

# Selected Opinions

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From July 1, 2020 to June 30, 2021

Technical Services Department

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## Introduction

This is the twenty sixth compilation of opinions issued by the Institute's Accounting Standards Board (the Board) and the Auditing Standards & Ethics Committee (the Committee) on the enquiries raised by members, entities and regulators during the period from **July 2020 to June 2021**. This compilation of opinions is termed as "Selected Opinions".

The Institute, since July 2020, has also started the practice of uploading the selected opinions of the Board or Committee as issued, with the objective to facilitate members and to provide timely guidance. The latest selected opinions issued during the year can be accessed at: [www.icap.net.pk/latest-selected-opinions](http://www.icap.net.pk/latest-selected-opinions).

The selected opinions are issued for the general guidance of the members of the Institute and these are based on the specific fact patterns shared by the enquirers. In this document, the accounting opinions represent the opinions of the Board and opinions related to auditing and ethical matters represent the opinions of the Committee. These are not the official opinions of the Council of the Institute.

The opinions are based on the financial reporting, auditing and ethics frameworks applicable in Pakistan, on the date the Board or the Committee finalize a particular opinion. Since an opinion is arrived at on the basis of the facts and circumstances of each individual query provided by the enquirer, it may change if the facts and the circumstances change. An opinion may also change due to subsequent developments in law, pronouncements made by the Institute and other relevant changes, including any change in the financial reporting, auditing or ethics framework. The opinions are not a compendium of legal advice.

In every case the members have to make their own decisions in the light of facts and circumstances of the issue, and in consideration of the relevant applicable laws and framework. The Institute, the Board and the Committee will have no liability in connection with the selected opinions.

## Directorate of Technical Services

## 1.1 Treatment of Minimum Tax Paid on Turnover under IAS 12 Income Taxes

### Brief facts of the enquiry:

The Accounting Standards Board (the Board) received an enquiry, wherein, the Board's guidance had been sought on the following questions related to treatment of minimum tax paid on turnover under IAS 12 *Income taxes*:

- Whether the minimum tax due for a period under section 113 of the Income Tax Ordinance, 2001 fulfills the criteria to be recognised as current tax expense or as current tax asset?
- What are the deferred tax implications of minimum tax paid under section 113 of the Income Tax Ordinance, 2001 under IAS 12?

### Opinion:

The Board noted that paragraph 58 of IAS 12 requires that current tax shall be recognised as income or an expense and included in profit or loss for the period, except to the extent that the tax arises from:

- (a) a transaction or event which is recognised, in the same or a different period, outside profit or loss, either in other comprehensive income or directly in equity;
- (b) a business combination (other than the acquisition by an investment entity, as defined in IFRS 10 Consolidated Financial Statements, of a subsidiary that is required to be measured at fair value through profit or loss).

Further, paragraph 12 of IAS 12 requires that current tax for current and prior periods shall to the extent unpaid be recognised as a liability. If the amount already paid in respect of current and prior periods exceeds the amount due for those periods, the excess shall be recognised as an asset.

Current tax has been defined in IAS 12 as the amount of income taxes payable (recoverable) in respect of the taxable profit (tax loss) for a period.

Further, the term taxable profit has been defined in IAS 12 as taxable profit (tax loss) for a period, determined in accordance with the rules established by the taxation authorities, upon which income tax are payable (recoverable).

Based on the above requirements of IAS 12, the Board understands that, current tax expense is the amount which has been or will be assessed to be due for the period under the income tax laws. Any amount paid during the year to taxation authorities, in excess of such amount is a prepayment or advance payment of current tax of future periods. Therefore, in the light of the requirements of the Income Tax Ordinance, 2001, further analysis is required to ascertain whether minimum tax for a period under section 113 of the Income Tax Ordinance, 2001 can be regarded as the tax due for the reporting period or not.

Section 113(1) of the Income Tax Ordinance, 2001 outlines that minimum tax is payable where due to a tax loss for the year, the setting off of a loss of an earlier year, exemption from tax, the application of credits or rebates, or claiming of allowances or deduction:

- no tax is payable or paid by the person for a tax year; or
- the tax payable or paid by the person for a tax year is less than the minimum tax.

Section 113(3)(c) outlines that where the amount of minimum tax due for the period exceeds the amount of tax based on taxable income, the excess amount of tax paid shall be carried

forward for adjustment against tax liability for five tax years immediately succeeding the tax year for which the amount was paid.

The Board noted that from the above it is clear that the amount of minimum tax paid for a year can only be recovered:

- through adjustment against tax liability of future years;
- to the extent of tax liability of future years which is excess of minimum tax for that year.

Therefore, the Board noted that the amount of minimum tax for a period is the amount of tax due for the period in terms of definition of current tax provided in IAS 12 as the amount of tax payable to taxation authorities in any tax year cannot fall below the minimum tax. Accordingly, the Board understands that amount of minimum tax due for a period cannot be regarded as prepayment of current tax for future years.

With regards to the deferred tax implications of minimum tax, the Board noted section 113(3)(c) provides that where the amount of minimum tax due for the period exceeds the amount of tax based on taxable income, the excess amount of tax paid shall be carried forward for adjustment against tax liability for five tax years immediately succeeding the tax year for which the amount was paid.

The recoverability of minimum tax is contingent upon availability of taxable profits in future years resulting in a tax liability which is in excess of minimum taxes for those years. The Board understood that this recoverability feature of minimum taxes renders it to be a tax credit under IAS 12.

The Board observed that the term tax credit is not currently defined in IAS 12. In March 2009, International Accounting Standards Board (IASB) issued Exposure Draft (ED)/2009/2 Income Taxes. The ED contained proposals by the IASB for an International Financial Reporting Standard (IFRS) on income tax to replace IAS 12. The IASB undertook this project for two reasons. First, it had received many requests to clarify various aspects of IAS 12. Second, IASB and US Financial Accounting Standards Board (FASB) agreed to consider the accounting for income tax as part of their work to reduce differences between IFRSs and US generally accepted accounting principles (GAAP).

The ED proposed to include definition of the term tax credit which was converged with the definition provided by US SFAS 109 Accounting for Income Taxes. The proposed definition is reproduced below:

“Tax credit is a tax benefit that takes the form of an amount that reduces income tax payable”

The rationale for including definition of tax credit was explained in paragraph BC24 of the ED as follows:

“IAS 12 does not define the terms tax credit or investment tax credit. It excludes from its scope the accounting for investment tax credits, and prescribes different accounting for tax credits and tax deductions. This has led to questions about how some tax benefits should be classified. The exposure draft proposes definitions of tax credit and investment tax credit that converge with US GAAP. The Board acknowledges that the definitions focus on the way in which the tax authorities express the benefit. Because similar economic benefits could be expressed as either tax credits or tax deductions, this means that similar economic benefits may be accounted for in different ways. The Board concluded that it was beyond the scope of this project to include a comprehensive reconsideration of the accounting for tax credits and tax deductions. Nonetheless, clear definitions would make the new IFRS easier to use by removing doubt over the required treatment for tax benefits.”

However, the proposals contained in ED could not be finalized by the IASB and IAS 12 was retained with certain limited amendments. Accordingly, the definition of the term tax credit could not be included in the IFRS standards.

Further the Board observed, a taxation regime similar to minimum taxes under section 113 of the Income Tax Ordinance, 2001, also exists in US, which is called 'Alternative Minimum Tax (AMT)'. Under AMT, an entity has to pay tax for an amount equal to higher of the:

- tax based on taxable profits at regular corporate tax rate; or
- Alternative minimum tax based on a certain percentage of turnover.

Similar to minimum taxes under section 113 of the Income Tax Ordinance, the amount of AMT paid in excess of tax based on taxable income at regular tax rate can be carried forward and adjusted against normal tax liability of future years. SFAS 109 regards this tax benefit under AMT a 'tax credit' as it fulfills its definition that it is a tax benefit that takes the form of an amount that reduces income tax payable. Therefore, paragraph 17(d) and (e) of SFAS 109 require an entity to recognise a deferred tax asset for carry forward of tax benefit for AMT.

Therefore, the Board understands that based on the IASB's proposals contained in the ED, the term tax credit although not defined in IAS 12 is principally converged with the definition of this term in SFAS 109. Further, SFAS 109's treatment of carryforward tax benefit under AMT, which is substantially similar to minimum tax regime of Pakistan, reflects that tax benefit of minimum taxes under section 113 of the Income Tax Ordinance, 2001 is a tax credit in terms of IAS 12.

Paragraph 34 of IAS 12 requires that a deferred tax asset shall be recognised for the carryforward of unused tax losses and unused tax credits to the extent that it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilized.

Accordingly, the Board noted that a deferred tax asset should be recognised for the amount of minimum tax paid for a period in excess of tax based on taxable income subject to the probability of availability of future taxable profits against which the unused tax losses and unused tax credits can be utilized.

Based on the above analysis and discussion, the Board concluded that:

- The minimum tax levied under section 113 of the Income Tax Ordinance, 2001 should be recognized as current tax expense, in accordance with paragraphs 12 and 58 of IAS 12.
- A deferred tax asset should be recognised for the amount of minimum tax paid for a period in excess of tax based on taxable income subject to the probability of availability of future taxable profits against which the unused tax losses and unused tax credits can be utilized in accordance with paragraph 34 of IAS 12.

*(Issued in July, 2020)*

## 1.2 Accounting of Customer Contribution for Infrastructure under IFRS 15 *Revenue from Contracts with Customers*

### Brief facts of enquiry:

The Accounting Standards Board (the Board) received following enquiries related to the accounting of customer contribution received by a utility company (the Company), under IFRS 15 *Revenue from contracts with customers*.

- A. What shall be the timing of revenue recognition for customer contributions for construction of infrastructure (i.e. a pipeline required for the supply of gas by the Company).
- B. What shall be the timing of revenue recognition under following specific arrangements of customer contributions for infrastructure assets required for the supply of gas:
  - a) Arrangement for laying of a service line for a domestic consumer (customer).
  - b) Arrangement with the industrial consumer (customer) for laying of pipeline and transport of gas under the OGRA Gas (Third Party Access Rules), 2018.
  - c) Arrangement with the housing society for construction of network infrastructure in the housing society.
- C. How would the transitional requirements of IFRS 15 apply to contracts for customer contribution for construction of infrastructure that have been previously accounted for under IFRIC 18 *Transfers of Assets from Customers*.

### Opinion:

The Board based on the specific enquired fact pattern discussed the requirements of IFRS 15 on following matters:

#### Enquiry (A): Revenue recognition from customer contribution for construction of infrastructure

The Board noted that the infrastructure development/construction is an essential and fundamental function for the fulfillment of the Company's objectives i.e. supply of gas to customers whether domestic, commercial or industrial.

For scoping of enquired fact pattern under IFRS, the Board noted that contributions i.e. unconditional transfers of cash or asset in a voluntary non-reciprocal transfer, are scoped out of IFRS 15. Whereas exchange transactions (i.e. a reciprocal transaction in which two parties exchange items of commensurate value) are within the scope of IFRS 15.

In the enquired fact pattern, customer funds the infrastructure cost (cost of pipeline and necessary equipment) as part of an arrangement to obtain a connection to the Company's network for the gas supply. The term 'customer' is defined in IFRS 15 as a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration. Accordingly, the Board noted that the arrangement between the Company and its customers would be within the scope of IFRS 15.

### Application of IFRS 15

At contract inception, for each performance obligation, an entity applies the criteria in paragraph 35 of IFRS 15 to determine whether it recognizes revenue over time. If criteria of paragraph 35 are not met, then entity recognizes revenue at point in time in accordance

with provisions of paragraph 32. Before applying paragraph 35, an entity applies paragraphs 22-30 in identifying as a performance obligation, each promise to transfer to the customer a good or service that is distinct.

The entity assesses whether each of such goods or services is distinct in accordance with paragraph 27 of IFRS 15. The assessment under the criteria in paragraph 27 involves judgement. Under paragraph 27, a good or service promised to a customer is distinct if:

- a) the customer can benefit from the good or service on its own or together with other resources readily available to the customer (i.e. the good or service is capable of being distinct); and
- b) the entity's promise to transfer the good or service is separately identifiable from other promises in the contract (i.e. the promise to transfer the good or service is distinct within the context of the contract).

In assessing whether an entity's promises to transfer goods or services to the customer are separately identifiable, the objective is to determine whether the nature of the promise, within the context of the contract, is to transfer each of those goods or services individually or, instead, to transfer a combined item or items to which the promised goods or services are input.

The Board while analyzing the enquired matter noted that the information shared by the enquirer (relating to customer's funding of infrastructure development) contains following main features:

- Customer submits an application for 'Gas Connection' to the Company.
- Pursuant to a separate correspondence of the Company (issued under customer's application for gas connection) the customer is requested to fund the necessary infrastructure (e.g. pipeline). This correspondence specifies that a proposal letter for individual connection would be issued after the supply main has been laid and commissioned. The terms also specify that the Company will retain full authority to give connection from the laid infrastructure to any other customer also at its sole discretion. Further, it also specifies that for gas supply a separate agreement would be signed between the Company and the customer.
- In context of the customer funding for infrastructure, a 'Gas Purchase Agreement' between the Company and customer is entered into, further to the above correspondence. This agreement mainly spells out the Company's obligation to construct the infrastructure with customer funded amount and the Company's right to own and operate this infrastructure.
- Subsequent to the above agreement a separate 'Contract for Supply of Gas' is entered into between the Company and customer.

The Board based on the fact pattern mentioned in the enquiry and documentary information shared by the Company, noted that:

a) In accordance with paragraph 27 of IFRS 15, the Company's gas connection to the customer and laying of infrastructure through customer funding would be separate performance obligations if these are distinct, i.e.:

- if a customer can obtain economic benefits from the pipeline on its own or with other available resources; and
- the Company's promise to transfer the good or service is separable from other promises



under the contract(s) with customer.

b) The underlying 'promise' with a customer is to provide a gas connection, which in certain cases is provided subsequent to the laying of infrastructure. Construction of the infrastructure is a necessary activity for ensuring supply of gas.

c) The arrangement between the Company and the customer involves different activities at different timelines. However, primary objective of all these arrangements and activities remains the same, i.e., to provide/obtain gas supply. This clearly exhibits that the distinct good or service from the customer's perspective would be obtaining gas supply through laid pipeline and gas connection.

d) The Company under the arrangement is responsible to provide combined output i.e. required to integrate the pipeline and customer's gas connection in order to fulfill the principal objective/envisaged activity i.e. supply of gas. In entirety, the Company has promised the customer for gas supply through a gas connection. It provides a significant service of integrating the connection to the network and on-going supply. The Company is responsible to provide combined output i.e. connection to the network and ongoing supply of gas.

e) Importantly, in the enquired scenario supply of gas to a customer is highly dependent on the construction of a pipeline and the gas connection. There is two-way dependency, the Company cannot provide ongoing service (i.e. gas supply) without the connection to the network and the customer cannot benefit from the connection without the ongoing services.

f) Therefore, a customer funds cost of infrastructure to establish a connection with the Company's network, as a prerequisite to obtain gas supply from it. In such arrangements, the only performance obligation of the Company is to supply gas to the customer. Accordingly, all other promises/activities of the gas Company including constructing a pipeline (through customer funding or own resources) are part of gas supply arrangement

The Board concluded that in the enquired fact pattern:

a) Construction of infrastructure with customer's funded amount and supply of gas to such customer are not 'distinct' performance obligations, under paragraph 27 of IFRS 15.

b) Revenue recognition of the entire arrangement should be 'over time', in accordance with paragraph 35 of IFRS 15. The over-time revenue recognition should be based on the estimated period, the Company expects to supply gas to the customer. However, owing to nature of arrangement (i.e. difficulty in estimating the time period over which gas supply would be made to customer), the revenue recognition could be over the useful life of the customer funded pipeline.

#### **Enquiry (B): Consideration of the Company's special arrangements involving customer contributions for construction of network infrastructure**

##### **a) Arrangement for laying of service-line and supply of gas to domestic customers**

The Board, based on the information provided in the enquiry, noted that a domestic customer initially applies for a gas connection. However, in certain cases, as part of the gas connection arrangement customer also pays the Company for the cost of laying a service-line. This service-line is required to establish a connection with the Company's main-line and ultimately obtain gas supply from it.

In this arrangement, similar to Enquiry (A) above, the economic interest of a customer lies in obtaining gas connection and gas supply from the Company. The performance obligation of the

Company is to supply gas to the customer and all other promises/activities of the Company including construction of service-line (through customer funding or own resources) are part of ensuring supply of gas.

The Board based on the particular fact pattern of the arrangement for laying of service line and supply of gas to domestic customers concluded that:

a) The arrangement, in context of the identification of performance obligation under IFRS 15, is similar to the above arrangement discussed in detail under Enquiry A (above). Laying of a service-line with customer funded amount and subsequent provision of a connection and gas supply are not 'distinct' performance obligations.

b) Revenue recognition for the customer funded amount for construction of a service-line should be 'over time', based on the useful life of the related service-line, as explained in paragraph 8 (b) above.

**b) Arrangements with the industrial customers for laying of pipeline and transport of gas under the OGRA Gas (Third Party Access Rules) 2018**

The Board observed that under OGRA Gas (Third Party Access Rules) 2018 other entities can independently sell gas to customers in Pakistan after having transported it through their own infrastructure or through the infrastructure of the SSGC or SNGPL.

Based on the scenario shared by the enquirer, an industrial customer may be able to obtain economic benefits by funding the infrastructure cost to the Company and subsequently, obtaining gas supply from another third-party gas supplier, if such industrial customer:

- Enters into an arrangement with the Company for funding/construction of a pipeline, only without entering into gas supply contract with the Company;
- Enters into a gas supply contract with another third party gas supplier; and
- Obtains gas supply from another third party, transported through the Company's network/infrastructure.

However, conclusion on whether a customer's ability to obtain supply of gas from a supplier other than the Company under OGRA Gas (Third Party Access Rules) 2018, would make the construction of network as a distinct service under paragraph 27 of IFRS 15, requires an independent assessment of all the pertinent facts and circumstances of that case. The Board (based on the research of Technical Services Department) noted that current practices and scale of operations of third party gas suppliers and arrangements (if any) do not indicate that industrial customers, in general, can readily and conveniently replace the gas supply of the Company with third party gas supplier(s).

The Board based on the above discussion concluded that:

a) In current gas supply market, an industrial customer cannot obtain economic benefits from the infrastructure without obtaining gas supply from the Company. The Board is of the view that the construction of infrastructure and availability of gas supply to the industrial customers, in general, are not 'distinct' performance obligations, in accordance with IFRS 15.

b) Revenue recognition for the funds received by customers for infrastructure development should be over time, as discussed in (b) above.

**c) Arrangement with housing societies for construction of network infrastructure and supply of gas to household owners**

IFRS 15 outlines that promised goods or services in a contract may include granting rights to goods or services to be provided in future that a customer can resell or provide to its customers.

The Board based on the information provided in the enquiry and related information noted that the Company enters into two different types of arrangements with the housing societies:

a) **Arrangement I:** Under this arrangement, a housing society submits a gas supply application to the Company. The Company pursuant to this application enters into an arrangement with a housing society under which funds are provided by the housing society to the Company for laying of infrastructure.

b) **Arrangement II:** The Company enters into an arrangement with a housing society under which infrastructure is developed by housing society and transferred to the Company on completion. The Company is engaged by a housing society for supervision of the network being constructed by the housing society.

In both of the arrangements, infrastructure is transferred to the Company upon completion. The Company, after entering into both of the above arrangements, enters into separate contracts with the individual customers for gas connections as per its standard sales procedures.

The Board concluded that in the enquired fact pattern:

a) The only performance obligation of the Company is to provide gas connections and gas supply to customers that have/will have properties in such housing societies. The laying of infrastructure from funds of the housing society or obtaining control of infrastructure developed by housing society are necessary for supplying gas to individual customers. In such arrangements, as discussed in detail under enquiry (A) above, the performance obligations are not 'distinct'.

b) Revenue recognition against the funds received from customers for infrastructure development should be 'over time', in accordance with the principal discussed in (b) above.

**Enquiry (C): Application of transitional requirements of IFRS 15 on contracts with customers that were previously accounted for under IFRIC 18**

Under this enquiry, the Board's comments were requested on whether:

♣ Contracts with the customers for construction of/connection with the network infrastructure, for which the revenue has already been recognised in past under IFRIC 18, meet the definition of 'completed contracts' under the transitional provisions of IFRS 15; and

♣ Revenue already recognised by the Company for such contracts under IFRIC 18, need to be restated on transition to IFRS 15.

The Board noted that in the enquired matter, it is important to understand and assess the appropriateness of the Company's accounting policy for recognition of revenue from customer contributions for construction of infrastructure assets, under IAS 18, Revenue and IFRIC 18.

IFRS 15 defines a 'completed contract' as a contract for which the entity has transferred all of the goods or services identified in accordance with IAS 11 *Construction Contracts*, IAS 18, Revenue and related Interpretations. For the completed contracts, IFRS 15 provides transition

related practical expedients.

The Board noted that under IFRIC 18, if only one service was identified in a contract with a customer, revenue was to be recognised when such service was performed. Conversely, if more than one separately identifiable goods or services were identified, the fair value of the total consideration received (or receivable) for the agreement was to be allocated to each good or service. In such a case, the revenue recognition criteria of IAS 18 were to be applied to each good or service, separately.

Further, for an ongoing service rendered by an entity, the revenue recognition period would have to be determined by the terms of the agreement with the customer. However, if the agreement does not specify a period, revenue recognition would be over a period no longer than the useful life of the transferred asset used to provide the ongoing service.

In context of application of IFRIC 18, a key factor for the determination of separately identifiable services would be that whether construction of a pipeline with customer funding and connection to the network represent 'stand-alone value' for that customer. In this regard, based on the explanation provided in IFRIC 18 and the research of the Technical Services Department, the Board noted that two alternative views existed regarding the performance obligation(s) and their fulfilment:

- Pipeline constructed with customer funding has a stand-alone value independent of gas supply; or
- Pipeline constructed with customer funding has no stand-alone value as it is part of gas supply arrangement.

The Board observed that the new revenue standard i.e. IFRS 15 contains comprehensive guidance on identifying separate components, which applies to all revenue-generating transactions. Comparatively, IAS 18 and IFRIC 18 contained very limited discussion and guidance on the determination of whether a transaction contains separately identifiable components. The limited guidance could be a reason for the above alternative views. Management was required to exercise judgement and apply a consistent accounting policy for the determination of identifiable/distinct goods or services while applying IFRIC 18.

The Board concluded that in the context of the enquired matter, arrangements involving customer contributions for network infrastructure for which the revenue has already been completely recognised in prior years under IFRIC 18, meet the definition of 'completed contracts' under IFRS 15. The Company can accordingly consider the transitional requirements of IFRS 15 for completed contracts.

*(Issued in July, 2020)*

### 1.3 Classification of Interest Bearing Subordinated Loan by an NBFC

#### Brief facts of enquiry:

The Accounting Standards Board (the Board) received an enquiry wherein a Non-Banking Finance Company (NBFC) requested guidance about the classification of interest-bearing subordinated loans as 'equity' or 'liability' under the provisions of Non-Banking Finance Companies (Establishment and Regulation) Rules, 2003 and the applicable accounting and reporting standards.

#### Opinion

The Board noted that an NBFC is required to prepare statutory financial statements in accordance with the requirements of the:

- International Financial Reporting Standards (IFRS Standards) as adopted by Securities & Exchange Commission of Pakistan (SECP) under the Companies Act, 2017 (Companies Act);
- Provisions and directives of the Companies Act;
- Non-Banking Finance Companies (Establishment and Regulation) Rules, 2003 (NBFC Rules); and
- Non-Banking Finance Companies and Notified Regulations, 2008 (NBFC Regulations).

Further, where requirements of NBFC Rules, NBFC Regulations and Companies Act differ from IFRS Standards, such requirements shall prevail over the IFRS Standards.

The Board observed that clause (xix) of Rule 2 of the NBFC Rules provides an 'inclusive' definition of equity. This definition includes subordinated loans as a component of equity. On the other hand, the NBFC Rules do not define a financial liability.

The Board also noted that Rule 7(d) of NBFC Rules requires an NBFC to comply with the requirements of IFRS Standards notified under the Companies Act. The Board accordingly observed that for statutory financial reporting purposes, IFRS Standards would determine the classification of a subordinated loan (either as equity, liability or a compound instrument).

Under the IFRS Standards, IAS 32 *Financial Instruments: Presentation*, deals with the classification criteria of a subordinated loan as debt or equity.

IAS 32 does not classify a financial instrument between equity and financial liability on the basis of its legal form. Instead, it considers the substance of the financial instrument, and applies the definitions to the instrument's contractual rights and obligations.

Based on the classification criteria set forth for financial liability and equity under IAS 32, a subordinated loan would fulfill the classification criteria of equity if it does not include:

- Any contractual obligation to deliver cash or another financial asset to another entity; or
- Contractual obligation to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the NBFC. and;

If the contract will or may be settled in NBFC's own equity instruments, it is:

- a non-derivative that includes no contractual obligation for the NBFC to deliver a variable number of its own equity instruments; or;

- a derivative that will be settled only by the NBFC exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments.

In principle, the specific terms and conditions of each subordinated loan agreement (i.e. substance rather than form) would determine the classification of a subordinated loan as equity or liability under IAS 32.

An NBFC while applying IFRS Standards would generally classify a subordinated loan as a financial liability as it would be required to settle the principal and interest through transfer of economic resources (i.e. cash). A mere subordination of a loan to all the other indebtedness and payment of interest and principal in compliance with equity and capital adequacy requirements, do not overcome the definition and classification conditions of a financial liability of IAS 32.

The Board (based on the Technical Services Department's limited review of the audited financial statements of a sample of NBFCs) also noted that as a general practice, NBFCs classify their subordinated loans as financial liability or equity in accordance with the requirements of IAS 32.

The Board concluded that an NBFC while preparing statutory financial statements under the Companies Act should apply the requirements of IFRS Standards to classify a subordinated loan as equity or liability (or a compound instrument).

*(Issued in July 2020)*

## 1.4 Determination and Reassessment of Discount Rate under IFRS 16 *Leases*

### Brief facts of the enquiry:

The Accounting Standards Board (the Board) received following enquiries relating to the application of IFRS 16 *Leases*:

- Whether discount rate shall be reviewed / reassessed at any specific time, other than at the time of lease modification?
- Whether existing leases are subject to re-measurement in case of change in interest rates by the State Bank of Pakistan (SBP) under the monetary policy?
- Whether a company shall re-assess discount rate at a specific frequency, when as a practical expedient a single discount rate is used for a portfolio of leases?

### Opinion:

The Board based on the enquired fact pattern discussed the following matters:

A. Requirement for reassessment / review of discount rate under IFRS 16

B. Impact of changes in SBP policy interest rate on the discount rate under IFRS 16

C. Frequency of reassessment of discount rate for leases measured using portfolio approach under IFRS 16

#### A. Requirement for reassessment / review of discount rate under IFRS 16

The Board noted that IFRS 16 outlines specific scenarios (paragraphs 40 - 43 and 45 of IFRS 16) under which a lessee shall re-measure the lease liability using a revised discount rate.

These scenarios, in addition to lease modification, include:

- a change in the lease term;
- a change due to reassessment of an option to purchase the underlying asset;
- a change in amount payable under residual value guarantee; and
- a change in floating interest rates.

#### B. Impact of changes in SBP Policy Interest Rate on the discount rate under IFRS 16

The Board observed that a mere change in the policy interest rate by the SBP would not require reassessment of the discount rate or re-measurement of existing lease liability. However, the Board noted that if the change in policy interest rate by the SBP results in a change in the floating rate used to determine lease payments, then the lessee would be required to use revised discount rate and accordingly re-measure the lease liability.

#### C. Frequency of reassessment of discount rate for leases measured using portfolio approach

The Board noted that IFRS 16 as a practical expedient permits that its requirements can be applied at a portfolio level (i.e. leases with similar characteristics). Accordingly, an entity can establish and apply a single discount rate to all leases in a portfolio, provided that using single discount rate would not result in a materially different answer than using a discount rate determined for each individual lease.

The Board also noted that under the portfolio approach any reassessment or review of discount rate shall be required under the scenarios outlined in paragraph 1, above.

Moreover, in such a case a lessee would also be required to assess whether the specific circumstances triggering reassessment of discount rate and re-measurement of lease liability are relevant for the entire lease portfolio as a whole or for any particular lease within that portfolio. Where the specific circumstances are valid only for a particular lease within the portfolio then such lease shall be singled out and excluded from the portfolio and a revised discount rate shall be determined for re-measurement of that particular lease only.

*(Issued in August 2020)*



### 1.5 Clarification on Uniformity of Accounting Policies under IAS 28 *Investment in Associates and Joint Ventures*

#### Brief facts of the enquiry:

The Accounting Standards Board (the Board) received a request to share its comments on an application filed by a company for exemption from IFRS 9 *Financial Instruments*.

In the enquired fact pattern, the enquirer is required to prepare statutory financial statements in accordance with the accounting and reporting standards as applicable under the Companies Act, 2017 (the Companies Act). Further, the enquirer is an associated company of a licensed Non-Banking Finance Company (herein after referred to as “the associated NBFC”).

The enquirer also submitted that:

- Under the Companies Act, IFRS 9 is applicable from July 01, 2019. However, Securities & Exchange Commission of Pakistan (SECP), through S.R.O. 273(I)/2020 (dated March 30, 2020) has deferred the effective date of IFRS 9 for NBFCs. IFRS 9 is applicable to NBFCs from June 30, 2021 (while earlier application is permitted).
- The associated NBFC is not applying IFRS 9 as it has availed the above noted deferment granted by SECP.
- The enquirer is required to account for the associated NBFC (being an associated entity) under the equity method of accounting of IAS 28 *Investment in Associates and Joint Ventures*. IAS 28 requires that the associate’s financial statements shall be prepared using uniform accounting policies for like transactions and events in similar circumstances.
- As associated NBFC has availed a statutory relaxation (from IFRS 9), application of IFRS 9 by enquirer would make its accounting policy different from its associated NBFC.

The enquirer based on above scenario submitted that exemption from the application of IFRS 9 be allowed to the enquirer.

#### Opinion:

The Board noted that the enquirer, in its separate financial statements, has elected to account for its associated NBFC by using the equity method as described in IAS 28.

The Board noted that paragraph 35 of IAS 28 requires that an associate’s financial statements shall be prepared using uniform accounting policies for like transactions and events in similar circumstances.

Paragraph 36 of IAS 28 explains that if an associate uses accounting policies other than those of the entity for like transactions and events in similar circumstances, adjustments shall be made to make the associate’s accounting policies conform to those of the entity when the associate’s financial statements are used by the entity in applying the equity method.

The Board observed that the enquirer while preparing its statutory financial statements is required to apply IFRS 9. The Board also noted that the enquirer requested for exemption from IFRS 9 on the basis that IFRS 9 exemption is available to the enquirer’s associated company (which is a NBFC).

The Board noted that, in Pakistan, State Bank of Pakistan (SBP) and SECP being the banking sector and corporate regulators, respectively, have granted various general and sector specific exemptions/deferments from IFRS requirements.

The Board observed that, there could be a situation where a particular company could be availing a regulatory exemption/relaxation from IFRS requirement, however, other group companies or investor of such company are not exempted and thereby required to follow the relevant IFRS requirement.

For the preparation of consolidated financial statements or separate financial statements (where equity method of accounting is applied), the above-noted situation raises the issue of uniformity of accounting policies. For example, in a group that includes a power sector company and a banking company, the power sector company would be required to follow IFRS 9 while the bank is presently not required to apply IFRS 9.

In context of the uniformity of accounting policies under the above scenario, based on a limited research of audited statutory financial statements of companies, the Board noted that adjustments for uniformity of accounting policies for like transactions and events are not made with regards to the statutory exemptions/deferments from IFRS requirements.

The Board observed that the benefit of relaxations/exemptions from IFRS requirements granted to a certain company should be considered while preparing consolidated financial statements or separate financial statements (where equity method of accounting is applied). Accordingly, when a specific accounting policy of a company is based on the SECP/SBP granted exemption then the investor or parent of such a company should not be required to apply uniform accounting policy for like transactions or events.

In all other cases, the parent or an investor (applying equity method of accounting) should make adjustments to the financial information of their subsidiaries or associates for uniformity of accounting policies.

The Board also recommended that SECP for the purpose of clarity and common understanding of all stakeholders, may consider issuing a directive to disseminate above views.

The Board concluded that in the submitted fact pattern:

(a) The enquirer while preparing separate financial statements should apply IFRS 9 to the transactions and events pertaining to it.

(b) Since, the associated NBFC has availed relaxation from the requirements of IFRS 9 under the Companies Act, and its accounting policy is based on such statutory relaxation, the enquirer while applying the equity method in its separate financial statements is not required to apply uniform accounting policy by making adjustments to the associated NBFC's accounting policy (that is based on a statutory relaxation).

*(Issued in September, 2020)*

## 1.6 Clarification on the Applicability of SECP's S.R.O 986(I)/2019

### Brief facts of the enquiry:

The Accounting Standards Board (the Board) received enquiries regarding:

- A. Scope of exemption from IFRS 16 *Leases*, under S.R.O 986(I)/2019; and
- B. Accounting of capitalized exchange losses under exemption from IAS 21 *The Effects of Changes in Foreign Currency*

### Opinion:

The Board based on the enquired fact pattern discussed the following matters:

- Whether, pursuant to the S.R.O 986(I)/2019, lease arrangements for the land of the project (where power plant is constructed), office premises and branch are exempt (or not) from the application of IFRS 16.

In this regard the enquirer submitted three alternate views:

- **View A:** All lease arrangements of the power project, including land, office premises and branch office are exempt.
- **View B:** The project asset's which are specifically mentioned in the PPA, such as land are exempt. However, lease arrangements for other assets such as office premises and branch office, are not exempt.
- **View C:** Lease arrangements of land, office premises and branch office are not exempt.
- Whether the exchange losses capitalized under the exemption from IAS 21 granted vide S.R.O 986(I)/2019 can be depreciated/amortised over the tenure of the loan (rather than over the life of the asset).

### A. Scope of exemption from IFRS 16 *Leases*, under S.R.O 986(I)/2019

The Board recognised that the exemption from IFRS 16 (granted through S.R.O. 986(1)/2019) is in perspective of the power generation arrangement i.e. the Power Purchase Agreement (PPA), between a power producer and a power purchaser. Relevant part of the S.R.O. 986(1)/2019 is reproduced hereunder:

*"IFRS 16 (Leases) to the extent of the power purchase agreements executed before the effective date of IFRS 16 i.e. January 1, 2019."*

(Emphasis is ours)

The Board noted that the exemption from IFRS 16 'to the extent of the power purchase agreement' for a power producer would cover the circumstances where:

- a) Lease arrangement is the PPA;
- b) Power producer is a lessor under such PPA;
- c) Power purchaser is a lessee under such PPA; and
- d) Power producer has conveyed the right of use of assets (generally complex/power generation facility) to the power purchaser against the capacity invoices.

On the other hand, all other arrangements where power producer is either a lessee or a lessor are not exempt under the above-mentioned S.R.O.

The Board based on the above discussion concluded that the scope of exemption from IFRS 16 under S.R.O. 986(1)/2019 only includes those assets which have been leased by a power producer to a power purchaser (i.e. customer) under the PPA (executed before January 1, 2019) against the capacity invoices.

#### **B. Accounting of capitalised exchange losses under exemption from IAS 21 *The Effects of Changes in Foreign Exchange Rates***

The Board noted that the exemption from the requirements of IAS 21 (granted through S.R.O. 986(1)/2019) is to the extent of capitalization of the exchange differences related to foreign currency long-term loans and related interest.

Relevant part of the S.R.O. 986(1)/2019 is reproduced hereunder:

*“International Accounting Standard 21 (The Effects of Changes in Foreign Exchange Rates) to the capitalisation of exchange differences.”*

The Board noted that exchange losses pursuant to above relaxation are capitalised in the items of property, plant and equipment.

The Board also noted that IFRS (i.e. IAS 16 *Property, Plant and Equipment*) outlines the principles for recognition and depreciation of property, plant and equipment.

Cost of an item of property, plant and equipment besides purchase price, may include various other components such as duties, borrowing costs, site restoration costs etc.

Paragraph 50 of IAS 16 requires an item of property, plant and equipment (asset) to be depreciated over its useful life.

IAS 16 defines the useful life of an asset as (emphasis added) ‘the period over which an asset is expected to be available for use by an entity; or the number of production or similar units expected to be obtained from the asset by an entity’.

Importantly, depreciation is not based on or aligned with the liability incurred in acquiring the asset, rather it is based on the pattern in which the asset is used.

The Board based on the limited review of financial statements of power sector companies (done by the Technical Services Team) noted that companies capitalize the exchange losses (under the exemption from IAS 21) in the carrying amount of property, plant and equipment, and are depreciating such amounts over the life of the related asset or term of the PPA.

The Board also considered it pertinent to discuss and explain the relevant background information about the exemption from IAS 21. This exemption was initially granted by SECP in the backdrop of certain revisions in the repealed Companies Ordinance 1984. SECP made those revisions in 2004.

Prior to those revisions, under the repealed Companies Ordinance 1984, companies were allowed to include exchange differences (gain/losses relative to the foreign currency borrowings out of the proceeds of which assets were acquired) in cost of respective fixed assets. The fixed assets were depreciated as per depreciation policy. However, SECP removed the provision of capitalisation of exchange differences from the corporate law. All companies, consequently, were required to charge exchange differences in the profit and loss account in accordance with IAS 21. However, subsequently, SECP on the request of power producer

companies granted the exemption by allowing capitalisation of foreign exchange losses which otherwise are not allowed under the IFRS.

Relevant part of the fourth schedule related to 'Fixed Assets' of the repealed Companies Ordinance 1984 (which was applicable prior to 2004) is as under:

*“Any exchange, gain or loss in any year, as a consequence of fluctuations in rate of exchange, relative to the foreign currency borrowings out of the proceeds of which assets were acquired may be added to or deducted from the value of the respective assets and where such addition or deduction is made, the amount thereof under each sub-head shall be disclosed together with the depreciation policy therefor.”*

The Board also observed that under IAS 23 *Borrowing Costs*, the exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs are one of the examples of borrowing costs. These exchange differences can be capitalised as borrowing costs incurred on a qualifying asset. Importantly, such capitalised exchange differences are depreciated over the life of the qualifying asset, rather than over the tenure of related foreign currency borrowing.

The Board based on the above discussion concluded that the exchange differences on foreign currency borrowings capitalised in the carrying value of asset (under the exemption from IAS 21 granted through S.R.O. 986(I)/2019) should be depreciated over the period the related asset is expected to be available for use to company. Therefore, the depreciation/amortization should not be based on the tenure of the borrowing.

*(Issued in September 2020)*

## 1.7 Applicability of IFRS 10 on Modaraba Management Companies and Modarabas

### Brief facts of the enquiry:

The Accounting Standards Board (the Board) received enquiries regarding:

- A. Application of IFRS 10 requirements to a modaraba management company and modaraba; and
- B. Preparation of consolidated financial statements by modaraba management company under the Companies Act, 2017.

### Opinion:

The Board based on the enquired fact pattern discussed the following matters:

- Considering the typical structure of modaraba management companies in Pakistan, where these are required to hold 10% units of modarabas and charge management fees up to 10% of profits of modarabas (i.e. total stake of 20% in modaraba):
  - Whether modaraba management companies fulfill the requirements of 'control' as given under IFRS 10?
  - What should be the acceptable benchmark (i.e. 20% or more) when a modaraba management company assesses its control over a modaraba?
- If a modaraba management company meets the requirements of 'control' under IFRS 10:
  - Can it be construed that the directives of the Companies Act override the requirements of IFRS 10 and treat a modaraba management company and modaraba as associates, only; and require modaraba management company and modaraba(s) to submit separate financial statements, and hence override the requirements of IFRS 10 for consolidation of modaraba and modaraba management company?

### A. Application of IFRS 10 requirements to a modaraba management company and modaraba

Paragraph 6 of IFRS 10 states that *“an investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.”*

The Board noted that in context of the submissions shared in the enquiry, under IFRS 10 a modaraba management company having control over a modaraba, would be required to prepare consolidated financial statements.

The Board noted that based on paragraph 7 of IFRS 10 a modaraba management company would have control of a modaraba if it has all the following elements:

- (a) Power over the modaraba;
- (b) Exposure, or rights, to variable returns from its involvement with the modaraba; and
- (c) The ability to use its power over the modaraba to affect the amount of its returns.

The Board noted that the three elements are cumulative, therefore absence of any element fails the control assessment.

The Board also noted that, in general, two elements i.e., (a) power over the modaraba, and

(b) exposure or rights to variable returns from its involvement with the modaraba, appear to be present between a modaraba management company and modaraba.

**(a) Power over the modaraba:** The Board noted that under the regulatory framework applicable to modarabas and modaraba management companies, the power to manage the affairs of a modaraba rests solely with the modaraba management company. The board of directors of modaraba company performing the governance role, approve all major decisions relating to operating and financial policies of modaraba. Further, the key management personnel of the modaraba is appointed by and accountable to the board of directors of the modaraba management company.

**(b) Exposure, or rights, to variable returns from its involvement with the modaraba:** The Board observed that under IFRS 10, variable returns are returns that are not fixed and have the potential to vary as a result of the performance of an investee.

With regards to a modaraba management company, in general, it obtains following returns in the capacity of a management company and investor.

*Dividend:* Modaraba management company is required to hold at least 10% of total modaraba certificates at all times. Accordingly, modaraba management company would earn dividend income at par with the other modaraba certificate holders.

*Management fee:* Modaraba management company is entitled to a remuneration for the management services rendered up to a maximum of 10% per annum of the net annual profits of the modaraba, under the statutory framework.

The management fee and dividend on investment of a modaraba management company are linked to performance and profit of modaraba, therefore are variable returns in accordance with IFRS 10.

**(c) The ability to use its power over the modaraba to affect the amount of the modaraba management company's returns:** The third element of control (paragraph 17 of IFRS 10) is the link between power and returns. This is reflected by an investor's ability to use its power over an investee to affect the amount of the investor's returns. This involves assessing whether an investor acts as a principal or an agent.

The Board noted that in the enquired matter, the key factor would be modaraba management company's ability to use its power over the modaraba to affect the amount of its returns (i.e. variability of returns).

Paragraph B60 of IFRS 10 explains that all of following factors are to be considered in assessing if an investor acts as a principal or an agent:

- (a) the scope of the decision maker's authority over the investee;
- (b) the rights held by other parties, including substantive removal rights;
- (c) the remuneration to which the decision maker is entitled; and
- (d) the decision maker's exposure to variability of returns from other interests it holds in the investee.

The factors consider the nature of the decision-maker's rights and its incentives to act primarily on its own behalf or on behalf of others.

In terms of IFRS 10, two of the above factors are determinative regardless of other indicators;



(a) a single party holds substantive kick-out rights; (b) the decision maker's remuneration is not commensurate with the services provided. While judgment is required in assessing the other factors for determination of relationship between modaraba management company and modaraba.

In the context of modaraba management company and its relationship with modaraba, the Board observed that:

**(a) The scope of the decision maker's authority over the investee:** The modaraba management company has decision-making authority and the ability to undertake the relevant activities of the modaraba within the regulatory parameters. The affairs of the modaraba are governed by the board of directors of the modaraba management company.

**(b) the rights held by other parties, including substantive removal rights:** The modaraba certificate holders do not hold any substantive rights to remove the modaraba management company. The modaraba certificate holders can redeem their certificates within particular limits set by the governing documents of modaraba. The modaraba certificate holders also do not have the power to modify the investment/lending mandate or windup the modaraba.

**(c) the remuneration to which the decision maker is entitled:** Modaraba management company is entitled to a fee for management of modaraba (up to a maximum of 10% of the modarabas annual net profit), and is considered to be commensurate with the level of services.

**(d) the decision maker's exposure to variability of returns from other interests it holds in the investee:** The existence of this factor would depend on the particular facts and circumstances of each modaraba management company.

The Board while analyzing the exposure to variability of returns, in context of the enquired fact pattern noted that investment of 10% along with a 10% management fee exposes the modaraba management company to 20% variable return (i.e. economic interest).

The Board noted that:

Although paragraphs B72 of IFRS 10 note that a greater magnitude of economic interest is associated with a greater likelihood of the investor acting as a principal. However, IFRS 10 through paragraphs BC141 and BC142 makes it clear that for determination of principal/ agent no quantitative threshold of variability of returns exists.

IFRS 10 also contains Application Guidance, and the examples 13 to 15 of this guidance indicate that the decision-maker needs to consider all relevant factors to determine control.

IFRS 10 does not specify any quantitative benchmarks/thresholds (i.e. percentages of economic interest) that are conclusive evidence for determining control of an investee. However, IFRS 10 through Application Examples at least indicate to the IASB's thinking, possibly narrowing the range for level of aggregate economic interest in which judgement about significance of exposure to variability of returns has to be made.

In the application example 14A of IFRS 10, an investor despite extensive decision-making authority to direct relevant activities of the fund, but with exposure to 22% variability of economic interest is considered to be an agent. In context of the enquired matter, modaraba management company's aggregate variable economic interest of 20% is below 22%. As per the guidance provided in IFRS 10 (through Application Examples), this exposure to variability of economic interest indicates that the modaraba management company is an agent.

On the other hand, IFRS 10 in the Application Example 14B, explains that an investor having



37% variable economic interest is considered a principal (the 37% variable return is based on 20% direct investment, 1% fee, and 20% of profits if a specified profit level is achieved). Example 14B also notes that *“having considered its remuneration and the other factors, the fund manager might consider a 20% investment to be sufficient to conclude that it controls the fund. However, in different circumstances (i.e. if the remuneration or other factors are different), control may arise when level of investment is different.”*

The Board also observed that under the statutory provisions, 10% investment by a modaraba management company in the modaraba is the minimum level of investment. A modaraba management company with higher level of investment in the modaraba, could be a principal, based on the principle outlined in IFRS 10. The relevant facts and circumstances of each case must be carefully considered, to conclude on whether a modaraba management company's exposure to variability of returns is of significance leading to establishment of principal relationship with the modaraba.

The Board, based on the information provided in the enquiry and above discussion, concluded that:

(a) IFRS 10 provides three elements of control and absence of any element fails the control assessment.

(b) IFRS 10 does not specify any quantitative benchmarks/thresholds (i.e. percentages of economic interest and variability) that are conclusive evidence for determining control of an investee. The decision-maker needs to consider all relevant factors to determine control.

(c) Based on guidance provided in the IFRS 10 and more specifically the Application Examples 14A and 14B, a modaraba management company's 10% investment in modaraba and 10% management fee do not appear to create exposure to variability of returns of such significance to conclude that it controls the modaraba.

Modaraba management companies with higher level of investments in modarabas (more than minimum 10% investment in modaraba) or other interests, would have higher exposure to variability of returns. In such cases, the variability of returns and other factors, could result in establishing control of a modaraba.

### **B. Preparation of consolidated financial statements by modaraba management company under the Companies Act**

The Board noted that differing views could exist on the requirement to prepare consolidated financial statements by a modaraba management company under the Companies Act.

IFRS 10 adopted by SECP, determines whether an investor is required to consolidate an interest in an investee. IFRS 10 is part of the financial reporting framework applicable to a modaraba management company. While, the Companies Act also specifies financial reporting requirements for the preparation of consolidated financial statements. Further, the Companies Act also contains a specific section related to the financial statements of modarabas and modaraba management companies.

The Board also observed that it is well understood that the provisions of Companies Act and other statutory laws that are applicable to modaraba management company and modaraba override the requirements of IFRS.

In context of the enquired matter, the divergent views primarily originate from varied understanding of the definitions and statutory requirements of the Companies Act. Therefore, the enquired matter is primarily a legal matter rather than an accounting matter.

The requirement to prepare consolidated financial statements by a modaraba management

company (under the Companies Act) in essence results from differences between IFRS and the Companies Act. The Companies Act and IFRS have different definitions/concept of 'Associated companies/undertakings', 'Holding company' and 'Subsidiary', and criteria for determination of control.

The Board observed that the financial reporting framework should guide and determine the applicability of accounting principles and basis of preparation of financial statements for companies/entities. Based on this principle, the requirements and guidance contained in IFRS 10 should be followed for determination of control and preparation of consolidated financial statements. This approach would eliminate the departures from IFRS requirements and would also ensure common understanding and application of financial reporting provisions.

Application of IFRS with additional disclosures, when necessary, is presumed to result in financial statements that achieve fair presentation.

Accordingly, the Board concluded that:

(a) IFRS 10 is a part of the financial reporting framework applicable to modaraba management company. However, specific provisions/directives of statutory law override the requirements of the applicable financial reporting framework.

(b) In principle, the applicable financial reporting framework should determine the application of accounting principles and basis of preparation of financial statements of entities. This approach would eliminate the departures from IFRS and would also ensure common understanding and application of financial reporting provisions. Based on this principle-based approach, the requirements and guidance contained in IFRS 10 should be followed.

(c) In view of the provisions of the Companies Act, the requirement to prepare consolidated financial statements by a modaraba management company is primarily a legal matter rather than an accounting matter. Varied understanding and differing views on the enquired matter can be eliminated by following the above principle-based approach to financial reporting.

*(Issued in September 2020)*

## 1.8 Recognition of Deferred Tax Liability/Asset under IAS 12 *Income Taxes* by a Company Paying Minimum Tax

### Brief facts of the enquiry:

The Accounting Standards Board (the Board) received an enquiry wherein the Board's guidance had been sought on the recognition (or non-recognition) of deferred tax asset/liability under IAS 12 *Income Taxes*, in a specific fact pattern where a company expects to pay only minimum tax (under section 113 of Income Tax Ordinance, 2001) for a foreseeable future.

### Opinion:

The Board observed that under the Income Tax Ordinance, 2001, entities that pay 'minimum tax' (under section 113) are allowed to carryforward the minimum tax paid in excess of normal income tax liability. This carryforward of minimum tax is for a period of five (5) years, and is available to reduce normal tax of future years but not below minimum income tax liability of such future year.

The Board noted that IAS 12 defines deferred tax liability as the amount of income tax payable in future periods in respect of taxable temporary differences.

IAS 12 paragraph 15 sets out the principle that deferred tax liability should be recognised for all taxable temporary differences, except the following circumstances:

- (a) on the initial recognition of goodwill; or
- (b) on the initial recognition of an asset or liability in a transaction which:
  - (i) is not a business combination; and
  - (ii) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).

Therefore, the Board noted that above listed circumstances are the only exceptions when deferred tax liability is not required to be recognised. In all the other circumstances, deferred tax liability is required to be recognised for taxable temporary differences.

With regards to the deferred tax asset, the Board noted that under IAS 12, it could be recognised on account of:

- (a) Deductible temporary differences
- (b) Carry forward of unused tax losses
- (c) Carry forward of unused tax credits

With regards to the recognition of deferred tax asset, paragraph 34 of IAS 12 requires an entity to recognise a deferred tax asset only to the extent it is probable that future taxable profit will be available against which the deferred tax asset can be utilized and recovered.

Paragraph 37 of IAS 12, requires reassessment of deferred tax assets at the end of each reporting period.

Further, the Board noted that application guidance on above requirements of IAS 12 pertaining to recognition of deferred tax liability/asset, in the circumstances where a company only pays minimum tax under section 113 of the Income Tax Ordinance, 2001 is also covered under

section 3.0 of TR 27. Paragraphs 3.1 and 3.3 of TR 27 are reproduced below:

*“In case in a particular year, current tax liability is calculated under provisions of Section 113 due to taxable loss the effect of temporary differences should be calculated and deferred tax liability/ asset should be recognized.”*

*“A deferred tax asset should be recognized for the carry forward of unused tax losses and unused tax credits (as allowed under the provisions of the Income Tax Ordinance, 2001) to the extent that it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilized.”*

Accordingly, the Board understands that guidance contained in TR 27 can be applied in the circumstances where a company expects to pay only minimum taxes for foreseeable future.

In the submitted fact pattern, the Board noted that:

- (a) Temporary differences can arise regardless of the fact that the company expects to pay only minimum taxes in the foreseeable future. This is because the determination of tax profit or loss and tax bases of assets and liabilities is the prerequisite for determining whether or not the company is required to pay minimum tax under section 113 of the Income Tax Ordinance, 2001.

Such taxable temporary differences also do not fall under the exceptions outlined in paragraph 15 of IAS 12 (consequent to which entities are not required to recognise a deferred tax liability).

- (b) The timing of reversal or ability to delay reversals for the foreseeable future does not alleviate the requirement to establish a deferred tax liability.
- (c) An assumption inherent in an entity's statement of financial position is that the reported amounts of assets and liabilities will be recovered and settled.
- (d) It cannot be predicted that an entity will always be a minimum tax taxpayer.
- (e) Also it would be counterintuitive to assume that an entity would permit its minimum tax credit carryforward to expire unused, which would have to occur if that entity was always a minimum tax taxpayer.

Based on the above discussion, the Board concluded that in the submitted fact pattern, a company is required to:

- (a) recognise deferred tax liability for all the taxable temporary differences regardless of the fact that the company expects to pay only minimum taxes in the foreseeable future.

Further, since the company would be required to compute the taxable temporary differences and recognise deferred tax liability, therefore, the company would need to determine the tax profit or loss and maintain record of tax bases of its assets and liabilities.

- (b) consider recognition of deferred tax asset on its deductible temporary differences, carryforward of unused tax credits and losses. The company shall recognise a deferred tax asset only to the extent it is probable that future taxable profit will be available against which the deferred tax asset can be utilized and recovered.

*(Issued in November 2020)*

## 1.9 Measurement of Unfunded Gratuity Scheme under *IFRS for SMEs*

### Brief facts of the enquiry:

The Accounting Standards Board (the Board) received following questions relating to measurement of an unfunded gratuity scheme, under *IFRS for SMEs* Standard:

- Whether a medium-sized company is required to perform actuarial valuation in respect of its unfunded gratuity scheme; and
- Whether the actuarial valuation of un-funded gratuity scheme has to be performed by an independent third party actuary.

### Opinion:

Paragraph 28.9 of *IFRS for SMEs* Standard outlines that post-employment benefits include retirement benefits and other post-employment benefits. It further states that arrangements whereby an entity provides post-employment benefits are post-employment benefit plans. An entity shall apply this section to all such arrangements whether or not they involve the establishment of a separate entity to receive contributions and to pay benefits.

Post-employment benefit plans are classified as either defined contribution plans or defined benefit plans, depending on their principal terms and conditions.

As explained in paragraph 28.10 of the *IFRS for SMEs* Standard, under defined benefit plans, the entity's obligation is to provide the agreed benefits to current and former employees, and actuarial risk (that benefits will cost more or less than expected) and investment risk (that returns on assets set aside to fund the benefits will differ from expectations) are borne, in substance, by the entity.

The Board considered that in accordance with paragraph 28.15 of *IFRS for SMEs* Standard, an entity shall measure a defined benefit liability for its obligations under defined benefit plans at the net total of the following amounts:

- (a) the present value of its obligations under defined benefit plans (its defined benefit obligation) at the reporting date (paragraphs 28.16-28.22 of *IFRS for SMEs* Standard provide guidance for measuring this obligation), minus
- (b) the fair value at the reporting date of plan assets (if any) out of which the obligations are to be settled directly (paragraphs 11.27-11.32 of *IFRS for SMEs* Standard establish requirements for determining the fair values of those plan assets that are financial assets).

Further, a company shall measure its defined benefit obligation on a discounted present value basis.

The Board noted that paragraph 28.18 of *IFRS for SMEs* Standard specifies the requirement for the performance of actuarial valuation by an entity in order to measure its defined benefit obligation and the related expense under its defined benefit plans. The paragraph requires the entities to use the projected credit method to perform the valuation where the entity has the ability to use the said actuarial valuation method without undue cost or effort.

However, paragraph 28.19 provides that where an entity is not able, without undue cost and effort, to use the projected unit method to measure its obligation and cost under defined benefit plans, the entity is permitted to make the following simplifications in measuring its defined benefit obligation with respect to current employees:

- (a) ignore estimated future salary increases (i.e. assume current salaries continue until current employees are expected to begin receiving post-employment benefits).

(b) ignore future service of current employees (i.e. assume closure of the plan for existing as well as any new employees).

(c) ignore possible in-service mortality of current employees between the reporting date and the date employees are expected to begin receiving post-employment benefits (that is assume all current employees will receive the post-employment benefits). However, mortality after service (life expectancy) will still need to be considered.

An entity that takes advantage of the foregoing measurement simplifications must nonetheless include both vested benefits and unvested benefits in measuring its defined benefit obligation.

The Board noted that *IFRS for SMEs* Standard contains the concept of 'Undue cost or effort'. However, this term is not defined in the *IFRS for SMEs* Standard. The Board understands that it will depend on the entity's specific circumstances and management's professional judgement in assessing the costs and benefits. That assessment should include a consideration of how the economic decisions of the users of the financial statements could be affected by the availability of the information. Applying a requirement would result in 'undue cost or effort' because of either excessive cost or excessive endeavors by employees in comparison to the benefits that the users of the SME's financial statements would receive from having the information.

With regards to the question that who could perform actuarial valuation, paragraph 28.20 of the *IFRS for SMEs* Standard clarifies that there is no mandatory requirement for the appointment of an independent actuary for the purpose of valuation of its defined benefit plans.

*"This IFRS does not require an entity to engage an independent actuary to perform the comprehensive actuarial valuation needed to calculate its defined benefit obligation. Nor does it require that a comprehensive actuarial valuation must be done annually. In the periods between comprehensive actuarial valuations, if the principal actuarial assumptions have not changed significantly the defined benefit obligation can be measured by adjusting the prior period measurement for changes in employee demographics such as number of employees and salary levels."*

(Emphasis is ours)

The Board noted that the *IFRS for SMEs* Standard aims at appropriate and accurate valuation of an entity's defined benefit plans in accordance with projected unit credit method or a simplified method, as applicable, which may be performed internally or through a third party. The Board noted that the management on the basis of its professional judgement may opt to perform the actuarial valuation internally or through an independent expert, as may be fit for the achievement of appropriate and accurate valuation of the defined benefit plan in its financial statements.

Based on the above discussion, the Board concluded that in accordance with *IFRS for SMEs* Standard:

(a) Unfunded gratuity scheme is a defined benefit plan. A company:

- Where it is able to do so without undue cost and effort, it should use the projected unit credit method to measure its obligation for the gratuity scheme; or
- Where undue cost or effort is involved, it can measure the obligation for the gratuity scheme under the simplified approach (as explained in paragraph 28.19 of *IFRS for SMEs* Standard).

(b) The actuarial valuation is not mandatorily required to be performed by an independent third party actuary (as explained in paragraph 28.20 of *IFRS for SMEs*).

(Issued in November 2020)

## 1.10 Implications of IFRS 16 on Aviation Industry

### Brief facts of the enquiry:

The Accounting Standards Board (the Board) received an enquiry, wherein, the enquirer highlighted the significant adverse impact of change in foreign currency exchange rates related to lease liabilities under IFRS 16 *Leases* on the financial statements of the Company (operating in aviation industry) and requested the Board to consider following measures to address the same:

- A. Issuance of Technical Release by the ICAP to define right-of-use asset as a monetary item so that impacts of foreign currency translations of right-of-use asset and lease liability offset each other;
- B. Issuance of Technical Release by the ICAP to allow recognition of foreign exchange gain/(loss) on translation of lease liabilities over the lease term;
- C. Deferment of adoption of IFRS 16 for aviation industry; or
- D. Issuance of any other Technical Release to provide relief to the aviation industry.

### Opinion:

The Board noted that IFRS 16 requires that the right-of-use asset should be measured at cost model or revaluation model.

IFRS 16 in its Basis of Conclusions (paragraphs BC196-BC199) explains that:

- Any foreign currency exchange differences relating to lease liabilities denominated in a foreign currency should be recognised in profit or loss; and
- Subsequent changes to a foreign exchange rate should not have any effect on the cost of a non-monetary item i.e. right-of-use asset.

In other words, lease liability would be revalued through profit and loss at the current exchange rate (similar to a foreign currency loan) while the right-of-use asset would remain at the historical exchange rate (similar to an item of property, plant and equipment).

The Board observed that paragraph 23 of IAS 21 *Effect of Changes in Foreign Exchange Rates*, explains that at the end of reporting period the:

- a) Foreign currency monetary items shall be translated using the closing rate;
- b) Non-monetary items that are measured in terms of historical cost in a foreign currency shall be translated using the exchange rate at the date of transaction.

Paragraph 16 of IAS 21 outlines that right-of-use asset is a non-monetary asset as this right does not contain any right to receive a fixed or determinable number of units of currency.

The Board noted that the Financial Accounting Standards Board (FASB) of USA also issued the new leasing standard i.e. Accounting Standards Codification (ASC) 842. In context of the nature of right-of-use asset and the possible impact of exchange rate changes on the right-of-use asset, paragraph 842-20-55-10 of ASC 842 explains that:

- The right-of-use asset is a non-monetary asset;



- Lease liability is a monetary liability; and
- The lease liability is re-measured using the current exchange rate, while the right-of-use asset is measured using the exchange rate as of the commencement date.

The Board also noted that International Air Transport Association (IATA) formed an Industry Accounting Working Group (IAWG) for developing application guidance on IFRS 16.

In its publication (titled IATA Industry Accounting Working Group Guidance IFRS 16, *Leases*) IATA also explained that right-of-use asset is a non-monetary asset and foreign exchange rate changes would only impact the lease liability.

This publication also highlighted and discussed the adverse effects of exchange rate movement and resultant management of foreign currency mismatch. It noted that there are a number of viable approaches to eliminating or minimizing the foreign exchange volatility created in the financial statements (by IFRS 16).

The Board noted that in general, it is understood that businesses are likely to be exposed to foreign exchange risk/s arising from volatility in the currency markets.

The Board considered that changes in foreign exchange rate (US dollar to Pakistan Rupee) are market driven, affecting all entities in Pakistan. The IFRS Standards contain accounting guidance on the financial risk management, and accordingly expect entities to properly identify, anticipate and manage volatility in equity and the income statement through financial risk management objectives and strategies. In this regard, companies that are reporting under IFRS can use different techniques, including hedging to safeguard against unfavorable foreign currency risks. Accordingly, under IAS 21, the presentation of a foreign currency liability in functional currency provides relevant information to users about measurement and level of economic resources to settle the obligation. Further, the exchange losses arising on the translation of foreign currency lease liabilities are an indicative of the performance of the company, and are accordingly reported in the statement of profit or loss.

The Board noted that changes in a reporting entity's economic resources and claims result from that entity's financial performance. Information about a reporting entity's financial performance helps users to understand the return that the entity has produced on its economic resources. In this regard, the statement of profit or loss is the primary source of information about an entity's financial performance for the reporting period.

In view of above, it is important to reflect the adverse impact of translation of foreign currency lease liabilities in the statement of profit or loss as this has resulted from events and conditions during the year, representing possible outflow of economic resources in Pakistan Rupees, and impacting company's returns adversely.

The Board observed that the ICAP issues Accounting Technical Releases (TRs) on matters that have relevance and implications on financial accounting and reporting at wider-scale, and such matters are not explained in the financial reporting framework. Fundamentally, a Technical Release while explaining an accounting requirement cannot be in conflict with the requirements of IFRS Standards.

The Board also noted that based on the requirements and explanations contained in IFRS Standards, including IFRS 16 and IAS 21, adequate basis and guidance is available to company to determine the required accounting. Further, there is no evidence that a widespread financial reporting problem exists.

The Board noted that IASB, in the exposure draft of IFRS 16 as well as in the final issued standard, has discussed the matter of accounting of exchange losses related to lease liabilities.



The IASB standard-setting is based on the areas where wide-spread implications are noted across various jurisdictions. In context of the enquired matter, IASB has already considered and concluded that the accounting of right-of-use assets should be principally similar to the items of property, plant and equipment.

The Board noted that no other entity, regulator or other stakeholder in Pakistan has raised this matter with the Board; therefore, the matter lacks the widespread and material effect (if any) on the entities reporting under IFRS Standards in Pakistan. Approaching IASB, accordingly, as suggested by the enquirer would not provide additional input or change in the requirements of the standard.

Based on the above analysis, the Board concluded that:

- (a) Under IFRS Standards, the right-of-use asset is a non-monetary asset.
- (b) In accordance with IFRS 16 as well as IAS 21, foreign currency exchange differences relating to lease liabilities (denominated in a foreign currency) should not be included in the carrying amount of the related right-of-use asset.
- (c) IFRS 16 provides sufficient guidance on accounting of foreign currency exchange impacts. IFRS 16 in its Basis of Conclusions provides detailed discussion and rationale for not allowing re-measurement of right-of-use asset due to change in foreign exchange rates. In consideration of requirements and discussion available in relevant IFRS Standards, Institute is not required to issue a Technical Release / Accounting directive.
- (d) In consideration of all the relevant factors, including guidance and requirements contained in IFRS Standards, approaching IASB and IFRIC for consideration of the Company's specific scenario would not be appropriate.
- (e) To ensure compliance with the accounting and reporting standards as applicable in Pakistan, company in context of the submitted matter should apply IFRS 16 and IAS 21 for measurement of right-of-use assets and lease liabilities.

*(Issued in November 2020)*

## 1.11 Change in Accounting Policy by an NBFC to Avail the Exemption from IFRS 9

### Brief facts of the enquiry:

The Accounting Standards Board (the Board) received an enquiry wherein the Board's guidance had been sought on whether a Non-Banking Finance Company (NBFC) that has applied IFRS 9 *Financial Instruments* in the year 2019 (accordingly prepared its financial statements for the year ended June 30, 2019 by applying IFRS 9), can in subsequent year avail the SECP granted deferment from IFRS 9. Therefore, reversing the impact of already applied IFRS 9 in its financial statements.

### Opinion:

The Board noted that IFRS 9 had been effective from July 01, 2019. However, SECP granted deferment from IFRS 9 to NBFCs, making it effective for NBFCs from June 2021.

In the submitted fact pattern, an NBFC has applied IFRS 9 in its prior year financial statements i.e. 2019. In the subsequent year i.e. 2020, this NBFC intends to avail the SECP granted deferment from IFRS 9, thereby reverse the impact of already applied IFRS 9.

The Board considered that under the IFRS Standards, IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, outlines the criteria for change in an accounting policy.

Relevant paragraph 14 of IAS 8 is reproduced here-under (emphasis added):

*“An entity shall change an accounting policy only if the change:*

*(a) is required by an IFRS; or*

*(b) results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows.”*

In accordance with the requirements of IFRS Standards, the accounting policies can only be changed if one of the above-mentioned criteria of IAS 8 is met.

The Board further observed that the NBFC's intention to change its accounting policy(ies) to avail benefit of SECP granted relaxation from the IFRS 9 does not appear to fulfill the criteria for change in accounting policy as outlined in IAS 8. Such criteria could only be met if an NBFC could justify that the application of IFRS 9 did not provide relevant and reliable information and change in accounting policy is required under paragraph 14(b) of IAS 8.

The Board considered it pertinent to highlight that certain NBFCs may have prepared and finalized their financial statements for June 2019 by applying IFRS 9, as SECP deferment notification from IFRS 9 was issued in November 2019. (SECP on the request of certain NBFCs notified the deferment from IFRS 9, on November 07, 2019).

The Board also noted that IFRS 9 could have significant implications for any NBFC, especially in context of the application of expected credit loss model on the financial assets. The Board also recognised that the objective of SECP for deferring the application of IFRS 9 for NBFCs is to provide sufficient time to NBFCs for effective implementation of IFRS 9. In consideration of this, SECP has granted deferment from IFRS 9 till June 30, 2021.

Based on above discussion the Board concluded that in context of the enquired matter:

a) A change in accounting policy by an NBFC (after applying IFRS 9 in the year 2019) to avail regulatory deferment from IFRS 9, does not seem to meet the criteria for change in accounting

policy as outlined in IAS 8.

b) However, SECP may under its regulatory powers allow an NBFC to avail regulatory relaxation/deferral of IFRS 9.

*(Issued in November 2020)*

## 1.12 Accounting Treatment of SBP's Temporary Economic Refinance Facility

### Brief facts of the enquiry:

The Accounting Standards Board (the Board) received an enquiry, wherein, the Board's guidance had been sought on the accounting of the Temporary Economic Refinance Facility (TERF) scheme introduced by the State Bank of Pakistan (SBP), under the IFRS Standards.

### Opinion:

The Board based on the submitted fact pattern, discussed the following matters:

- whether loan obtained under SBP introduced TERF scheme is at below-market interest, in accordance with IFRS 9 Financial Instruments; and
- whether below-market interest (if any) is a grant requiring accounting under IAS 20 Accounting for Government Grants and Disclosure of Government Assistance.

The Board noted that TERF scheme is a 'temporary' relief measure taken by the SBP in context of COVID-19 related economic situation and with the objective to provide stimulus to the economy by supporting new investment and BMR of the existing projects.

A key feature of the TERF scheme is that a borrower can obtain loan from a Participating Financial Institutions (PFI) for acquisition of plant and machinery at maximum mark-up rate of 5% per annum. While, SBP is providing refinance to PFIs at the service charge of 1% per annum.

The Board noted that the determination of whether mark-up rate is below-market (i.e. off-market) is judgmental and depends on specific facts, circumstances and terms of the arrangement. The off-market markup rate would be based on the comparison to a loan having similar characteristics (i.e. similar amount, purpose, currency, maturity, type of interest and collateral etc.).

In view of the KIBOR and data available about the lending rates, the TERF scheme markup rate of 5% (maximum) seems to be below the market rate. Based on this, together with the SBP's underlying nature and objective of the TERF scheme, the Board noted that a transfer of resources from the government to a borrower is taking place under the TERF scheme. This transfer of resources is reflected by below-market mark-up rate on the loan obtained under the TERF scheme, since the borrower does not need to pay mark-up to a PFI at market rate and SBP by funding at service charge rates of 1% per annum is foregoing interest income at prevailing market rate.

The Board noted that, in accordance with paragraph B5.1.1 of IFRS 9, the loan obtained under the TERF scheme from a PFI should be recognised at the fair value of loan. The fair value of the loan would be the present value of loan receipts discounted using prevailing market rates of interest for a similar instrument. In subsequent periods, the loan amount would be recognised using the effective interest method. Further, in accordance with paragraph 3.1.1 of IFRS 9 the loan would be derecognized when it is extinguished.

The Board also observed that IAS 20 applies to the accounting for, and the disclosure of, government grants and to the disclosure of other forms of government assistance. Paragraph 3 of IAS 20 defines 'government grants' as assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity. Government assistance is explained in IAS 20 as an action by government designed to provide an economic benefit specific to an entity or range of entities qualifying under certain criteria.

Government grants are recognized when there is reasonable assurance that: (1) the recipient will comply with the relevant conditions and (2) the grant will be received. When assessing whether 'reasonable assurance' exists, it is important to consider all facts and circumstances.

The Board observed that a loan obtained by a borrower under the TERF scheme contains a government grant under the requirements of IAS 20 due to the following:

- ♣ The TERF scheme, in substance involves transfer of resources from the government to the borrower since the objective is to provide cheaper finance to borrower. Accordingly, a borrower does not need to pay mark-up at market rate. The government is in substance foregoing interest income at prevailing market rate;
- ♣ A borrower availing the loan would also need to comply with certain conditions such as purchasing of imported/ locally manufactured new plant and machinery either for new or BMR of existing projects; and
- ♣ The above condition relates to the operating activities of a business.

Paragraph 10A of IAS 20 explains that the benefit of a government loan at a below-market rate of interest is treated as a government grant. The loan shall be recognised and measured in accordance with IFRS 9 Financial Instruments. The benefit of the belowmarket rate of interest shall be measured as the difference between the initial carrying value of the loan determined in accordance with IFRS 9 and the proceeds received. The benefit is generally accounted for and presented as deferred grant in accordance with IAS 20.

In context of loan obtained by a borrower under TERF scheme, the difference between the loan proceeds and fair value of the loan shall be recorded as 'deferred grant', in accordance with paragraph 10A of IAS 20.

The Board also noted that the recognition of government grant in profit or loss should be on a systematic basis over the periods in which the expenses for which the grants are intended to compensate. Under paragraph 29 of IAS 20, grants related to income should be presented either as a credit in the statement of profit or loss, either separately or under a general heading such as 'other income', or as a deduction of related expense.

The Board also noted that TERF scheme is not identical with the Export Refinance (ERF) as the latter is not a 'temporary' scheme. Rather, ERF scheme is an established scheme/product under which loans are provided at particular rate(s), importantly this mark- up rate is the market rate for obtaining funds under this particular product/scheme. There is no incremental resource provided specifically to one exporter, as compared to other exporter. Therefore, being a particular type of financing facility available to all businesses for export purposes, the mark-up rate is not below the market rate (rather it is the market rate) and hence does not contain an element of government grant.

Therefore, the Board concluded that the loan obtained under the TERF scheme by a borrower from a PFI should be:

- a) Initially recognised at its fair value in accordance with IFRS 9. The fair value of the loan would be the present value of loan proceeds received, discounted using prevailing market rate of mark-up for a similar instrument.

The benefit of below-market mark-up (i.e. differential between the loan proceeds and fair value of the loan) should be accounted for as deferred grant in accordance with IAS 20.

- b) In subsequent periods, the loan amount would be accreted using the effective interest rate method. The accreditation would increase the carrying value of the loan with a

corresponding effect on the interest expense for the year in the statement of profit or loss. As per IFRS 9, the loan liability and related mark-up shall be derecognized when it is extinguished i.e., these amounts are paid-off.

While, the grant should be recognised in statement of profit or loss, in line with the recognition of interest expense that the grant is compensating, in accordance with IAS 20.

*(Issued in November 2020)*

### 1.13 Accounting Treatment of Files of Plots in a Real Estate Project/Scheme

#### Brief facts of the enquiry:

The Accounting Standards Board (the Board) received following questions relating to accounting of 'files of plots' in a real estate project/scheme:

- i) Whether purchasing a file of a plot in a real estate project/scheme qualifies the recognition criteria for an asset, under the IFRS;
- ii) If the file is an asset, what shall be the classification of such asset;
- iii) In case a file is purchased on installment basis, then what shall be the initial recognition and subsequent measurement; and
- iv) In case the file is held for the purpose of sale what shall be the sale recognition criteria in case of sale of file in an ordinary course of business.

#### Opinion:

In the context of the submitted fact pattern, the Board discussed whether the 'file of a plot' would fulfill the definition and recognition criteria of an asset under the Conceptual Framework for Financial Reporting (the Framework), and the proper classification of such asset under the IFRS Standards.

The 'file of a plot' fulfills the definition of 'asset' outlined in the Framework.

File of a plot:

- is an economic resource, that gives company the right to obtain potential economic benefits (through sale of file to third party or through acquisition of plot);
- this economic resource is controlled by the company, as a result of its contractual right arising from the past event i.e. purchasing the file.

File of a plot being an asset should be recognised under the IFRS Standards. In the submitted fact pattern, the company is a real estate entity and is holding the files of plots for sale in its ordinary course of business. In such circumstances, file of a plot in a real estate project/scheme, in substance is inventory of company, and accordingly IAS 2 *Inventories*, would apply.

In the submitted fact pattern, in case company makes payments (on installment basis to the real estate developer/society) in accordance with the terms and conditions attached to holding the file, such payments should be accounted for as advance against inventory.

Where no further payments are due and risk and rewards related to the file of plot have been transferred to company, then the entire amount would be accounted for as inventory. Subsequently, inventory shall be measured in accordance with requirements of IAS 2.

In accordance with IFRS 15 *Revenue from Contracts with Customers*, company shall recognise revenue from the sale of file of a plot at the 'point of time' when the control over the promised good (i.e. file) is transferred from the company to the buyer.

IFRS 15 provides a list of indicators to consider when determining the point in time at which control passes to the customer, including but not limited to whether:

- the entity has a right to payment;
- the customer has obtained legal title to the asset;
- the entity has transferred possession of the asset to the customer;
- the customer has significant risks and rewards of ownership of the asset;
- the customer has accepted the asset.

Therefore, in the submitted fact pattern, the point of time where the control over the file of a plot in a real estate project/scheme is transferred from the seller (i.e. company) to a buyer shall be the revenue recognition point. The transfer of the control may be established when:

- the buyer is under an obligation to make the payment for the file;
- Company has transferred to the buyer significant risks and rewards of ownership of file and the company retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the file;
- The file is under the physical possession of the buyer;
- The buyer has the legal title to the file and possesses the legal right to acquisition of respective plot; and
- The buyer has provided acceptance over the acquisition of file.

*(Issued in November 2020)*



## 1.14 Accounting of Common Control Transactions

### Brief facts of the enquiry:

The Accounting Standards Board (the Board) received an enquiry, wherein, the Board's guidance had been sought on measurement of acquired assets and liabilities by a company in a common control group reorganization transaction in the light of the requirements of ICAP's draft Technical Release (draft TR) *Accounting for Common Control Transactions*.

In the submitted fact pattern, a Scheme of Arrangement (SoA) was executed between companies under common control in which one company (receiving company) received certain assets and liabilities from another associated company (transferred company). As a consideration for transfer of assets and liabilities by the transferred company, the parent company of the receiving company (parent company) cancelled its direct shareholding in the transferred company.

The receiving company, while accounting for the above transaction in its financial statements, measured the assets and liabilities received under the SoA at the value of parent company's cancelled shares. This value was calculated on the basis of proportionate net assets of the transferred company as reported in its consolidated financial statements.

The enquirer requested the Board to guide on the propriety of the accounting treatment adopted by the receiving company for measurement of assets and liabilities under the SoA.

### Opinion:

The Board noted that the submitted SoA is a common control transaction and IFRS Standards do not contain accounting requirements and guidance for common control transactions.

In the absence of accounting and reporting specific requirements of IFRS Standards, IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* requires that management should use judgement to develop an accounting policy, drawing from sources based on the following hierarchy:

- The requirements within other IFRS Standards which deal with similar and related issues;
- The definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the Framework;
- Pronouncements from other similar standard-setting bodies as well as other accounting literature and industry practice (to the extent they do not conflict with the above).

With regards to the draft Technical Release (draft TR) *Accounting for Common Control Transactions*, the Board noted that it was issued in June 2020, outlining guidance for accounting of common control transactions.

Paragraph 13 of the draft TR requires a receiving entity to account for a common control transaction by applying the 'Predecessor method', under which (emphasis added):

*"The receiving entity shall recognise the assets and liabilities of the transferred entity at their carrying amounts as reflected in the financial statements of the transferred entity, on the date of common control transaction. There shall be no:*

*(a) Fair-value adjustment to the assets and liabilities of the transferred entity; or*

*(b) Recognition of new assets and liabilities for the transferred entity."*

Further, paragraph 15 of the draft TR outlines that (emphasis added):

“In some instances, the court’s approved scheme/arrangement may also specify the amounts of the assets and/or liabilities or the methods to determine those amounts, of the transferred entity. In such circumstances, the receiving entity shall use such prescribed amounts and methods for accounting for the common control transaction under the predecessor method.”

The Board observed that the draft TR issued by ICAP sets-out recognition of assets and liabilities acquired/assumed by a receiving entity in a common control transaction at their respective carrying values as reflected in the financial statements of transferred entity.

Further, under the draft TR, in circumstances where a court order approving a scheme of arrangement prescribes the values of transferred assets and liabilities, then the receiving entity should recognise the assets and liabilities acquired/assumed at such carrying values.

In the context of the submitted fact pattern and information received from the enquirer, the Board noted that the Court Order of Honorable High Court of Sindh sanctioned SoA. Further, under the Court Order, the measurement was based on the carrying value of assets in the audited (standalone) financial statements of transferred entity for the year ended June 2018.

The Board also observed that as a result of the SoA, there is no change in the economic interest of the group from the pre-SoA position. Consequently, there is no dilution or increase in the economic interest of transferred entity’s shareholders in the investment.

Though the Board in consideration of enquirer’s specific request, analysed the matter under the draft TR, however, the Board also considered it important to highlight that the draft TR was issued by the ICAP for comments of general membership on June 8, 2020. Whereas, the subject SoA had the effective date of July 01, 2018 and accordingly, was accounted for in the financial statements of the Company for the year ended June 30, 2019. Further owing to the draft status of the TR, its requirements cannot be considered authoritative.

Based on above discussion and the specific request of the enquirer to consider the enquired matter under the draft TR, the Board concluded that:

- The receiving company, pursuant to the SoA being a common control transaction, would have accounted for the assets and liabilities acquired/assumed in its financial statements, at their respective carrying amounts (unless specific amounts are provided in the court order sanctioning the scheme).
- The respective carrying amounts would be determined on the basis of the amounts reflected in the financial statements of the transferred company, on the effective date of SoA.

*(Issued in November 2020)*

## 1.15 Guidance on the Implementation of IFRS 14 *Regulatory Deferral Accounts*

### Brief facts of the enquiry:

The Accounting Standards Board (the Board) received following enquiries and concerns related to the implementation of IFRS 14 *Regulatory Deferral Accounts*, from a listed utility company (the Company):

- a) Whether the application of IFRS 14 requirements are 'optional' for first time adopters of IFRS Standards?
- b) Whether IFRS 14 is only applicable on the first time adopters of IFRS Standards?
- c) Whether the differential margin/tariff adjustments of utility companies in Pakistan qualify to be treated as regulatory deferral account balances under IFRS 14?
- d) The application of IFRS 14 presentation requirements may distort overall presentation of financial statements and affect the stakeholder confidence.

### Opinion:

#### A. Whether the application of IFRS 14 requirements are 'optional' for first time adopters of IFRS Standards?

The Board noted that under IFRS Standards the regulatory deferral account balances do not meet the definition and recognition criteria for 'assets' and 'liabilities'.

However, under IFRS 14 *Regulatory Deferral Accounts*, an entity can recognise and present regulatory deferral account balances in its financial statements.

IFRS 14 outlines a 'Grandfathering approach' for the recognition and measurement of regulatory deferral account balances.

Paragraph 5 of IFRS 14 'permits' the entities to continue applying the previous generally accepted accounting policies (GAAP) to the recognition, measurement, impairment of regulatory deferral account balances on transition to full IFRS Standards.

While following the previous GAAP based accounting policies for the recognition and measurement of regulatory deferral account balances, the presentation and disclosure requirements of IFRS 14 should be followed.

The Board concluded that under IFRS 14:

- a) a first time adopter of IFRS Standards is 'permitted' to continue application of previous GAAP accounting policies for regulatory deferral account balances.
- b) If an entity does not avail this permission, then it cannot recognise regulatory deferral account balances in its financial statements.
- c) an entity is not permitted to change an accounting policy to start recognizing regulatory deferral account balances, or to recognise a wider range of such balances by modifying a previous GAAP policy.

#### B. Whether IFRS 14 is only applicable on the first time adopters of IFRS Standards?

The Companies Act, 2017 (the Companies Act) specifies the financial reporting requirements

for companies.

Under the Companies Act, the Securities & Exchange Commission of Pakistan (SECP), notified the adoption of IFRS 14, through S.R.O 1480/(I) of 2019 (dated November 27, 2019).

IFRS 14 is effective for annual periods beginning on or after July 01, 2019 for all companies that are required to follow the IFRS notified by SECP, under the Companies Act.

Relevant wordings of SECP notification are as under:

*“..... is pleased to notify that the International Financial Reporting Standard (IFRS) 14 - “Regulatory Deferral Accounts” and any further revisions issued by the International Accounting Standards Board shall be followed for the preparation of financial statements for the annual reporting periods beginning on or after 1st July 2019 by all classes of companies that are required by the Act to follow IFRS as notified by the Commission.”*

(Emphasis is ours)

The Board noted that paragraph 5 of IFRS 14 outlines that an entity is eligible to apply IFRS 14 only if it:

- a) conducts rate-regulated activities;
- b) accounted for regulatory deferral account balances in its financial statements immediately before the adoption of IFRS 14; and
- c) elects to apply requirements of IFRS 14 in its first IFRS financial statements.

It is to be noted that the Board and Institute while considering and recommending the adoption of IFRS 14 after due process, were cognizant to the fact that many Pakistani companies, noticeably, utility companies would be meeting the criteria noted in (a) and (b), above. However, these companies, in general, would not be preparing financial statements under full IFRS Standards. Rather, these would be preparing their statutory financial statements in accordance with the IFRS notified by SECP.

The Board observed that SECP has notified adoption and application of IFRS 14 for all companies that are preparing their financial statements in accordance with IFRS notified by SECP.

The Board with the objective to provide enhanced and common understanding to all stakeholders regarding the scope and application of IFRS 14 in Pakistan, suggested that SECP may consider issuing a clarification/guidance on the scope of IFRS 14 as it can be applied by companies that are preparing statutory financial statements under the Companies Act and not transitioning to full IFRS Standards.

The Board concluded that IFRS 14 can be applied by a company while preparing statutory financial statements under the Companies Act. Such a company for the preparation of statutory financial statements may:

- a) elect to apply the requirements of IFRS 14 in its first IFRS financial statements; or
- b) elect to apply the requirements of IFRS 14 in its financial statements prepared in accordance with the IFRS notified by SECP.

Importantly, if a company does not elect to apply IFRS 14 then it cannot recognise regulatory deferral account balances in its statutory financial statements.

**C. Whether the differential margin/tariff adjustments of Utility Companies qualify to be treated as regulatory deferral account balances under IFRS 14?**

The Board noted that the settlement mechanism of:

- a) shortfall in revenue requirement for indigenous natural gas; and
- b) both shortfall and surplus in revenue requirement of RLNG business,

provide for the adjustments in future tariffs as a part of determination of final revenue requirements.

Whereas, the settlement of the surplus in revenue requirement for indigenous natural gas is paid in cash to the Federal Government as the Gas Development Surcharge (GDS) under the Natural Gas (Development Surcharge) Ordinance, 1967. Since, the settlement mechanism of GDS does not fulfill the conditions of defined rate regulation under IFRS 14, therefore, GDS would be scoped in and accounted for under other applicable IFRS Standards.

The Board highlighted that its analysis and conclusion on the enquired matter is based on the settlement mechanism of the surplus or deficit in the revenue requirements as laid down in the Oil & Gas Regulatory Authority (OGRA) Ordinance, 2002 and the policy decisions of the Federal Government. Therefore, as part of its analysis and determination of accounting implications of the enquired matter, the Board had not considered any other possible settlement mechanisms for differential margin/tariff adjustments which are not currently provided under the existing regulatory framework. Therefore, any future decision of the Federal Government for an alternative settlement mechanism of differential margin/tariff adjustments would need to be considered and assessed separately considering its particular facts and features.

The Board concluded that the existing settlement mechanism of:

- a) shortfall in revenue requirement for indigenous natural gas; and
- b) both shortfall and surplus in revenue requirement of RLNG business,

in substance represents the defined rate regulation as envisaged under IFRS 14 and IASB's standard-setting project on the rate regulated activities.

**D. The application of IFRS 14 presentation requirements may distort overall presentation of financial statements and affect the stakeholder confidence.**

It is to be noted that the Board extensively approached all the relevant stakeholders for consultation purposes, prior to recommending the adoption of IFRS 14 to the SECP. The objectives of the Board's outreach and consultations were to create stakeholders' awareness and seek comments on IFRS 14.

The Board noted that the objective of IFRS Standards (including IFRS 14) is to report information that faithfully represents transactions and other events based on their economic substance. Moreover, Paragraph 15 of IAS 1 *Presentation of Financial Statements* states that financial statements shall present fairly the financial position, financial performance and cash flows of an entity. 14. The Board further explained that globally, utility companies engaged in rate regulated activities have effectively implemented IFRS 14. Based on the limited research of financial statements of few international rate regulated companies, it was noted that significant amounts of regulatory deferral account balances were reported in the financial statements consequent to adoption of IFRS 14.

The Board concluded that the specific presentation and disclosure requirements outlined in IFRS 14 would enable the users to have a more relevant understanding of the nature and financial impact of the regulatory deferral account balances of an entity in respect of its rate regulated activities. The Board also noted that a company in its financial statements may provide additional explanatory disclosures as permitted in IAS 1, to provide useful and relevant information to stakeholder's for understanding the impacts of IFRS 14.

*(Issued in February, 2021)*

## 1.16 Accounting of Periodic Overhauling / Maintenance Costs of Property, Plant and Equipment

### Brief facts of the enquiry:

The Accounting Standards Board (the Board) received an enquiry, wherein, the Board's guidance had been sought on accounting of major overhauling/maintenance costs incurred on the items of property, plant and equipment.

The enquirer submitted fact pattern of a company which uses the generators to produce electricity through gas and furnace oil. The generators have been designed in such a way that their periodic overhauling/maintenance is required after completing specific number of running hours.

The enquirer suggested that in order to avoid the full financial impact of this maintenance in the profit or loss of an individual reporting period, a yearly provision for periodic overhauling/maintenance costs should be recognized with recognition of a corresponding expense in the statement of profit or loss.

In this regard, guidance was sought on whether the company can create a yearly provision for periodic overhauling/maintenance costs under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

### Opinion:

In the context of the submitted fact pattern, the Board noted that guidance on the enquired matter is available in the relevant IFRS Standards, i.e. IAS 37, *Provisions, Contingent Liabilities and Contingent Assets* and IAS 16, *Property, Plant and Equipment*.

The Board noted that paragraph 10 of IAS 37 defines a 'liability' as a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. Further, IAS 37 also defines the 'provision' as a liability of uncertain timing or amount.

The Board further noted that paragraphs 4.28-4.29 of the *Conceptual Framework for Financial Reporting (the Conceptual Framework)* explain that the first criterion for a liability is that it should be an 'obligation'. The Conceptual Framework explains that obligation should be unavoidable, therefore it would obligate one party to transfer an economic resource, while another party will have a right to receive that economic resource.

Paragraphs 18-19 of IAS 37 explain that financial statements deal with the financial position of an entity at the end of its reporting period and not its possible position in the future. An entity does not have a liability for obligations that it could avoid through its future actions, even if those future actions are unrealistic. Therefore, provision is not recognised for costs that need to be incurred to operate in the future. The only liabilities recognised in an entity's statement of financial position are those that exist at the end of the reporting period.

The Board also observed that IFRS Interpretations Committee (IFRS IC) issued two interpretations: IFRIC 6 *Liabilities arising from Participating in a Specific Market—Waste Electrical and Electronic Equipment* and IFRIC 21 *Levies*. In both cases, the IFRS IC applied the guidance in paragraph 19 of IAS 37 and concluded that an entity does not have a present obligation if it could avoid the transfer through its future actions (irrespective of whether those actions are realistic).

In the enquired fact pattern, the periodic overhauling/maintenance costs are expected to be incurred after a certain period, and this cost has not been incurred yet. Accordingly, at



present, company has no obligation for this overhauling/maintenance cost and the counterparty (responsible for overhauling/maintenance services) has no right to receive the economic resources. Further, a cost that is expected to be incurred in future could also be avoided, for example by selling the generator without performing maintenance/overhauling or abandoning the use of the generator altogether or changing the terms of the arrangement.

The Board noted that IAS 16 deals with the recognition and measurement of items of property, plant and equipment, and in the context of enquired matter the requirements of IAS 16 are also relevant.

Paragraph 7 of IAS 16 states that the cost of an item of property, plant and equipment shall be recognised as an asset if, and only if:

- a) it is probable that future economic benefits associated with the item will flow to the entity; and
- b) the cost of the item can be measured reliably.

Paragraph 10 of IAS 16 requires an entity to evaluate the costs incurred in relation to the property, plant and equipment against the above noted recognition criteria.

The Board noted that under paragraph 14 of IAS 16, major inspections and overhauling should be identified and accounted for as a component of property plant and equipment if

- such major inspections and overhauling meet the recognition criteria of IAS 16 (noted above); and
- the component of property, plant and equipment is expected to be used over more than one period.

On the other hand, the costs of periodic overhauling/maintenance that do not fulfill the recognition criteria for capitalization (as property, plant and equipment) should be recognised as an expense in the statement of profit or loss, when incurred.

The Board based on the above discussion concluded that IFRS Standards provide sufficient guidance, and in the enquired fact pattern:

- a) In accordance with IAS 37, a provision for future overhauling and maintenance costs should not be recognised. There is no present obligation because no obligating event (overhauling and inspection) has taken place.
- b) In accordance with IAS 16, major overhauling/maintenance costs that meet the recognition criteria for property, plant and equipment are capitalised. While overhauling/maintenance costs that do not meet the recognition criteria should be recognised as an expense in the statement of profit or loss, when incurred.

*(Issued in March, 2021)*

### 1.17 Classification of Interest-Free Loans Repayable at the Discretion of the Borrowing Entity

#### Brief facts of the enquiry:

The Accounting Standards Board (the Board) received an enquiry, wherein, the Board's guidance had been sought on the classification of interest-free loans as financial liability or equity, which are:

- repayable at the discretion of the borrowing entity; and
- received from parties other than the entity's sponsors or directors (i.e. associated companies, related parties or unrelated third parties).

#### Opinion:

The Board noted that in the context of enquired matter, the accounting treatment of an intra-group loan is dependent on its terms and conditions (in particular on whether it has a fixed maturity or is repayable on demand) and whether the interest rate is at market or below market.

The Accounting Technical Release 32 (TR 32) *Accounting Directors' Loan* provides guidance on the measurement of intra-group loans. TR 32 is based on IAS 32 *Financial Instruments: Presentation*. Paragraph 2.1 of IAS 32 states that:

*'IAS 32 contains the principles for distinguishing between liabilities and equity issued by an entity.'*

Therefore, an entity is required to consider and apply requirements and principles outlined in IAS 32 for classification of a financial instrument as liability and / or equity.

The requirements of IAS 32 relating to classification of financial instruments do not distinguish between related party and unrelated party transactions.

Intra-group loans may be advanced on terms that are not at arms-length or are informal with unspecified terms. Such loans can also have features that expose the lender to risks that are not consistent with a basic lending arrangement.

In case the loans are not advanced on normal market terms, the actual terms, conditions and circumstances of the loan will determine their proper classification and measurement under IAS 32. Accordingly, the required accounting depends on the terms, conditions and circumstances of the loan.

The Board noted that entities need to determine the substance of the transfer of funds between entities in a group for determining their proper classification under IAS 32. In the separate financial statements of group entities, the nature of the transfer, based on its contractual terms and conditions, will determine if it is a capital contribution, deemed distribution or a loan in the scope of IFRS 9 *Financial Instruments*.

In certain cases, an intra-group loan may be payable at the discretion of the borrowing entity. In such a case, it could be either a capital contribution or financial liability depending on its contractual terms and conditions.

The Board considered that where a loan is between group entities other than a parent and subsidiary, the accounting treatment would require consideration of various factors, including assessment that whether transaction is carried out at the behest of the ultimate parent/controlling party.

The Board noted that while assessing the nature of the transaction (i.e., whether it is a contribution or a loan) the following considerations could be helpful in clarifying the nature of the transaction in absence of formal loan agreements:

- What was documented in the minutes of meetings and what is the mutual understanding of both entities?
- Have similar transactions in the past resulted in the lending entity demanding repayment?
- How have these balances been presented in prior year financial statements that have been approved by the directors?

The Board noted that under paragraph 15 of IAS 32, the issuer of a financial instrument is required to classify the instrument, or its component parts, on initial recognition as a financial liability, a financial asset or an equity instrument in accordance with the substance of the contractual arrangement and the definitions of a financial liability, a financial asset and an equity instrument.

The Board observed that the role of 'substance' in the classification of a financial instrument should be restricted to considering the instrument's contractual terms, and anything that falls outside the contractual terms should not be considered.

The Board noted that the principle for classification of a financial instrument as equity is outlined in paragraph 16 of IAS 32. Under this principle, the instrument is an equity instrument if, and only if, both conditions (a) and (b) below are met.

(a) The instrument includes no contractual obligation:

- to deliver cash or another financial asset to another entity; or
- to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the issuer.

(b) If the instrument will or may be settled in the issuer's own equity instruments, it is a non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments.

The Board highlighted that if the classification requirements of IAS 32 are considered in the context of an interest-free loan, then the sole determining factor for its classification as financial liability or equity would be the contractual repayment terms. The application of IAS 32 principles for classification of interest-free loan which is repayable at the discretion of either borrowing or lending entity are summarized in the below table:

| Classification with rationale   | Repayable at discretion of |        |
|---|----------------------------|--------|
|   | Borrower                   | Lender |
| <p><i>The loan fulfills classification criteria of equity instrument</i></p> <ul style="list-style-type: none"> <li>• The borrower has an unconditional right to avoid delivering cash or another financial asset to settle the contractual obligation.</li> <li>• The lender does not have an enforceable right to demand the repayment of loan before liquidation.</li> </ul> | ✓                          |        |

| Classification with rationale  | Repayable at discretion of |        |
|--|----------------------------|--------|
|  | Borrower                   | Lender |
| <p><i>The loan fulfills classification criteria of financial liability</i></p> <ul style="list-style-type: none"> <li>• The borrower has no unconditional right to avoid delivering cash or another financial asset to settle the contractual obligation.</li> <li>• The lender has an enforceable right to demand the repayment of loan at any time.</li> </ul> |                            | ✓      |

The Board based on the information provided along with the enquiry and its above discussion concluded that:

- (a) an issuer of a financial instrument is required to apply its judgement and assess in the light of requirements of IAS 32 as to whether a financial instrument should be classified and presented as a financial liability or equity.
- (b) If a loan is interest-free and repayable at discretion of the borrowing entity under the contractual terms, then from the borrowing entity's perspective, such loan does not fulfill definition of a financial liability under IAS 32. However, such a loan would meet the classification conditions of an equity instrument as outlined in paragraph 16 of IAS 32. Accordingly, such loan should be classified as equity in the issuing entity's statement of financial position.
- (c) If a loan is repayable any time at the discretion of the lending entity, then it fulfills the definition of a financial liability. Such a loan is in substance repayable on the demand of the lending entity, and accordingly, the borrowing entity shall record the full amount as a current liability.

*(Issued in March, 2021)*

## 1.18 Classification of Expense in the Income and Expenditure Account of a Public Sector Project

### Brief facts of the enquiry:

The Accounting Standards Board (the Board) received a submission from a public sector company requesting for a clarification on the proper classification of expenses.

In the fact pattern described in the enquiry:

- The public sector company carries out various projects.
- Financial statement (i.e. income and expenditure account) of a project includes certain expenses classified as 'advertisement/outreach plan expenses'.
- A stakeholder related to company, however, notes that those expenses should have been classified and shown as 'remuneration to consultant/HR', rather than as 'advertisement/outreach plan expenses'.

The submission, in view of stakeholder's observation, requested the Board to clarify whether expenses were appropriately and correctly classified as 'advertisement/outreach plan expenses' in the project's financial statement.

### Opinion:

The Board noted that government sector entities (other than companies registered under the Companies Act, 2017), generally prepare their financial statements in accordance with the New Accounting Model (NAM).

While, government sector companies that are registered under the Companies Act, 2017 prepare their financial statements in accordance with IFRS Standards or IFRS for SMEs.

The Board also observed that the financial statements of project are generally prepared in accordance with the special purpose financial reporting framework.

The Board observed that expenses can be classified by their 'nature' or 'function'.

The Board also observed that there are no bright line tests for determination of nature or function of an expense and hence, it requires exercise of professional judgement by the management of the reporting entity considering all relevant facts and circumstances of each case.

The Board based on the information provided in the submission noted that the income and expenditure account of the project has been prepared in accordance with the 'modified cash basis of accounting', which is a special purpose framework of financial reporting.

With regards to the enquirer's query regarding appropriate and correct classification of expense(s), the Board observed that this aspect is a matter of judgment considering all the relevant facts and circumstances of each case i.e. characteristics of goods or services obtained, nature of operations of reporting entities and contractual terms etc. A preparer of financial statements is required to evaluate and determine the proper classification of expense.

The Board also noted that it responds to the stakeholders' enquiries related to the application and interpretation of requirements of the general purpose financial reporting frameworks applicable in Pakistan. The financial reporting frameworks, including modified cash basis of

accounting, do not prescribe the basis for classification of a service between 'Remuneration to consultant/HR' expense or 'Advertisement/outreach plan' expense.

Determination of appropriate classification of any expense, therefore, is not a matter that involves application and interpretation of requirements of the applicable financial reporting framework. Rather, such a determination is a matter of factual assessment and judgement involving review and consideration of the contractual arrangements, scope of work and related deliverables, as noted above.

The Board, based on the information provided in the submission and above discussion, concluded that:

(a) a financial reporting framework (including cash or modified cash basis of accounting) does not prescribe the basis for classification of an expense between 'Remuneration to consultant/HR' or 'Advertisement/outreach plan';

(b) classification of any expense requires assessment and judgement by the preparer of financial statements. Including other factors, this would be based on the study and understanding of the scope of work/service, terms and conditions for obtaining any good or service and goods and services actually obtained by the entity; and

(c) interpretation and clarifications about the general purpose financial reporting frameworks applicable in Pakistan are provided by the Board. Appropriate and correct classification of expenses as 'Remuneration to consultant/HR' or 'Advertisement/outreach plan' does not involve clarification on the application of an accounting standard or framework.

*(Issued in June, 2021)*

## 1.19 Classification of a Loan under IAS 1 *Presentation of Financial Statements*

### Brief facts of the enquiry:

The Accounting Standards Board (the Board) received a request about classification of a loan as current or non-current.

In the fact pattern described in the request:

- A financing agreement for a long term loan is signed between XYZ (borrower) and ABC (lender).
- Subsequently, a dispute on the terms of the financing agreement arises between the borrower and lender.
- The borrower does not repay the due amount of the loan, as per the financing agreement. While, lender recovers the loan by liquidating the assets given as security by the borrower.
- Borrower and lender file legal cases against each other, for breach of financing agreement. These suits are pending with the court of law.
- Borrower obtains a legal advice, wherein the legal advisor notes that court's decision on the pending legal cases is not expected within next twelve months. The amount under the financing agreement is a non-current obligation, accordingly.
- Borrower in its statutory financial statements, classifies the amount due under the financing agreement as a non-current liability.

The submission, based on the above fact pattern, requested the Board to provide guidance on classification of loan as current or non-current, in accordance with International Financial Reporting Standards.

### Opinion:

The Board noted that IAS 1, *Presentation of Financial Statements*, contains guidance for determination and classification of a liability as 'current' or 'non-current'.

Paragraph 60 of IAS 1 requires an entity to present current liabilities and non-current liabilities as separate classifications in the statement of financial position.

Paragraph 69 of IAS 1 specifies the criteria for classification as a 'current' liability, as under (emphasis is ours):

*"An entity shall classify a liability as current when:*

*(a) it expects to settle the liability in its normal operating cycle;*

*(b) it holds the liability primarily for the purposes of trading;*

*(c) the liability is due to be settled within twelve months after the reporting period; or*

*(d) it does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification.*

*An entity shall classify all other liabilities as non-current."*



The Board observed that IAS 1 outlines the principle that:

(a) a financial liability is classified as current/non-current on the basis of contractual terms that are enforceable at the reporting date; and

(b) future events (whether confirmed or expected) regarding the change in the contractual terms should not be considered in determining the classification of a financial liability.

The Board noted that IAS 1 also explains the impacts of refinancing of a long-term loan and breach of a provision of a loan agreement on the classification of a loan (as current / noncurrent) as follows:

- **Refinancing of a long-term loan:** IAS 1 in paragraph 72 explains that financial liabilities are classified as current when they are due for settlement within twelve months, even if the original term was for a longer period than twelve months and an agreement to refinance on a long-term basis is completed after the reporting date but before the financial statements are authorised for issue.
- **Breach of a provision of loan agreement:** IAS 1 in paragraphs 74-75 clarifies that financial liabilities are classified as current when as a consequence of a breach of a provision of a long-term loan agreement (on or before the end of the reporting period) the liability becomes payable on demand.

In this case, the liability is classified as current, even if the lender has agreed, after the reporting period and before the authorization of the financial statements for issue, not to demand payment as a consequence of the breach.

However, liability would be classified as non-current if the lender has agreed by the reporting date to provide a period of grace ending at least twelve months after the end of the reporting period, within which the entity can rectify the breach and during which the lender cannot demand immediate repayment.

- **Non-adjusting event for classification of loan:** IAS 1 in paragraph 76 states that in respect of loans classified as current liabilities, if the following events occur between the end of the reporting period and the date the financial statements are authorised for issue, those events are disclosed as non-adjusting events in accordance with IAS 10 *Events after the Reporting Period*:

(a) refinancing on a long-term basis;

(b) rectification of a breach of a long-term loan arrangement; and

(c) the granting by the lender of a period of grace to rectify a breach of a long-term loan arrangement ending at least twelve months after the reporting period.

IAS 1 in its Basis for Conclusions (paragraphs BC41-BC44) further discusses and explains the above aspects.

The Board, with regards to the contract and contractual terms, noted that paragraph 13 of IAS 32, *Financial Instruments: Presentation*, states that 'contract' and 'contractual' refer to an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law. Contracts, and thus financial instruments, may take a variety of forms and need not be in writing.

On the enforceability of a contract, IFRS Standards outline the principle that determining whether a contractual right or obligation is enforceable is a question to be considered within the context of the relevant legal framework (or equivalent framework) that exists to ensure that the parties' rights and obligations are upheld. This also clarifies that determination of legal enforceability is not an accounting matter.

The Board also noted that for the classification of a liability (e.g. loan), expectations about future outcome of events (such as expected timing and nature of court's decision, expected timing and nature of dispute resolution), in general, are not a part of the mutually agreed contractual terms i.e. financing agreement between lender and borrower.

The Board also noted that in case of legal disputes, the future outcomes (favorable or non-favorable) are beyond control of the parties to the contract, at the reporting date.

The Board, based on the information provided in the submission and above discussion, concluded that:

(a) classification of a loan between current and non-current liability, in accordance with IAS 1, would be based on the assessment of the:

- rights of borrower and lender under the terms of financing agreement in place at the end of the reporting period; and
- compliance with conditions (generally termed as covenants of financing agreement) as at that date.

The resulting classification does not change on the basis of expectations about events after the end of the reporting period.

(b) in context of the fact pattern, borrower should determine classification of loan under paragraph 69 (c) and (d) of IAS 1.

Borrower should classify and present loan (entire amount of loan or part thereof) as a 'non-current liability', at the reporting date, if, under the financing agreement:

- the loan (or part of loan) is contractually due to be settled after twelve months of the reporting date; or
- borrower has an unconditional right to defer settlement of loan or a part of it for at least twelve months after the reporting date.

In case, above-noted criteria of a non-current liability is not fulfilled for the entire amount of loan or part thereof, such amount should be presented as a current liability, at the reporting date.

The Board also observed that above assessment and determination would require taking into account the terms and conditions of the financing agreement and establishment of facts.

*(Issued in June, 2021)*

## 2.1 Enquiry on Award of Contract for 100% Physical Verification & Reconciliation to Statutory Joint Auditors

### Brief facts of the enquiry:

On the directions of Departmental Accounts Committee of a leading Oil & Gas Company (the Company), we would like to seek clarification from the concerned technical committee of ICAP regarding one of our procurement matter, where the Company has outsourced a consultancy assignment of 100% physical verification and reconciliation of stores & spares to M/s ABC. *(M/s ABC & Co., Chartered Accountants are joint statutory auditors of the Company along with M/s EFG, Chartered Accountants).*

M/s ABC & Co. has applied in the bidding process for providing "100% physical verification and reconciliation of inventory" and awarded the contract based on its competitiveness as "technically qualified" and "financially lowest" bidder.

Later on, Commercial audit (Government auditors) team during audit for the year 2018-19 raised an observation that since M/s ABC & Co is appointed as statutory auditors by shareholders of the Company and providing tax consultancy services to the Company; therefore, the award of contract for 100% physical verification & reconciliation of inventory to statutory joint auditors should not be executed with M/s ABC & Co. due to conflict of interest.

On the directions of Departmental Accounts Committee, we have apprised the matter to the Corporate Law Division of the Securities and Exchange Commission of Pakistan (SECP). They have drawn our attention to clause 5.10.3 of PSX Rules and para 290. 174 of the Code of Ethics of the Chartered Accountants (Revised April 28, 2015), where relevant provisions regarding "prohibited services" and "valuation services to audit client" are explained.

We understand that M/s ABC & Co were awarded contract in compliance with all statutory requirements as in the following manners: -

- a) Contract were awarded to the firm in compliance with all procurement procedures.
- b) M/s ABC & Co. has provided undertaking that administratively separate team from the audit team of financial statements of the Company would be responsible to perform the assignment.
- c) Consultancy services for physical verification and reconciliation of stores does not fall under the category of prohibited services under PSX rules 5.10.3 as said services does not constitute as prohibited services explained in the clause.
- d) Consultancy services regarding physical verification does not constitute as valuation services in terms of para 290.169 of Revised code of Ethics for Chartered Accountants.

In view of above position, your kind advice is solicited on award of contract to M/s ABC & Co. being joint statutory auditor of the Company and tax consultant in line with the relevant provisions of Code of Ethics for Chartered Accountants and other statutory obligations including PSX rule book.

### Opinion:

The Auditing Standards & Ethics Committee of the Institute (the Committee) considers and issues opinions on audit and ethics related matters after consideration of:

- The particular facts and information provided in each enquiry; and

- The requirements of the International Standards on Auditing (ISAs), applicable Code of Ethics for Chartered Accountants (ICAP Code of Ethics), audit and ethics related provisions of the Companies Act, 2017, related rules and regulations and Rule Book of Pakistan Stock Exchange Limited (the PSX Rules).

The Committee observed that in the enquired fact pattern, M/s ABC & Co. is a firm of Chartered Accountants registered with the Institute.

The enquirer is a listed company and it has appointed M/s ABC & Co. for the provision of following services:

- Joint statutory auditor;
- Tax consultant; and
- 100% physical verification and reconciliation of stores & spares.

The enquirer has also represented that M/s ABC & Co. has been awarded the contract for 100% physical verification and reconciliation of stores & spares through a competitive bidding process.

The Committee would like to clarify that its analysis and response to the enquired matter does not include study and evaluation of the legal and statutory obligations and internal policies applicable to the enquirer.

The Committee observed that the statutory auditors of listed companies can also provide a variety of non-assurance services that are consistent with their skills and expertise. However, these permissible services to a listed audit client are subject to the requirements of the PSX Rules, Listed Companies (Code of Corporate Governance) Regulations, 2019 (the CCG Regulations) and ICAP Code of Ethics applicable to the statutory auditor.

## 1. The PSX Rules

Clause 5.10.3 of the PSX Rules list down the prohibited services, (reproduced in *Annexure A* to this letter). Accordingly, this clause prohibits a statutory auditor of a listed company to provide certain non-audit services.

The prohibited services include rendering of 'valuation service'. However, the 100% physical verification of stores and spares is not mentioned in the list of the prohibited services.

## 2. The CCG Regulations:

The requirements of Regulation 32(4) and 32(5) of the CCG Regulations state that:

*“(4) It is mandatory that no company shall appoint its external auditors to provide services in addition to audit except in accordance with these Regulations and shall require the auditors to observe applicable International Federation of Accountants guidelines in this regard.*

*“(5) It is mandatory that the company shall ensure that the auditors do not perform management functions or make management decisions, responsibility for which remains with the Board and management of the company”.*

The CCG Regulations do not provide any listing of permissible or prohibited services. However, above Regulation 32(5) outlines the principal that statutory auditor should not perform any management decisions on behalf of the audited company. Further, the above mentioned applicable guidelines of International Federation of Accountants are issued by

the Institute in the form of the Code of Ethics for Chartered Accountants.

Under the provisions of the CCG Regulations, the audit committee, as representative of the shareholders, is required to oversee the relationship with the auditors and keep the nature and extent of non-audit services under review. The audit committee must satisfy itself that the independence and objectivity of the auditors are not compromised.

### 3. The Code of Ethics for Chartered Accountants:

The Code of Ethics for Chartered Accountants applicable to M/s ABC & Co., in context of the enquired matter and time period, would be the ICAP Code of Ethics 2015.

Paragraph 290.169 of the ICAP Code of Ethics 2015 explains that a valuation service *“comprises the making of assumptions with regard to future developments, the application of appropriate methodologies and techniques, and the combination of both to compute a certain value, or range of values, for an asset, a liability or for a business as a whole.”*

Further, paragraph 290.174 of the ICAP Code of Ethics 2015 prohibits rendering of ‘valuation service’ to an audit client that is a public interest entity.

In view of above explanation, the Committee noted that physical verification and reconciliation of stores and spares is not a valuation service under ICAP Code of Ethics.

Further, ICAP Code of Ethics 2015:

- Contains restrictions on the range of non-audit services to public interest entities (paragraphs 290.164 to 290.213). However, these restrictive services do not include physical verification of assets.
- Outlines the principal, that while rendering non-audit services to an audit client, an auditor is required to apply the conceptual framework of the code of ethics to identify threats to compliance with the fundamental principles and assess their significance and implication(s).
- Through Section 220 ‘Conflicts of Interest’ of the ICAP Code of Ethics 2015 provides guidance that a conflict of interest may create a threat to objectivity and other fundamental principles. All reasonable steps should be taken to identify circumstances that may create threats to compliance with the fundamental principles and could also pose a conflict of interest. Based on this, M/s ABC & Co. shall be able to satisfy themselves and the client that any conflict can be managed with available safeguards.
- Explains that the responsibility of evaluation of such threats to compliance with the fundamental principles rests on the auditor. The auditor should consider qualitative as well as quantitative factors while performing such evaluation. Such obligation on the part of an auditor becomes more critical in a situation where the applicable guidelines or regulations do not clearly prohibit any specific service. The guidance, in this regard, are given in paragraphs 200.13, 290.10, 290.32 and 290.154 to 290.158 of the ICAP Code of Ethics 2015.
- The auditors while providing non-assurance services such as 100% physical verification of stores and spares shall deploy safeguards, which generally will take the form of information barriers.

These information barriers may include the following features (this list is not exhaustive):

- Ensuring that there is, and continues to be, no overlap between the teams servicing the relevant clients and that each has separate internal reporting lines;
  - Physically separating, and restricting access to, departments providing different professional services, or creating such divisions within departments if necessary, so that confidential information about one client is not accessible by anyone providing services to another client where their interests conflict; and
  - Setting strict and carefully defined procedures for dealing with any apparent need to disseminate information beyond a barrier and for maintaining proper records where this occurs.
- Outlines that where a conflict of interest is so fundamental that it cannot be managed effectively by the implementation of appropriate safeguards and could seriously prejudice the interests of a client, the engagement shall not be accepted or continued even if the client consent to the engagement.
  - Prohibit an auditor to assume management function on behalf of the audited company as such a situation may create self-review, self-interest and familiarity threat, through Paragraphs 290.159 to 290.163.
  - Specifies that an audit appointment should not be accepted if the client provides, for whatever work, a large proportion of a firm's gross practice income. That approach limits undue financial dependency on any client without irrelevant restrictions on the balance between different types of income.

The Committee noted that in context of the enquired matter and application of ICAP Code of Ethics 2015, M/s ABC & Co. would be required to consider the ethical requirements and exercise professional judgment when identifying and evaluating the interests and relationships that might create a conflict of interest and implementing safeguards. Further, when necessary, M/s ABC & Co. would have to eliminate or reduce any threat to compliance with the fundamental principles to an acceptable level.

The Committee considered it pertinent to mention that the compliance with the above ethical requirements, including application of safeguards involves judgment and independent decision making of M/s ABC & Co.

The Committee, based on the information provided in the enquiry and above discussion, concluded that:

- a) Rendering of service of 100% physical verification and reconciliation of stores & spares by M/s ABC & Co.:
  - a) Is not specifically mentioned as a 'prohibited' service, under the PSX Rules, the CCG Regulations and the ICAP Code of Ethics 2015;
  - b) Is not a 'valuation service' under the PSX Rules and ICAP Code of Ethics 2015;
- b) The auditor of a listed company can render the non-audit service of 100% verification of stores and spares, subject to compliance with ethical requirements. In case any conflict of interest arises for the auditor it has to be addressed through applying appropriate safeguards as mentioned in paragraph 6 above.

*(Issued in August 5, 2020)*

## 2.2 Reconsideration of ICAP Technical Opinion on Appointment of One Auditor in place of Two Retiring Auditors

### Brief facts of the enquiry:

The Auditing Standards & Ethics Committee of the Institute received enquiry regarding:

Reconsideration of ICAP opinion issued on March 6, 2020 on appointment of one auditor in place of two retiring auditors.

The enquirer apprised following additional information and details regarding Company's policy in respect of appointment of Statutory Auditors and the actual objective behind their intent to switch from joint auditors to a single auditor in order to assist the Technical Committee for reconsideration of their opinion:

#### 1) Existing Policy on Appointment of Joint Auditors:

- a) Selection of Auditors only from internationally affiliated Big 4 Firms on fixed fee basis.
- b) Change of Auditors every 6 years with change of partners every 3 years.
- c) Both the Auditors shall not be changed simultaneously.

#### 2) Switching to Single Auditor Approach:

The Company intends to switch over to a single audit firm considering the following factors:

- a) Ease of external audit management through a single auditor vis-a-vis joint auditors and avoidance of duplication of work, without compromising on corporate governance.
- b) Major listed companies in Energy sector have single auditor except OGDCL.
- c) Exorbitant fee quoted for other allied assignments forming integral part of the statutory audit e.g. review of valuations, ECL model and other disclosure requirements upon applicability of new IFRS etc.
- d) Assignment of other audit engagement services such as Audit of Retirement Funds, CSR & Board of Management (BoM) Financial Statements, WPPF and Secretarial certifications as required under various Statutes/ Trust deeds etc. to incoming single auditor.

#### 3) Technical Qualification:

Quality Assurance remained the Company's top priority both in case of joint auditors and also while switching to a single audit firm, only 4 Big Audit Firms will be considered as technically qualified to participate in the hiring process for the appointment of a single auditor and these firms are being requested by the Company to submit their sealed bids for Financial Years 2021/2022 within a defined period as per the Terms of Reference duly approved by BoM.

#### Points for Consideration:

- i. Spirit of under-cutting principle is that any company does not compromise on quality of audit for a probable fee reduction. In our view, based on above facts, the under-cutting principle is not directly applicable on the Company, considering that these audit firms are



already pre-qualified and hence there is no possibility of quality compromise.

- ii. At present, the Company has a joint audit arrangement wherein the audit fee is equally paid to both the audit firms. After switching to single auditor, as per above referred ICAP's opinion, the single audit firm's fee cannot be lower than the composite fee previously been paid to joint Audit Firms.

This aspect of ICAP's earlier opinion needs to be re-visited as under the prevailing auditing standards, a major portion of the work is being done in full (including review of Financial Statements and other deliverables) by both the Audit Firms. Hence, it appears strange that an incoming single audit firm will get composite audit fee without making any significant effort or any major shift in the scope of their work, except that now the report will be signed by a single audit firm instead of joint Audit Firms.

In our view, capping shall be made applicable on a minimum fee taken by an individual audit firm in a joint audit arrangement instead of capping on composite audit fee.

- iii. Other Audit Engagements (Point 2d):

In addition to Statutory Audit/ Half yearly reviews, ICAP's opinion is also requested that whether the under-cutting principle and capping on last Year's fee is also applicable on other audit engagements as well.

## Opinion

The Auditing Standards & Ethics Committee of the Institute (the Committee) considers the audit and ethics related matters and issues its opinions after consideration and analysis of:

- The particular facts and information provided in each enquiry; and
- The requirements of the International Standards on Auditing as applicable in Pakistan (ISAs), the Code of Ethics for Chartered Accountants (ICAP Code of Ethics), and audit and ethics related provisions of the Companies Act, 2017 (the Companies Act).

The Committee based on the fact pattern mentioned in your enquiry understands that the company intends to appoint a single statutory auditor. While in the prior year(s) the company had appointed joint statutory auditors.

In this context, the Committee's analysis and response to the enquired matter is based on the parameters outlined in paragraph (1) above, and does not include study or evaluation of the legal and statutory obligations and internal policies applicable to the company.

The Committee considers it pertinent to mention that the members of the Institute are regulated under the Chartered Accountants Ordinance, 1961 (the Ordinance).

The Ordinance prescribes "undercutting" as a professional misconduct. Relevant provision of the Ordinance is reproduced below:

*"A Chartered Accountant in practice shall be deemed to be guilty of professional misconduct, if he accepts a 'position as auditor' previously held by some other Chartered Accountant in such conditions as to constitute undercutting."*  
(underline is ours)

Under the Companies Act, companies are required to appoint their statutory auditors.



In the position of a statutory auditor, consequent to and under the requirements of the laws applicable to the appointing company, an auditor besides audit of financial statements is also responsible for the review of financial statements and other audit/certification engagements that can only be performed by a statutory auditor.

The members of the Institute are also required to comply with the ICAP Code of Ethics.

ICAP Code of Ethics based on the above statutory requirement of the Ordinance sets out following principles for establishing the audit fees:

- a) Auditor may enter into fee arrangement(s) which they deem appropriate, commensurating to the size, scale and scope of the audit engagement. Accordingly, when entering into negotiations regarding professional services auditor can quote whatever fee he/she deems appropriate.
- b) Owing to the provision of the Ordinance which holds ‘undercutting’ as a professional misconduct, an auditor cannot accept an audit at a fee lower than the previous year’s audit fee.

However, above restriction has an exception. An auditor can accept an audit at a fee lower than last year’s audit fee, when such auditor determines that scope or quantum of work is materially reduced from the scope or quantum of work carried out during the previous year’s audit.

The principle of undercutting therefore requires that the auditor should not reduce the audit fee from the last year. However, equally important is the evaluation of specific facts and circumstances of each engagement to determine whether lowering of audit fee constitutes undercutting or not.

The term undercutting is not defined in the Ordinance, ISAs and the ICAP Code of Ethics.

The dictionary meaning of undercutting is “to offer goods or services at a lower price or rate than (a competing price or rate) or than that of (a competitor)”.

The Technical Advisory Committee of the Institute explained the term undercutting in its technical opinion issued in 2009 on ‘Appointment of one auditor in place of two retiring auditors’, reproduced below as:

*“... Literal meaning of the verb ‘undercut’ means “to sell or work at lower price than”. To Stretch the term, Undercutting may also mean to gain out of an event, transaction or appointment at the cost of another. Accordingly, if the incoming auditor takes up an audit appointment at lower fees to the detriment of the existing auditor whether directly or indirectly, it would amount to undercutting. To put it plainly, the Committee observed that charging a smaller fee in itself is not a conclusive proof of undercutting since there may be good reasons for it to prove otherwise. Undercutting is, therefore, always a question of fact dependent on the circumstances of each case”.* (underline is ours)

The above discussion highlights that the undercutting related provision of the Ordinance is applicable to the ‘auditor’. Further, the ICAP Code of Ethics links undercutting to the audit engagements, only.

Reading together the above-mentioned provision of the Ordinance (paragraph 3 above) and requirements of the ICAP Code of Ethics (paragraph 5 above) transpires that the auditor’s fee

should not be lower than the last year's fee, for the:

- a) Statutory audit and related engagement(s) that can only be performed by a statutory auditor under the provisions of the applicable laws.
- b) Audit of financial statements of an entity performed by an auditor.

The Committee, based on the above principled requirements and their application to the enquired fact pattern and also in consideration of responsibilities of statutory auditor, noted that:

- a) Duties of the statutory auditor are established by the law applicable to the company e.g. the Companies Act. These duties would be same for any statutory auditor, whether acting as a single auditor or as a joint auditor.
- b) In joint audits, two (or more) audit firms are appointed to share responsibility for a single audit engagement and to produce a single audit report. The auditors carrying out the audit collectively and signing the auditors' report jointly are called joint auditors. While, each audit firm would be referred to as a 'joint auditor'. In general, the audit fee is equally shared by the joint auditors.
- c) In context of auditor's responsibility, every statutory auditor (whether appointed as a single auditor or as a joint auditor) is required to ensure that the audit is conducted in accordance with the ISAs and that sufficient appropriate audit evidence (including the work performed by the other joint auditor) has been obtained, which would enable the statutory auditor in expressing an audit opinion on the financial statements.
- d) With regards to the joint audit, with the expression of an audit opinion on the financial statements a joint auditor is jointly and severally responsible for the audit with other joint auditor(s). Therefore, the joint auditor takes the responsibility for the entire audit (i.e. not only of his own work but also jointly responsible for the work of other joint auditor).
- e) The quantum of audit work, in general, varies as a result of changes in underlying business/operations of the company or auditor's approach. Resultantly, the quantum of audit work could vary from one year to the next year. However, this aspect would involve evaluation of facts and circumstances in each case.

On the matter of audit fee and its relationship with the audit quality, the Committee considers it relevant to highlight that the Audit Quality Framework issued by the International Auditing and Assurance Standards Board outlines that there is usually a relationship between the quality of an audit and the quality and quantity of the resources used in its performance (as usually reflected in the audit fee).

While auditors have a primary responsibility for the quality of the audits they perform, other stakeholders have an equally important role to play in ensuring that financial considerations in relation to audit fees do not drive actions and decisions that impair audit quality. The Committee, accordingly, understands that company's management and those charged with governance have an important role to play in ensuring that financial considerations relating to audit fees do not compromise independence and audit quality.

**Conclusion**

The Committee based on the:

- a) information provided in the enquiry;
- b) consideration and evaluation of the legal and ethical requirements related to undercutting (contained in the Ordinance and ICAP Code of Ethics); and
- c) consideration and analysis of the duties and responsibilities of a statutory auditor outlined in the Companies Act and the ISAs

concluded that the audit fee of a single auditor shall not be less than the audit fee of a joint auditor.

The Committee also concluded that in accordance with the provisions of the Ordinance and requirements of ICAP Code of Ethics, undercutting is prohibited for the:

- a) statutory audit, review and related engagement(s) that can only be performed by a statutory auditor under the applicable laws; and
- b) audit of financial statements of an entity (such as audit of financial statements of provident fund of company, audit of financial statements of a project etc.)

*(Issued in August, 2020)*

## 2.3 Advice regarding Acceptance of Audit Engagement

### Brief facts of the enquiry:

We are a firm of Chartered Accountants and this letter aims at requiring professional advice regarding the following situation:

We have been appointed as auditors of a company under sub-section (3) of Section 246 of the Companies Act, 2017. As per the requirements of the code of ethics, a professional clearance letter was sent to the retiring auditors. The retiring auditors through a letter have refused to issue No Objection Certificate (NOC) because 50% of their agreed audit fee is still outstanding.

Management of the company is of the view that the retiring firm has no right to any audit fee as the firm has failed to comply with its statutory duties by not signing the audit report for the year ended June 30, 2020. The management of the company vide its letter has requested the firm to refund the prepaid audit fee. On the other hand, the retiring auditors are of the view that the firm has a rightful claim of prepaid and outstanding fees.

In this backdrop, the management of the company has solicited opinion from lawyer on the following questions:

- i. Whether the balance fee as claimed by the Retiring Auditors is disputed fee?
- ii. Whether the Retiring Auditors was justified not to give NOC to new auditors until the alleged outstanding fee is paid?
- iii. Whether the new auditors would deem to be guilty of professional misconduct by accepting the appointment as Auditors?

It is pertinent to mention here that lawyer has opined that since the fee claimed by the retiring firm is disputed therefore, new auditor cannot be held guilty of professional misconduct.

In view of the aforementioned circumstances/legal opinion, kindly guide us whether we can continue with the audit.

### Opinion

The Auditing Standards & Ethics Committee of the Institute (the Committee) considers and issues opinions on audit and ethics related matters after consideration of:

- The particular facts and information provided in each enquiry; and
- The requirements of the International Standards on Auditing as applicable in Pakistan (ISAs), the Code of Ethics for Chartered Accountants (ICAP Code of Ethics), and audit and ethics related provisions of the Companies Act, 2017 (the Companies Act).

The Committee based on the fact pattern mentioned in the enquiry understands that the firm has been appointed as auditors of a company in accordance with the requirements of Section 246 of the Companies Act, 2017. The previous auditors have refused to issue No Objection Certificate (NOC) because 50% of their agreed audit fee is still outstanding. The Committee also noted that management of the company has also obtained legal opinion on the matter.

In this context, the Committee's analysis and response to the enquired matter is based on the parameters outlined in paragraph (1) above, and does not include ascertainment of facts relating to the enquired matter and study or evaluation of the legal and statutory obligations.

In context of the enquired matter, the Committee would like to refer requirements of Section 320 'Professional Appointments' of the ICAP Code of Ethics 2019 (ICAP Code 2019). The relevant provisions are reproduced below:

***“Communicating with the Existing or Predecessor Accountant***

- 320.5 A1 A proposed accountant will usually need the client's permission, preferably in writing, to initiate discussions with the existing or predecessor accountant.
- R320.6** If unable to communicate with the existing or predecessor accountant, the proposed accountant shall take other reasonable steps to obtain information about any possible threats.

***Communicating with the Proposed Accountant***

- R320.7** When an existing or predecessor accountant is asked to respond to a communication from a proposed accountant, the existing or predecessor accountant shall:
- (a) Comply with relevant laws and regulations governing the request; and
  - (b) Provide any information honestly and unambiguously”.

The Committee would also like to draw attention to the Institute's Auditing Technical Release 16 (ATR 16) 'Acceptance of Audit When Audit Fee of Existing Auditor(s) is Outstanding'. ATR 16 provides guidance whether new auditor can accept the audit engagement when the undisputed statutory audit fee of the previous auditors is outstanding. The relevant extracts of ATR 16 is reproduced below for reference: (underline is ours)

It is pertinent to emphasize that ATRs are part of the Institute's directives and noncompliance of any one of the ATRs is considered as misconduct.

Based on the above discussion, the Committee concluded that an incoming auditor is required to follow the requirements of the ICAP Code 2019 and ATR 16 before accepting new audit engagement.

The Committee, in context of the enquired matter, further noted that determination of whether professional fees of previous auditor are outstanding and/or disputed is not a matter requiring interpretation of auditing standards, ICAP Code 2019 and ATR 16, rather this involves applicability and enforceability of the contractual terms between the parties.

Moreover, the Committee would advise the incoming auditor to use professional judgement to evaluate the matter of outstanding audit fees of previous auditors and take decision about acceptance of the new audit engagement.

*(Issued in March, 2021)*

## 2.4 Signing of Audit Reports after the Expiry of Tenure of the Auditor

### Brief facts of the enquiry:

Our client is a public sector entity engaged in implementing a public interest project as a Concessionaire under a Concession Agreement (CA) with another public interest entity. The Concession is for a period of twenty-four years.

We have been appointed as auditors (the joint auditor) under the provisions of CA for two consecutive terms of three years each that have been completed on December 20, 2020.

Under the terms of reference of joint auditor given in CA, inter alia, we were required to carry-out the six monthly audits of receipts in the project accounts of the Concession. The audit field works of receipts and payments accounts of certain six-monthly periods during our tenure, were performed and the draft audit reports thereon were issued before the expiry of our tenure as joint auditor. However, due to delay in approval of these accounts and pending management representation letters the audit reports of these periods could not be signed off during our tenure as joint auditor. Subsequently, after the expiry of our term these representation letters were provided to us for issuance of audit reports.

### Queries:

With reference to above background and the fact that currently we are not the auditors of the Concession our queries are as under:

- a. Can we now issue the audit reports in respect of six-monthly periods whose draft reports were issued before the expiry of our term as auditor, whereas, the related management representation letters were issued after the expiry of our term as auditors;
- b. Can we continue the audit field work in respect of six-monthly periods whose field work was in progress on the date of expiry of our term as auditors and issue the audit reports on completion of the same; and
- c. Can we now initiate the audit field work in respect of six-monthly periods which fall within our tenure and issue the audit reports on completion of the same.

### Opinion

The Auditing Standards & Ethics Committee of the Institute (the Committee) considers and issues opinions on audit and ethics related matters after consideration of:

- The particular facts and information provided in each enquiry; and
- The requirements of the International Standards on Auditing as applicable in Pakistan (ISAs), the Code of Ethics for Chartered Accountants (ICAP Code of Ethics), and audit and ethics related provisions of the Companies Act, 2017 (the Companies Act).

The Committee's analysis and response to the enquired matter is based on the parameters above, and does not include ascertainment of facts relating to the enquired matter and study or evaluation of the contractual arrangements between parties.

The Committee, with regards to the enquired matter noted that enquirer has shared following contractual terms along-with the enquiry:

“The duration of the appointment of the joint auditor (or the replaced joint auditor, as the case may be shall be until the Concession End date (or the Termination Date, if earlier), unless otherwise agreed in writing by the Parties. The term of the appointment of a

chartered accountancy firm as the Joint Auditor shall be for a period of three (3) years and such chartered accountant firm may serve for a maximum of two (2) consecutive terms.”

The scope of work (as shared by the enquirer) includes the following:

“Carrying out audits of the Project Accounts bi-annually or at such other intervals as reasonably requested by ...., the Concessionaire and/or the Agent Bank and submit its report to ...., the Concessionaire and the Agent Bank.”

The Committee, accordingly, based on the information provided in the enquiry and enquirer’s discussion with the Technical Services Department noted that the enquirer was:

- appointed to carry out the audit of a project - accordingly the appointment was to carry out a special audit;
- appointed, initially for a period of three years, and subsequently re-appointed for another term of three years;
- required to carry out the audit of receipts in the project’s accounts on a bi-annual basis or at such interval as may be requested.

Further, during the period (i.e. six years) of auditor’ appointment, auditor issued draft audit reports of certain six-month periods but these reports were not signed off (due to delay in approval of these accounts and pending management representation letters) by the auditor till the end of his term of appointment i.e. six years’. Further, the audit field work of certain six-monthly periods was either in progress or not initiated at all.

The Committee noted that International Standard on Auditing (ISA) 210, *Agreeing the terms of Audit Engagements* explains that: (underline is ours)

*“The objective of the auditor is to accept or continue an audit engagement only when the basis upon which it is to be performed has been agreed, through:*

*(a) Establishing whether the preconditions for an audit are present; and*

*(b) Confirming that there is common understanding between the auditor and management and, where appropriate, those changed with governance of the terms of the audit engagement.”*

Further, the auditor and management may change the terms of the audit engagement. Where the terms of engagement are changed, the auditor and management shall agree on and record the new terms in the engagement letter or other suitable form of written representation.

It is relevant to mention that the auditor should also consider and perform audit procedures, including additional procedures for events and transactions occurred after the date of auditor’s report as per ISA 560 ‘*Subsequent Events*’.

The audit is evidenced by the audit report issued by the auditor. Further, the date of audit report indicates the point in time on which auditor concluded the audit and formed an opinion.

The Committee observed that the ISAs do not contain a definitive/ rule-based approach about when the auditor should date the report, rather ISAs outline the principle that explains the factors impacting the selection of the date. In this regard, the Committee noted that paragraph 49 of ISA 700, ‘*Forming an Opinion and Reporting on Financial Statements*’ (Revised) outlines that principle regarding date of signing off the audit report, as under:

*“The auditor’s report shall be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor’s opinion on the financial statements, including evidence that: (Ref: Para. A66 - A69)*

- a) All the statements and disclosures that comprise the financial statements have been prepared; and*
- b) Those with the recognized authority have asserted that they have taken responsibility for those financial statements”.*

The Committee, based on the information received in the enquiry and above discussion concluded that the engagement letter (or other suitable form of written agreement) between an auditor and engaging party is a legal document that determines the specific scope of auditor’s work, rights and responsibilities. The auditor and the engaging party can change the terms of the engagement letter and proceed accordingly. However, in principle the understanding and enforceability of terms of the engagement letter/ contract are subject matter of legal analysis and interpretation.

In the enquired fact pattern, where at the end of the auditor’s appointment period:

- Auditor has issued the draft audit report on the project accounts to the management of the project and the auditor has obtained sufficient appropriate audit evidence (therefore, no further audit work is required for issuance of final report), the auditor, subject to the terms of the engagement letter, may issue the signed audit report(s) (in the current date) in accordance with the guidance provided in ISA 700.
- Auditor has either not completed or started the audit field work, the auditor is required to consider the specific terms of the engagement letter to continue and/or conclude such audits of project’s accounts. Fundamentally, this is a legal matter requiring analysis and interpretation of the engagement terms (between auditor and contracting party), and does not involve interpretation or application of auditing standards.

In view of the above, the auditor may consider to discuss and agree the matter with the engaging party and may also act under the legal advice.

*(Issued in June, 2021)*