordinance, 1979) means, profit after the provision of current year's tax and also the provision for deferred tax?

2.2 Whether the profit after the provision of deferred tax will be considered for the purpose of section 12(9A) of the Income Tax Ordinance, 1979.

3. Relevant provisions of law

<u>Section 12 (9A) of the Income Tax Ordinance, 1979.</u>

Where an assessee, being a public company other than a scheduled bank or Modaraba, derives profits for any income year but does not

distribute cash dividend to such an extent that its reserves, after such distribution, are in excess of fifty percent of its paid up capital, so much of its reserves as exceed fifty percent of its paid capital shall be deemed to be the income having accrued to such company during that year:

Explanation: For the purpose of this sub section, the expression "reserves" shall have the meaning as may be prescribed.

Clause 59 of Part IV of the Second Schedule to the Income Tax Ordinance, 1979.

The provisions of sub section (9A) of section 12 shall not apply to –

(i) a company listed on a stock exchange which distributes at least forty percent of its after tax profits of the relevant year;

We will be highly obliged for your opinion in this regard.

Opinion: The appropriate Committee is of the view that the term "after tax profits" as used in sub-clause (I) of clause (59) of Part IV of the Second Schedule to the Income Tax Ordinance, 1979 has not been explained anywhere in the Ordinance, or CBR Circulars. The definition of tax as given in section 2(43) of the Ordinance is also not helpful.

However IAS 12 Accounting for Tax on Income (Reformatted) states as under in paragraph 16: -

Under the liability method, the tax expense for a period comprises: -

(a) the provision for taxes payable;
(b) the amount of taxes expected to be payable or considered to be prepaid in respect of timing differences originating or reversing in the current period; and
(c) the adjustments to deferred tax balances in the balance sheet necessary to reflect either a change in the tax rate or the imposition of new taxes.

Moreover according to the clarification issued by the Central Board of Revenue vide its letter no. F.12(9A)ITP/99 dated June 16, 2001, " 'after tax profits' as used in clause (59) of Part-IV of Second Schedule to the Income Tax Ordinance, 1979, refers to profits computed in accordance with the generally accepted and understood accounting / audit principles and standards and the Income Tax Ordinance".

Keeping in view the above, the Committee is of the opinion that "after tax profits" means the profit after the provision of current year's tax and also the provision for deferred tax.

1.14 PRUDENTIAL REGULATIONS – NEW CLASSIFICATION OF ASSETS RE: LEASING COMPANIES

Inquiry: I refer to the revised Prudential Regulation – VIII / Rule 14 vide BPRD Circular No. 9 dated 27 April, 2000 for all Banks / NBFIs for non-banking financial institutions regarding classification and provisioning of assets specially:

"The rescheduling / restructuring of non-performing loans / leases shall not change the status of classification of a loan / advance / leases etc. unless the terms and conditions of rescheduling / restructuring are fully met for a period of at least one year (excluding grace period if any) from date of such rescheduling / restructuring"

"The status of classification as well as provisioning is not changed merely because of the fact that a loan / lease has been restructured / rescheduled""

I would like to make the following suggestions for its proper implementation and adoption of standardized uniform practice at all levels.

i) All the practicing firms of chartered accountants should receive clear instructions / guidance to adopt a uniform approach in giving treatments to such cases.

   The clarity in instructions is highly important because different interpretation of the rules by different practicing chartered accountants break this uniformity and accord different treatments.

ii) The loans / leases which have been rescheduled once or more are required to be 100% provided till at least one year of lease rentals or loan installments are received consistently without break.

iii) It has been the practice of some leasing companies to restructure / reschedule the leases or create new leases adjusting the old one just to avoid necessary provisioning. It should be carefully monitored that the provisioning is not avoided by simple adjustment of one liability by creating another with or without change of names.

iv) In Annual Balance Sheet all rescheduled or restructured leases should clearly be disclosed without any exception.

v) It should be monitored that the prudential regulations are not flouted / by-passed by an arrangement of a very unreasonable low amount of repayment in the first year. I.e. less than 10% of the total amount plus accrued up to date mark-up / interest on the total amount so as only to meet the State Bank of Pakistan criteria of receiving one year's payment.

Opinion The appropriate Committee of the Institute has examined your letter dated May 25, 2000 and is of the opinion that responsibility for the preparation of financial statements is that of Management of an enterprise who have to keep in view the particular requirements of the applicable rules / regulations besides following in general the provisions of the Companies Ordinance, 1984, the International Accounting Standards applicable in Pakistan and the Technical Releases and any other directive issued by the Institute from time to time.

The job of an auditor is to express an opinion on the financial statements (including notes to the accounts) according to the auditors' report format prescribed for the enterprise.

The Institute also issues guidelines to its members whenever deemed necessary but the Institute cannot assume the role of a Regulatory Authority and issue instructions to its members asking them to ensure compliance of any regulation. You would have noticed that in paragraph 8 of Circular under reference, the external auditors have been asked to verify compliance with the requirements of the Prudential Regulation VIII/NBFIs Rule 14 and not to ensure compliance. The appropriate Committee's para-wise comments are as follows: -

Paragraph i

The BPRD Circular No. 9 is quite clear on the subject and does not need any further elaboration. It may be mentioned here that the basic structure of this circular was developed by a Joint Committee of ICAP and the State Bank of Pakistan

Paragraph ii

Your suggestion does not appear to be in line with paragraph 3 of Circular No. 9 which requires that the rescheduling / restructuring of non-performing loans shall not change the status of classification of a loan / advance.

Paragraph iii

This is covered in paragraph 2 of the Circular.

Paragraph iv

This is not required by paragraph 3 of the Circular

Paragraph v

The job of an external auditor is to verify compliance with the Regulation and not monitor which is the function of the Regulatory Authority.

1.15 REVALUED ASSETS - DEPRECIATION ON

Inquiry: We shall be thankful to take guidance in the following matter: -

A public limited company revalued its assets from Rs.100,000/- to Rs.1,000,000/- Surplus of Rs.900,000/- was being shown in Balance Sheet on liabilities side.

The Company charged depreciation on the revalued cost of machinery. This practice is not acceptable to the tax department. They allowed depreciation on the cost to the assessee. Similarly workers are also disputing. According to them depreciation should be charged on the cost to the Company for the purpose of 5% of Workers Profit Participation Fund.

Opinion: Section 235(4) of Companies Ordinance, 1984 says, “after revaluation as aforesaid, depreciation on the assets so revalued shall be provided with reference to the value assigned to such assets on revaluation”.

The Committee is of the opinion that effect of depreciation will be taken on revalued amounts while calculating 5% Workers Profit Participation Fund.

1.16 SAP-1, BANK REPORT FOR AUDIT PURPOSES

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 different variations to the issue. First, under IAS 10, *Contingencies and Events Occurring after the Balance Sheet Date*. Second, under IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*. Third, under IAS 32, *Financial Instruments, Disclosure and Presentation.*

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

Paragraph 28 of IAS 37 has changed the above position and for those liabilities which are not contractual in nature and which do not involve transfer of financial assets are required to be disclosed as per the requirements of IAS 37. It requires that 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 should not to be disclosed.

Those liabilities which are contractual in nature and which involve transfer of financial assets are required to be disclosed in the financial statements as per IAS 32, which requires that those contingent liabilities which are contractual in nature and which involve transfer of financial assets are to be disclosed at the

fair value as per paragraph 77 of IAS 32 even though an outflow or resources is remote.

The Committee is of the opinion that as " bills discounted with recourse " fall in the definition of financial instruments, therefore these are required to be disclosed as contingent liabilities in the financial statements.

1.17 WORKERS' PROFITS PARTICIPATION FUND – CALCULATION OF

Inquiry: Whether the contribution to WPPF @ 5% of net profit of a company is to be made before charging interest on WPPF?

This question is raised because a fellow member of the Institute, in his suggested answer to a question set by the Institute in Paper-2 of PE-1 May 1997 examination, has suggested to calculate contribution to WPPF @ 5% of net profit before charging interest on WPPF.

Opinion: The appropriate Committee of the Institute is of the view that the treatment of interest on WPPF in the suggested solution of question is correct and in accordance with the Circular No 2 of 1991 dated July 24, 1991 issued by Corporate Law Authority.

2. AUDITING

2.1 AUDIT FEE – REDUCTION IN

Inquiry: This to being to your kind attention that the Management of ABC Sugar Mills Limited is pressing for the reduction of the audit fees for the above year. The results of the previous years in listed below:

	Sales	**Expenses**	**Sugar Cane Crushed**	**Audit Fee**
	Rs.000	**Rs.000**	**Tonnes**	
1997	598.904	639,895	536,000	175,000
1998	1,149,784	1,190,113	1,004,000	175,000
1999	1,144,461	1,207,067	932,000	175,000
2000*	1,229804*	1,187,611*	869,252*	175,000

* Un-audited figures

In view of the above and keeping in mind the ICAP guidelines we need your advice as what audit fee for the year September 30, 2000 we should accept. Please attend to this letter urgently.

Opinion: We refer to your letter dated November 3, 2000 and would advise you to take a decision in the light of section 11 of the Code of Ethics for Chartered Accountants issued by the Institute.

Inquiry: Please refer to your letter No. CA/DTS/TAC-2000 dated December 7, 2000 the position is as follows:-

i) The nature of pressure is that the audit fees must be reduced and the comparison is being made of other mills.

ii) We have already told them that as per section 11 of the Code of Ethics we cannot reduce the fees, as there is no reduction in the scope of the work.

iii) Now what the company needs is the confirmation from ICAP so that the client can be satisfied.

Opinion: According to section 11 of Code of Ethics of Chartered Accountants: -

“Chartered accountants in practice should be careful not to quote fee lower than that charged by the chartered accountants in practice previously carrying out the audit unless scope and quantum of work materially differs from the scope and quantum of work carried out by the previous auditor, as it could then be regarded as undercutting”.

But there is nothing in the Code of Ethics regarding change in audit fee by the existing chartered accountant.

2.2 AUDITED / CERTIFIED REPORTS - SIGNATURE/AUTHENTICATION OF

The appropriate Committee of the Institute has considered your under mentioned enquiry dated October 21, 2000 and wishes to place on record that no action is initiated by the Institute against any of its members without any specific complaint and even if it be specific, it has to be dealt with in accordance with a due process of investigation. The Committee regrets the insinuations made in your letter against a member of our Institute without any evidence. The Committee also wishes to convey to you that while suggestions from non-members are welcome, these have to be made after full understanding of the law to which our members are subject to and the professional practices required to be observed by them having regard to the objective circumstances. However, its further views have been given under each paragraph of your enquiry: -

PREAMBLE

We have before us TR-25, which was received by us earlier, with your courtesy, under cover of your letter dated May 15, 1999, evidencing that the Technical Services / Committee of the Institute of Chartered Accountants of Pakistan (ICAP) provides timely guidance to its members, so that they may respond appropriately to the latest regulatory developments. Such document besides providing guidance to your members, is useful for bankers / other users of audited / certified accounts as well.

Now, drawing your attention towards relevant paragraph of ATR-1 relating to signing in firm's name reading as "The Council decided that there should be no objection to signing audit documents by an individual member of the Institute in the name of the firm under which he practices", and seek your Institute's / Council's assistance / clarification in removal of difficulties being faced by our branch in fulfilment of Prudential Regulation # IV of State Bank of Pakistan and also forward herewith our suggestions for plugging the possibility of submission of unscrupulous audited / certified accounts to banks:-

INQUIRY

a) Signing in the name of Company:

i) Firm's signature done by Individual members vary, making it difficult for our branches to determine, whether the signature is genuine or unauthorised. Without any engagement on our part and with a request not to treat this report against any specific firm, we enclose for your eyes only, Annexure-I and II being Auditors' report by the same firm, having altogether different signatures in the name of the firm, making authentication in the name of firm a doubtful practice / convention.

ICAP COMMENTS

i) The reports appear to have been signed by two different partners of the same firm.

INQUIRY

ii) It has been observed that in cotton ginning season, such audited / certified accounts are issued / submitted with great speed, even where practising partners of an auditing firm may be sitting at Karachi / other cities.

ICAP COMMENTS

ii) Without a specific complaint against a member, the Institute cannot proceed in the matter.

INQUIRY

iii) On review of aforesaid Annexures, one would agree that such variation in signatures would have not been possible, had individual members affixed their own signature on behalf of the firm.

ICAP COMMENTS

iii) Signatures referred to by you are strictly in accordance with the relevant provisions of Companies Ordinance, 1984 which are as follows: -

> Section 252(2) Appointment of a partnership by the firm name to be the auditors of a company shall be deemed to be the appointment of all the persons who are partners in the firm at the time of appointment.
>
> Section 254(2) A firm whereof all the partners practising in Pakistan are Chartered Accountants may be appointed by its firm name as auditors of a company referred to in sub-section (1) and may act in its firm name.
>
> Section 257. Signature on audit report, etc., (1) only the person appointed as auditor of the company, or where a firm is so appointed in pursuance of sub-section (2) of section 254, only a partner in the firm practising in Pakistan, shall sign the auditors' report or sign or authenticate any other documents of the company required by law to be signed or authenticated by the auditors.
>
> Section (2) The report of auditors shall be dated and indicate the place at which it is signed.

INQUIRY

iv) In the Directory of Members and Firms issued by ICAP, if a column for signature were included this would be of great value. Moreover, the

member of ICAP while affixing signature on audited/certified accounts be required to mention his / her membership #, making it easy for reference by users.

v) The above quoted paragraph of ATR-1 may merit legal vetting as well.

ICAP COMMENTS

iv&v) The proposal to add signature of members in the Directory of Members and Firms is not practical. It shall be appreciated that it is not a practice in any part of the world.

INQUIRY

b) In the meantime, we shall appreciate if you consider it appropriate to issue an interim release / circular for your members advising following and would it be appropriate if we convey our branches accordingly: -

i) The Auditors' Report and each page of its annexed accounts and notes should bear company's seal and signature / initial of the signing chartered accountant with his / her membership #.

ii) Number of pages attached with Auditors' report as accounts and annexed notes be mentioned under Auditors' signature and seal as under:-

"*Annexed accounts and annexed notes consist of pages"*

ICAP COMMENTS

i)&ii) Our members are required to report on the accounts and not to authenticate them.

INQUIRY

iii) Where user / bank seeks confirmation with regards to genuineness of certified / audited accounts, the auditor be advised / required to confirm the same promptly in writing, Auditors should also satisfy, if requested, that he / they hold a valid practising certificate.

ICAP COMMENTS

iii) The Committee is of the view that no guidance is called for regarding immediate confirmation by the firm, as and when asked for by the bank. This is a matter, which should be resolved by the bank through its clients.

INQUIRY

iv) It may be re-emphasized to practicing members that audit / certification should not be issued of an entity, whose audit is undertaken by other practicing member (company or other) covering the same period.

c) We shall be glad to have your confirmation on 'b' above, to enable us to guide our branches accordingly. Thereafter you may give due consideration to points discussed at 'a' above.

ICAP COMMENTS

iv)&c) The Committee feels that no additional guidance is required in this case, specific cases should be reported to the Institute for appropriate action.

2.3 AUDIT REPORT ON DEDUCTION OF ZAKAT FROM DIVIDEND PAYMENT TO MODARABA CERTIFICATE HOLDERS

Inquiry: Our client a Modaraba has obtained a legal opinion from its legal advisor in respect of deduction of Zakat from dividend payment to certificate holders by the Modaraba. The legal advisor opined that Modaraba was not required to deduct any Zakat. A copy of the opinion given by the legal advisor is attached for your reference. The question is that if a Modaraba does not deduct Zakat from dividend payment to certificate holders, can an auditor amend paragraph relating to Zakat deductions in the audit report. The relevant paragraph is reproduced below: -

"Zakat deductible at source under Zakat and Ushr Ordinance, 1980, has been deducted by the Modaraba and deposited in the Central Zakat Fund established under section 7 of that Ordinance; and"

You will observe that in Companies Ordinance, 1984 auditor's report wording regarding Zakat deduction is as follows: -

"Whether or not in their opinion* Zakat deductible at source under the Zakat and Ushr Ordinance, 1980 was deducted by the company and deposited in the Central Zakat Fund established under section 7 of that Ordinance."

(*The correct wordings are "In our opinion-ICAP)

In the companies' audit report where Zakat is not deductible the wording of the report is amended accordingly because the paragraph empowers the auditor to state whether or not in their opinion Zakat is deducted. Whereas under Modaraba rules wording does not empower the auditor to change the wording of audit report.

In view of the above, we shall appreciate if you would please advise on the following issues:

a) Whether or not Modaraba should deduct Zakat from dividend payment to certificate holders

b) If Zakat is not deducted whether or not auditor can modify appropriately the wording of the report in respect of Zakat deductions.

We also enclose a copy of the letter of the Modaraba addressed to us in this regard. Please note that the distribution of cash dividend is to be made by March 7, 2001, therefore, your early reply will be highly appreciated.

Opinion: a) The Committee has noted that advocates have not been categorical in their opinion concerning the issue, i.e. whether Modaraba should or should not deduct Zakat. In their view, Modaraba does not fall within the ambit of item 8 of the First Schedule to the Zakat and Ushr Ordinance, 1980; the Modaraba certificates however are "securities" under the Companies Ordinance, 1984. In view of the latter position, in their opinion, "exemption is not available on account of distinction between Modaraba certificates and shares or securities". In other words, Modaraba certificates attract Zakat.

The Committee is of the view that it is a legal issue and not an issue of interpreting either the accounting or the auditing practices.

c) Regarding your second query, the Committee is of the view that unlike Companies Ordinance, 1984, the form of Auditor's Report to the Certificate Holders prescribed under the Modaraba Companies and Modaraba Rules, 1981 does not give any option to the auditor to modify his report. If Zakat deductible at source under the Zakat and Ushr Ordinance, 1980 has not been deducted by the Modaraba and deposited in the Central Zakat Fund established under section 7 of that Ordinance, then the auditor has to qualify his report.

Finally if the Modaraba has any reservation in the matter, it may proceed at its end and take up the case through legal attorney with the competent authority.

2.4 AUDITORS' REPORT FORMAT

Inquiry: Should we delete the wording "on a test basis" from paragraph 03 of the Auditors Report format while performing 100% procedures to bring down the overall audit risk to an acceptably low level? Or should we modify/add to the above paragraph suitably to indicate that 100% procedures were applied. Please advise so that the audit report be made in accordance with the actual work done.

Opinion: We are of the opinion that you cannot change the format of the report including its wording.

You are, therefore, advised that wording "on a test basis" will always come, even though you have applied 100% procedure.

Inquiry: The notes to the form 35A states:

> "In the case of non-listed company reference to 'Cash Flow Statement and statement of changes in equity and opinion thereon' may be omitted".

The management of non-listed company would like to add Cash Flow Statement to the Financial Statements presented to the Members and would also like the auditors to give their opinion thereon (we understand the auditor is not legally bound to do so).

Kindly advise whether :

a) The auditor should not give his opinion on the Cash Flow Statement.
b) He is legally allowed to do so but preferably avoid giving the opinion on the Cash Flow Statement to reduce his audit risk.
c) The client is encouraged to prepare and attach the Cash Flow Statement (As per IAS) and the auditor is also encouraged to give the opinion on the Cash Flow Statement.

Opinion: It is clearly mentioned in the S.R.O. 594/(I)/2000 that in case of a non-listed company reference to “cash flow statement or sources and application of funds and statement of changes in equity and opinion thereon ”may be omitted”.

However the clients are encouraged to prepare and attach the Cash Flow Statement and auditors are also encouraged to form their opinion on the same.

2.5 HONORARY AUDIT

Inquiry: I seek you guidance and opinion on whether I am eligible for the Honorary Audit of a Community based Education Society. The details are as follows: -

1. The above named Society is registered under the Societies Registration Act, 1860.

2. The appointment of the managing board of this Society is approved by the organization of which I am an employee.

3. Further, certain funding to this Society is also provided by my organization.

4. As per the Articles of Association of this Society: “The managing board shall appoint one or more Chartered Accountants within the meaning of the Chartered Accountants Ordinance, 1961 as Auditors of the Society whether on fee or honorary”

5. This Society has approached me for the honorary audit, but my understanding is that as I am an employee of the supervising organization, therefore, it makes me a related party concern.

6. Your guidance is sought for the following two matters:

    a) Should I undertake this assignment?

    b) Whether a non-practising Chartered Accountant can undertake this assignment (other than myself).

Opinion: The Committee is of the view that in the stated situation, the audit should not be undertaken by you as it involves conflict of interest whereas Paragraph 1.1 of the Institute's Code of Ethics for Chartered Accountants requires all chartered accountants to be, besides being fair and intellectually honest, to be also free of conflicts of interests. Further, Paragraph 1.3(c) also requires that "relationships should be avoided which allow prejudice, bias or influences of others to override objectivity". Paragraph 14.1(b), part C, that deals with employed chartered accountants, enjoins that an employee (chartered accountant) cannot legitimately be required to "breach the rules and standards of the profession"

As regards the position as to who can undertake the audit, the Committee is of the view that the issue may be dealt with in accordance with the articles of association of the society. A non-practising Chartered Accountant can undertake this assignment if there is no conflict of interest.

2.6 SUPERSEDING ANOTHER CHARTERED ACCOUNTANT IN PRACTICE

Inquiry: "An existing auditor gives 'no objection certificate (NOC)' in response to the communication by the prospective auditor, as to why the prospective auditor should not accept the audit of the client (a Private Limited Company) of the existing auditor."

Kindly advise whether the above action by the existing auditor would also amount to the resignation by the existing auditor from his office and a casual vacancy would be created. And, if this casual vacancy is filled in by the directors of the company all the formalities of the provisions of the Companies Ordinance 1984, regarding appointment of auditors to fill casual vacancy are deemed to be complied with.

Opinion:

(a) when existing auditor replies to prospective auditor without giving any professional reason he provides clearance to the prospective auditor to accept the audit; and

(b) by providing such a professional clearance it does not tantamount to resignation from the office of the auditor which will still be governed by the provisions relating to appointment and removal of auditors in accordance with section 253 of the Companies Ordinance, 1984.

Please note that the creation of casual vacancy exists if the existing auditor voluntarily retires or becomes incapacitated to properly discharge his duties in which situation directors fill the casual vacancy u/s. 252(4) of Companies Ordinance, 1984. While accepting audit in such situation the prospective auditor should ensure compliance to legal requirements contained in section 253 as stated above.